

# Personal Finance



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Turning Money into Wealth, 4/e

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and State University  
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*To Barb, my partner and my love—  
for showing me happiness that money can't buy*

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## About the Author

Arthur J. Keown is the R. B. Pamplin Professor of Finance at Virginia Polytechnic Institute and State University. He received his bachelor's degree from Ohio Wesleyan University, his M.B.A. from the University of Michigan, and his doctorate from Indiana University. An award-winning teacher, he is a member of the Academy of Teaching Excellence at Virginia Tech, has received five Certificates of Teaching Excellence, the W. E. Wine Award for Teaching Excellence, and the Alumni Teaching Excellence Award, and in 1999 received the Outstanding Faculty Award from the State of Virginia. Professor Keown is widely published in academic journals. His work has appeared in *The Journal of Finance*, the *Journal of Financial Economics*, the *Journal of Financial and Quantitative Analysis*, *The Journal of Financial Research*, the *Journal of Banking and Finance*, *Financial Management*, the *Journal of Portfolio Management*, and many others. Two of his books are widely used in college finance classes all over the country—*Financial Management* and *Foundations of Finance: The Logic and Practice of Financial Management*. Professor Keown is Fellow of Decision Sciences Institute and former head of the finance department. In addition, he has served as the co-editor of *The Journal of Financial Research*, and has served the Financial Management Association's *Survey and Synthesis Series*. He was recently inducted into Ohio Wesleyan's Athletic Hall of Fame and lives with his wife and two children in Blacksburg, Virginia, where he collects original art from *Mad Magazine*.

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# Preface

*Personal Finance: Turning Money into Wealth*, Fourth Edition empowers the student, through the presentation of the 15 fundamental principles of personal finance, to successfully make and carry out a plan for their financial future.

For many students, this course is their initial and only exposure to personal finance, so it is important that the material is presented in a way that leaves a lasting impression. This text will introduce the student to the concepts, tools, and applications of personal finance and investments, but it also assumes little or no prior knowledge of the subject matter and focuses on helping the student understand the process of financial planning and the logic that drives it. Tools, techniques, and equations are easily forgotten, but the logic and fundamental principles that drive their use, once understood, will stay and will become part of a student's "financial personality." Throughout the rest of their lives, students will have the ability to draw upon these principles to help them effectively deal with an ever-changing financial environment. For this reason, the presentation is centered around 15 fundamental principles of personal finance, which are introduced in Chapter 1 and then reappear in every chapter throughout the book.

To help students prepare for their financial future, *Personal Finance: Turning Money Into Wealth*, Fourth Edition:

- **Reinforces the 15 Principles of Personal Finance**—each chapter of the text touches back on the 15 principles outline in Chapter 1 and how to apply those principles to particular situations.
- **Highlights easy-to-follow advice**—the proactive checklists, which appear throughout the text, serve as a useful learning tool for students. These boxes identify areas of concern and questions to be asked when buying a car, getting insurance, investing in mutual funds, and performing other personal finance tasks.
- **Provides opportunity to work through many of their own personal finance decisions**—each new copy of the text is accompanied by a Personal Finance Workbook, free of charge. These workbooks contain tear-out worksheets to provide a step-by-step analysis of many of the personal finance decisions examined in the book. They can be used for homework assignments or to guide students through actual decisions. The workbook includes a section on how to use a financial calculator. Text references to the worksheets appear in the margin at the appropriate point.

## Other Points of Distinction

**"In the News" Boxes featuring Jonathan Clements** The "In The News" boxes with excerpts from the *Wall Street Journal* continue, but in this edition there are over 30 boxes from the *Wall Street Journal*, with 23 of them featuring the work of Jonathan Clements, the famous *Wall Street Journal* reporter.

**Learning Objectives** Each chapter opens with a set of action-oriented learning objectives. As these objectives are covered in the text, an identifying icon appears in the margin.

**Stop and Think** These short boxes provide the student with insights as to what the material actually means—implications and the big picture.

**Finance Matters** Boxes at the end of each chapter written by Marcy Furney, CFP, provide checklists of things to do—in effect, free advice from a certified financial planner.

**Mini Cases** Each chapter closes with a set of two mini cases that provide students with real-life problems that tie together the chapter topics and need a practical financial decision.

**Continuing Case—Cory and Tisha Dumont** At the end of each part in the book, a continuing case provides an opportunity to synthesize and integrate the many different financial concepts presented in the book. It gives the student a chance to construct financial statements, analyze a changing financial situation, calculate taxes, measure risk exposure, and develop a financial plan.

## New to the Fourth Edition

**Complete Coverage of Credit Scoring** The importance of your credit score cannot be overstated. In Chapter 6, there is extensive coverage of credit scoring, focusing on the importance of your FICO credit score, how it is computed, and how to manage it. In addition, your insurance credit score is examined in Chapter 10.

**Ties Together the Different Personal Finance Topics Through the Use of 10 “Financial Life Events”** The 10 “Financial Life Events” serve to tie together the concepts and tools in the book, providing the reader with a perspective on the whole of personal finance based upon different “Financial Life Events.” In the course of your lifetime you will experience many events that will change your goals, affect your financial resources, and create new financial obligations or opportunities for you. While there is an almost unlimited number of these type of life events, we focus on 10 of the most common, and with each one we present a comprehensive step by step discussion of how you should respond to them—pulling material from throughout the book and tying it together into a step by step action plan. These financial life events include:

- Life Event 1: Getting Started
- Life Event 2: Marriage
- Life Event 3: Buying a Home
- Life Event 4: Having a Child
- Life Event 5: Inheritances, Bonuses, or Unexpected Money
- Life Event 6: A Major Illness
- Life Event 7: Caring for an Elderly Parent.
- Life Event 8: Retiring
- Life Event 9: Death of a Spouse
- Life Event 10: Divorce



## Content Update

In response to continuing developments in personal finance and reviewer comments, the text has been revised and updated. Some of these changes include:

**Chapter 1** This chapter was updated and revised reflecting the growing importance of the Internet in personal finance decisions. In addition, this chapter now includes expanded coverage of securing a job including a table listing common interview questions.

**Chapter 2** The discussion dealing with choosing and how to pay a financial planner was updated and strengthened. In addition, there is a new “In the News” box by Jonathan Clements that deals with the importance of beginning to save as early as possible.

**Chapter 3** The time value of money chapter has been extensively revised, simplified, and streamlined so that it is accessible to any student regardless of his or her math skills. The emphasis is on understanding the power of compounding and the importance of starting a saving program early in life. To make the time value of money material more accessible to math phobic students, calculations are also presented in a simple step by step manner using a financial calculator, with a financial calculator for their use provided on the web.

**Chapter 4** The tax chapter was updated to reflect all the changes in the tax laws since the previous edition. In addition, a new “In the News” box by Jonathan Clements titled “With the Tax Code Up for Grabs, Here Are Five Principles to Invest By” was also added.

**Chapter 5** Includes sections on card blocking, stored value cards, and the Check Clearing Act for the 21st Century or Check 21. Also two new “In the News” boxes from the *Wall Street Journal* titled “Credit-Card Offers You Should Refuse” and “Credit Unions Offer More” were added.

**Chapter 6** An extensive discussion of credit scoring now appears in this chapter. This discussion focuses on the importance of your FICO credit score, how it is determined, and how to manage it. Discussion centers on determining creditworthiness, credit scoring, why having a good credit score (FICO score) is important, how your credit score is computed, what’s in your credit report, the five factors that determine your credit score, information not considered when calculating your FICO score, managing your credit score, and the Fair and Accurate Credit Transactions Act (FACT Act). In addition, the coverage of credit cards has been updated and revised, with increased attention given to the problems students can get into using credit cards.

**Chapter 7** The new bankruptcy law is discussed, focusing on the implications for individuals. Also a new “In the News” box from the *Wall Street Journal* titled “Being a Co-Signer Can Backfire” was added.

**Chapter 8** This chapter has been thoroughly revised and updated, with an emphasis on using the Internet to help in making more knowledgeable major financial decisions. In particular, more Internet sources are provided to help you in buying a car, along with a new checklist for those buying or selling a house. In addition, there is new discussion of interest only mortgages.

**Chapter 9** A discussion of Medicare reform is presented in this chapter. Beginning in 2006, the Medicare Modernization Act (MMA) will change the Medicare system by

adding a new voluntary drug benefit. There are new sections on the Drug Benefit, the new Medigap Plans, and Medicare Advantage. In addition, Health Savings Accounts (HSAs) are now discussed. Finally, a new “In the News” box by Jonathan Clements titled “Your Money or Your Life: Insurance With Cash Value Isn’t Always a Mistake” was added.

**Chapter 10** There is now a discussion of your insurance credit score in this chapter, which includes sections on “Keeping Your Costs Down—Insurance Credit Scoring.” In addition, a new “In the News” box by Jonathan Clements titled “Dare to Live Dangerously: Why Ditching Some of Your Insurance Can Pay Off” was added. Finally, this chapter has been totally updated and revised to reflect changes in property and liability insurance.

**Chapter 11** This chapter is updated to reflect what has happened in investments since the last edition. In addition, coverage of behavioral finance and investing was added with two new “In the News” boxes from the *Wall Street Journal* titled “Behavioral Finance and Investing: Examine Your Finances— Or Your Head”— Parts I and II were added.

**Chapter 12** Again, this chapter was updated to reflect the changing nature of the stock market. In addition, a new “In the News” box by Jonathan Clements titled “What Is That 1% Fee Buying You?” was added.

**Chapter 13** This chapter was updated to reflect the changing nature of the stock market. In addition, two new “In the News” box by Jonathan Clements titled “Look Beyond the Headlines”—Part I and Part II were added.

**Chapter 14** This chapter updated to reflect the changing nature of the bond market and the reintroduction of the 30 year treasury bond. In addition, easy to follow, step-by-step calculator calculations for determining a bond’s yield to maturity and value were added.

**Chapter 15** This chapter now includes a complete discussion of ETFs along with their advantages and disadvantages. In addition, two new “In the News” boxes by Jonathan Clements titled “Dispelling Mutual-Fund Myths” and “Why Brokers Want You to Buy ‘B Shares’” were added.

**Chapter 16** This chapter now includes the latest on corporate pension funds. In addition, it also includes a “A Retirement Checklist for the Ages,” which goes through all age brackets and discussion of what you should be doing to plan for retirement regardless of your present age. In addition, two new “In the News” boxes by Jonathan Clements titled “Seven Steps to a Golden Retirement”—Part I and Part II were added.

**Chapter 17** This chapter now includes a discussion of the cost of postponing when you begin to save for retirement by just one year. In addition, a new “In the News” box by Jonathan Clements titled “Avoid Leaving Heirs with a Headache” was added.

**Chapter 18** This chapter provides the discussion of financial life events mentioned in the “New to Fourth Edition” section above. In addition, two new “In the News” boxes from the *Wall Street Journal* were added. One is by Jonathan Clements titled “Getting Going: Post-Graduate Assignment: Start Saving” and the second is titled “Starting Out: Nursing a Debt Hangover from College.”

## For Instructors

The following supplements are available to adopting instructors. For detailed descriptions, please visit: [www.prenhall.com/keown](http://www.prenhall.com/keown)

**Instructor's Resource Center** **Register. Redeem. Login.** [www.prenhall.com/irc](http://www.prenhall.com/irc) is where instructors can access a variety of print, media, and presentation resources available with this text in downloadable, digital format. For most texts, resources are also available for course management platforms such as Blackboard, WebCT, and Course Compass.

**It gets better.** Once you register, you will not have additional forms to fill out, or multiple usernames and passwords to remember to access new titles and/or editions. As a registered faculty member, you can log in directly to download resource files, and receive immediate access and instructions for installing Course Management content to your campus server.

**Need help?** Our dedicated Technical Support team is ready to assist instructors with questions about the media supplements that accompany this text. Visit: <http://247.prenhall.com/> for answers to frequently asked questions and toll-free user support phone numbers. The following supplements are available to adopting instructors. Detailed descriptions of the following supplements are provided on the Instructor's Resource Center:

- Instructor's Manual
- Test Item File
- TestGen test generating software
- Instructor PowerPoint slides

## For Students

- **Personal Finance Workbook.** The first section of this workbook contains step-by-step calculator keystrokes to help you calculate important personal finance formulas. The second section is made up of a set of worksheets that provide you with the opportunity to develop and implement your own financial plan. Many of these worksheets are taken directly from figures and checklists in the text.
- **Companion Website** [www.prenhall.com/keown](http://www.prenhall.com/keown) contains valuable online resources for both students and professors, including:
  - Interactive Study Guide
  - Internet Exercises
  - Case Problems
  - Excel Worksheets
  - Dinkytown Calculators
  - Time Value of Money Calculator
  - Personal Finance Planner

## Acknowledgments

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Ruth and Derek worked on the Instructor’s Manual, which includes the solutions to all the end of chapter material in the text, completely revised and updated the Companion Website Internet quizzes for each chapter, and created all new Internet Case Problems for the Personal Finance Navigator text site. They also developed the Personal Financial Planner program.

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As a final word, I express my sincere thanks to those using *Personal Finance: Turning Money into Wealth* in the classroom. I thank you for making me a part of your team.

Arthur J. Keown