The Personal Balance Sheet

Insights into financial priorities on the roadmap of life.

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As you navigate along the roadmap of your life, the amount of financial resources available to you to help you go where you want and do what you want will vary. Your success in some part will depend on how well you adapt financially to the obstacles you encounter along the way as you balance your decisions between saving, investing, borrowing, and spending.

The balance between these four decisions can be represented on your personal balance sheet. Saving and investing increases the assets available on your personal balance sheet, while spending decreases your assets. In the short term, borrowing both increases your assets and increases your debts, effectively offsetting each other in terms of changes to your net worth. In the long term, borrowing can be beneficial to helping you achieve your goals.

As you start building your career, a loan can help to purchase a car for you to travel to work each day to earn income. But this loan has an offsetting cost in the form of interest that is required, in addition to each loan principal repayment until the amount of the loan is repaid. The decisions that you make to balance saving, investing, borrowing and spending will have a profound impact on the financial resources available that allow you to meet your day-to-day needs and reach your longer term goals.

The choice between borrowing and spending money depends on your priorities. Is it better to finance lifestyle choices or make purchases today; or to finance purchases or investments that have the ability to increase wealth and/or income in the future? Conversely, when money is saved or invested, it is with the intent of sacrificing today to increase tomorrow's enjoyment. However you choose to use your money, after paying for your necessary expenses, you will have to regularly decide if it is better to spend extra cash flow on material items that are currently of interest, to pay down debts, or invest for your future.

The choice between borrowing and spending money depends on (your) priorities:

- Enjoy it today, and pay for it tomorrow.
- Make a sacrifice today for tomorrow's pleasure.

The need to be more entrepreneurial with your personal finances

The choices that well-run small businesses make about borrowing, spending, saving, and investing are most often made with one goal in mind: to be successful. Businesses that do this well will stay focused on this goal and will adapt when changes in the business life cycle require decisions to be made in order to sustain success. The definition of success for small business owners can vary, but most often it may comprise of one or more of the following: making enough money to earn a living; increasing profitability; doing something they're passionate about; and that allows them to spend more time with family. Comparatively, if you are not a business owner, you should also employ the same entrepreneurial drive and focus to achieve similar successes with your own personal finances.

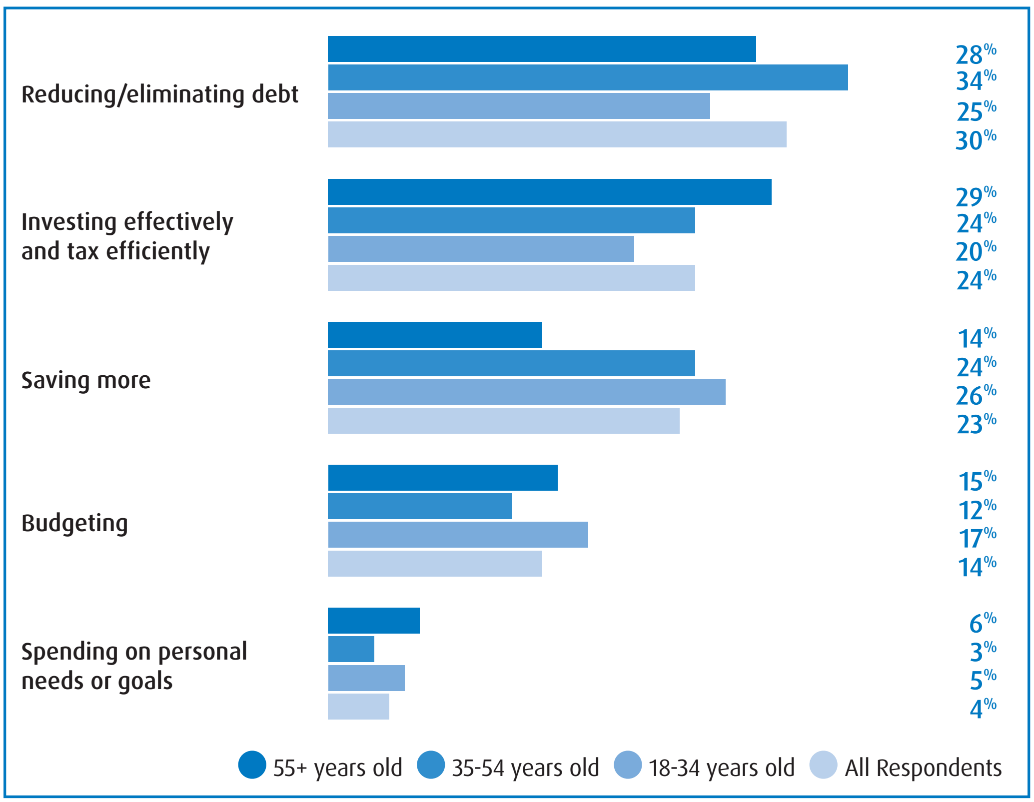
Is it better to purchase a luxury product, make a payment to reduce a line of credit, or invest with the goal of earning future dividends, interest, rental income, or capital gains? Often your current stage in life will have an impact on the financial decisions that are made about borrowing, spending, saving, and investing.

In a recent survey conducted by BMO Wealth Management, Canadians were asked about their current and planned saving, investing, borrowing and spending.[1] When asked **what is the single financial priority that is most important to you?** three main answers emerged: reducing or eliminating debt (30%), investing effectively and tax efficiently (24%) and saving more (23%). Spending on personal needs or goals was well behind at only 4%. Not surprisingly, survey respondents age 18–34 favoured saving more, people age 35–54 focused on reducing or eliminating debt, and those age 55 and over prioritized investing effectively and tax efficiently. These differences are shown in the graphs below. As financial needs and goals are always changing as people move from one life stage to the next, it is important to aim to be as financially flexible as a small business to be most successful. This means being able to change and adapt financial strategies to meet changing needs as situations evolve.

The three main financial priorities that Canadians have:

- Reducing or eliminating debt
- Investing effectively and tax efficiently
- Saving more

Most important financial priorities at this stage of life



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., April 2016.

Parenting

Parents (with their children's influence) decide how much of the family's financial resources to allocate to the children's needs, including schooling, sports, camps, music lessons, and saving for future educational goals through RESPs. Often this investment in the children is directly at odds with most children's desire to spend right away on the latest technology or clothing.

When gifts are given on birthdays and holidays, parents may wish to use this tradition as an opportunity to teach their children about the importance of balancing between spending on current wants, and the need to save, invest, and manage borrowing effectively. A similar lesson on balancing these financial components occurs when a maturing child obtains their first credit card. Spending limits combined with the need for timely repayment (hopefully from the child's own resources) provides positive lessons that can last a lifetime. It is the knowledge passed down from parents and grandparents that will help children grow and bloom into financially responsible members of society.

Building a career

After graduation, moving out and obtaining full time employment is often the first real test of the ability to balance the financial commitments of saving, investing, borrowing and spending. For millennials, who tend to be saddled with education debt and often pay high rent to live in attractive urban areas, the thought of saving and investing for the long term are lower priorities. A belief in **YOLO** (you only live once) means that most millennials would prefer to spend their disposable income on experiences, such as adventure holidays, instead of on something tangible or far off into the future.[2]

Yet at the same time, millennials are putting money into savings, but mostly to meet shorter term goals. TFSAs are very popular option to meet this type of savings goal. One study indicated that while savings was a top priority once essential living expenses were covered, contributions to fund retirement plans was only a focus for one in four of those that were putting extra income into savings.[3]

At this early life stage, putting in place a plan to achieve future goals such as saving for a down payment to buy a home, or reducing outstanding student debt are most important. By establishing a budget that focuses on saving and reducing borrowed amounts, as opposed to spending on current wants, it may be possible to achieve these goals more quickly.

Also, by having a plan in place to achieve these important longer–term goals, there is a greater opportunity to have increased future wealth, especially if the plan incorporates a regular savings component that invests a little from each pay period.

Saving for holidays is still important as there has to be rewards for all of the hard work put in. But this should be combined with saving, investing, and plans to reduce existing student debt to make the most of your financial balance sheet and opportunities.

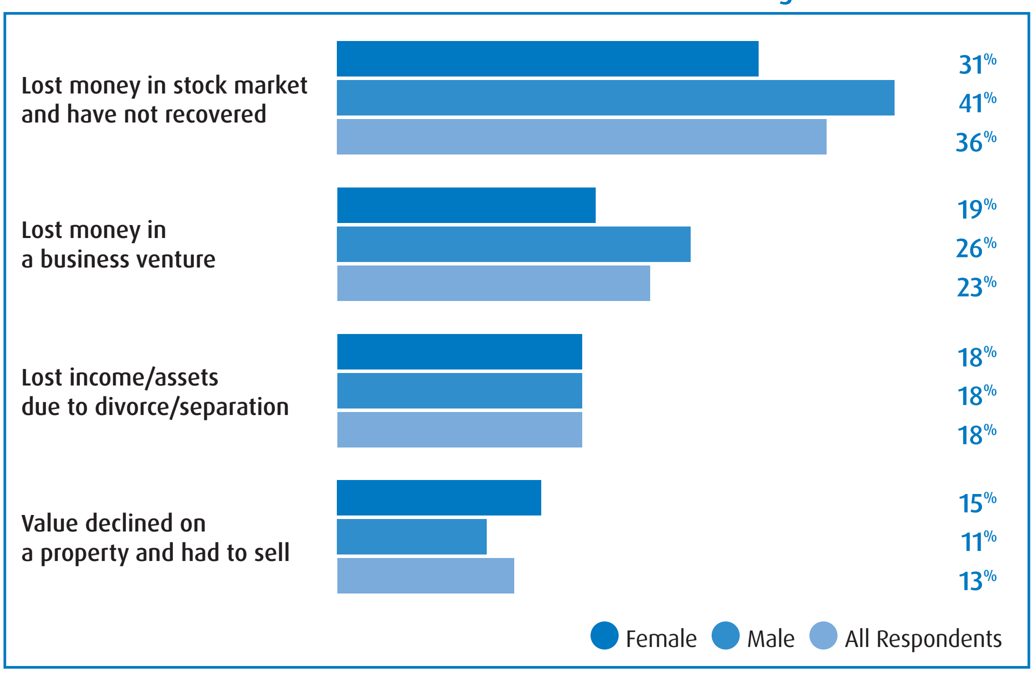
Working towards **having it all**

The desire to **have it all** can take its toll on health and happiness, especially upon reaching an age between the late 20s and early 30s. It is very difficult to find the time and resources to simultaneously build a successful career, nourish financial relationships, get married, have children and create the picture perfect home.[4] Often competing financial pressures mean making difficult choices: focusing on some things now, with the goal of making other things a priority after higher ranking goals are accomplished.

From a financial point of view, this means looking at the financial resources available in the form of income and investments and then prioritizing these resources to help achieve personal goals. A budget can help to ensure savings and investing happen with stated goals in mind.

But life events can make it more difficult to reach personal financial goals. In the survey, people were asked about events that had made it difficult to save or invest towards their financial goals. The previous loss of money in the stock market (36%), a business venture (23%) and separation or divorce (18%) were most frequently cited. Males were one–third more likely to have lost money in the stock market or a business venture than females.

Life events that made it difficult to save or invest for financial goals



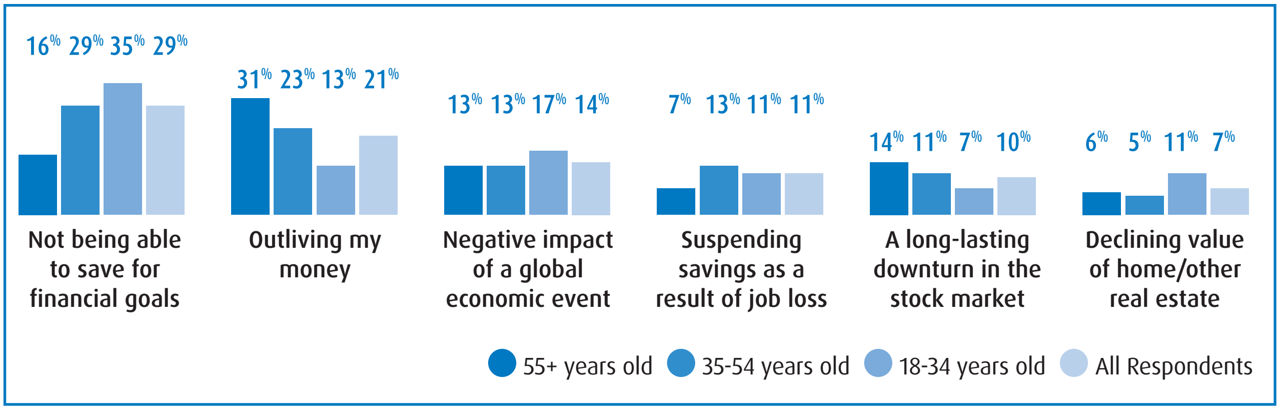
Source: BMO Wealth Management survey by ValidateIt Technologies Inc., April 2016.

Often **competing financial pressures** mean making difficult choices.

These losses that have occurred in the past weigh on people's minds and may make them more tentative and fearful as they prepare for their financial futures. The survey found that fears about not being able to save or invest towards financial goals were frequent (29% of those surveyed), and a fear of outliving any savings that could be accumulated was also high on the list (21%). Others feared events over which they had little control, included a negative global economic event (14%), not being able to save due to job loss (11%), a long-term downturn in the stock market (10%), and declining home values (7%).

The **main saving or investing concern** for Canadians is not being able to save for financial goals.

Main saving/investing concern when thinking about preparing for the future



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., April 2016.

Expanding the balance sheet

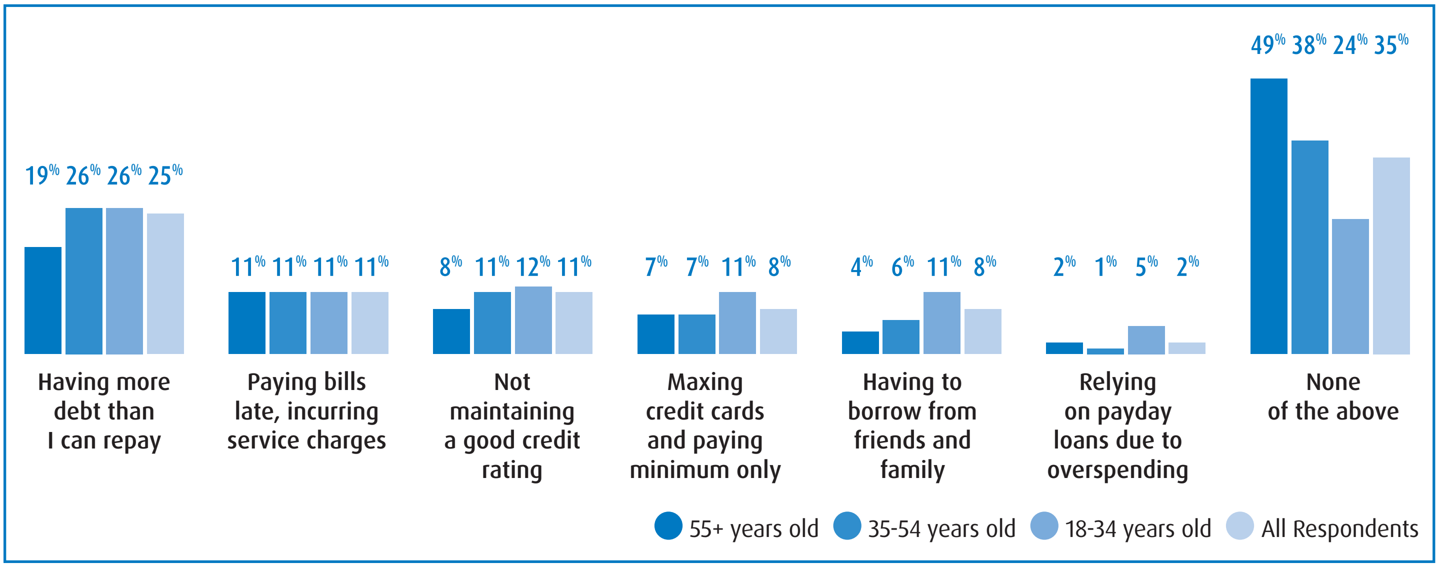
Millennials born between 1980 and 2000[5] – are at the stage in life where a desire to have it all will likely result in a rapidly expanding balance sheet. Both assets in the form of savings, investments and a possible purchase of real estate will grow, as will liabilities because of remaining education debt and the taking on of new debt to finance a home purchase or to fund a new business. Over time the growth of the balance sheet when debt is used wisely, spending is managed effectively, and saving and investing are implemented appropriately can all contribute to increased net worth (equity).

With the ever increasing cost of a home in Canada, especially in large urban centres, taking on a mortgage and other debt is often required to get into home ownership. While parents may generously help with the down payment, there will still be much debt on a millennial's personal balance sheet.[6]

The survey found that financial concerns do impact how many people prepare for the future, especially as it relates to having debt. Concerns included having more debt than can be repaid (25%), paying bills late and incurring service charges (11%), and not maintaining a good credit rating (11%). Interestingly, 35% of the people surveyed did not have concerns when borrowing money. This figure rose to 49% for people age 55 and over.

The **main borrowing concern** for Canadians is having more debt than they can repay.

Main borrowing concern when thinking about preparing for the future



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., April 2016.

Financial steps people can take to achieve their financial goals

With marriage, a growing family and home ownership come the added responsibilities that did not exist at earlier life stages. For example, an average mortgage in Canada at the time of renewal of financing is about $200,000[7], with amounts being higher in larger urban centres. Lines of credit and HELOCs also add to the borrowing side of the balance sheet. For many, home ownership is an investment in their family and hopefully in the future growth in value of their home asset.

Home insurance naturally comes to mind to protect the family should a disaster cause damage or destruction to the home. In addition, families should strongly consider also protecting their income sources should something happen that would impact the ability to bring in income to pay down debts and meet other financial responsibilities. Life insurance as well as disability insurance can help to provide necessary funds should something untoward happen to one of the family's primary members.

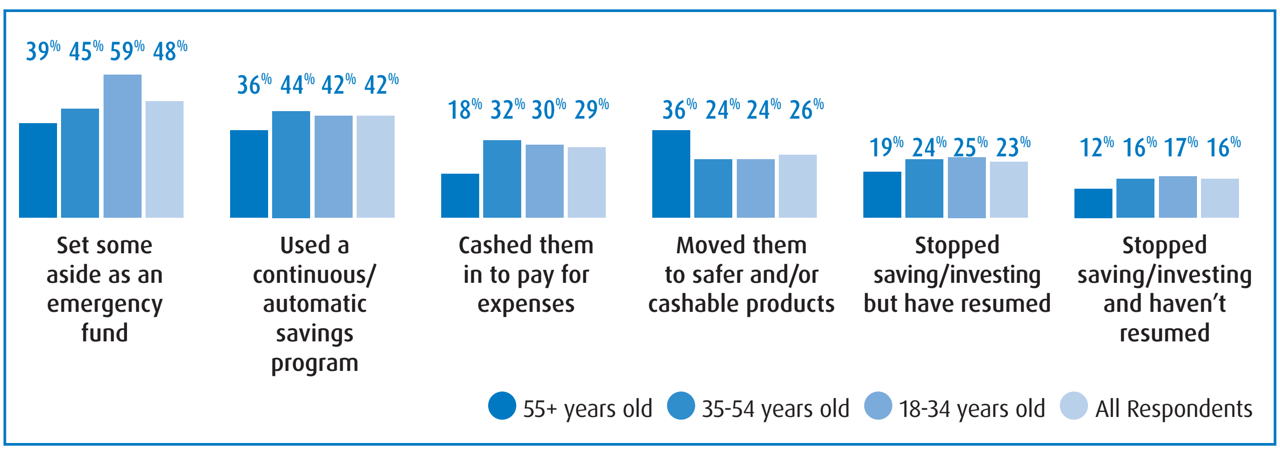
Setting up an emergency fund can also help in situations where either large costs have to be paid, or income is restricted. Emergency funds should be easily accessible and liquid, and be large enough to cover between three and six months' worth of expenses. Emergency funds can be established in TFSAs for example and grown through regular contributions using an automated savings program.

When children are part of the picture, establishing funding for their future educational goals through RESPs is important. This goal is also supported by the federal government through the Canada Education Savings Grant and Canada Learning Bonds, both of which are deposited directly into qualifying RESPs. Various provincial governments also have support in place to help grow educational savings plans.

Overall, many of the respondents to the survey noted that they have made positive steps towards growing their balance sheets and securing their financial futures. Almost half (48%) had set aside funds towards an emergency fund, and 42% use a continuous or automated savings program. Some have also had need to either reduce savings to pay for expenses (29%) or to have temporarily put their savings and investing plans on hold (a combined 39%) in the past.

Nearly half have set aside some of their savings as an emergency fund.

Actions taken with savings/investments



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., April 2016.

Divorce can be a costly setback

One of the most difficult and financially costly situations that can occur for a family is divorce. Not only does divorce shrink the size of the family balance sheet through division of assets and liabilities, but professional fees to go through the process can also add up quickly. This is described in more detail in a report called **The biggest life events that can derail your financial plan** that was issued by the BMO Wealth Institute in May 2013.[8] One of the findings in that report was that 75% of the people surveyed felt that they would face a major or catastrophic financial hit as a result of a divorce or separation. This is especially important as approximately 40% of marriages in Canada are expected to end up in divorce.[9]

If you find yourself going through a divorce, it is very important to reevaluate your financial circumstances and reestablish control. This is especially true for the spouse that may not have been involved in the family's financial affairs before the divorce occurred. Professionals are available that can help to get you organized and back on track financially through this emotionally difficult period. A financial professional can help you put plans in place that account for the changes, and help you put in place strategies right away. These financial strategies can include plans to reduce, consolidate or eliminate specific debts, or savings strategies to help you focus on new personal goals.

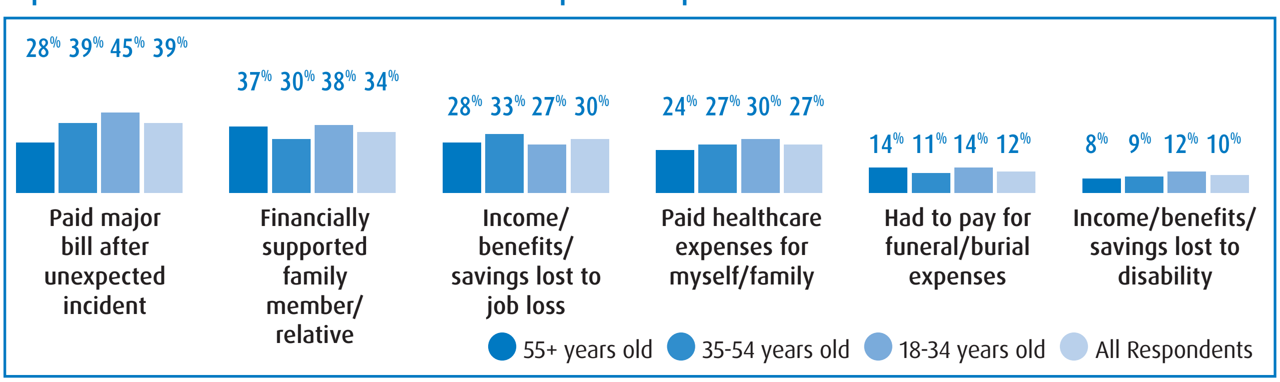
Retirement awaits

As you approach retirement, the shape of your personal balance sheet typically changes to be more heavily weighted towards assets, with less borrowing offsetting your net worth. A big reason for this is the combined effect of increasing asset values over time[10] and the repayment of debts, especially debt related to the purchase of a home. According to Canada Mortgage and Housing Corporation, more than half of Canadians (52.8%) aged 55 to 64 own their homes outright with no mortgage debt.[11]

Sometimes life events result in unexpected expenditures. The survey found that most respondents had paid a major bill after an unexpected incident (39%), provided financial support for a family member (34%), had lost income, benefits or savings as a result of job loss (30%), and paid out of pocket healthcare costs for themselves or family members (27%). Interestingly, the group that most often experienced a major bill after an unexpected incident (45%) was between the ages of 18–34. For those ages 55 and over, this unexpected cost was only reported by 28% of those surveyed.

39%
have been **impacted financially** with a major unexpected incident.

Experienced life events that resulted in unexpected expenditures

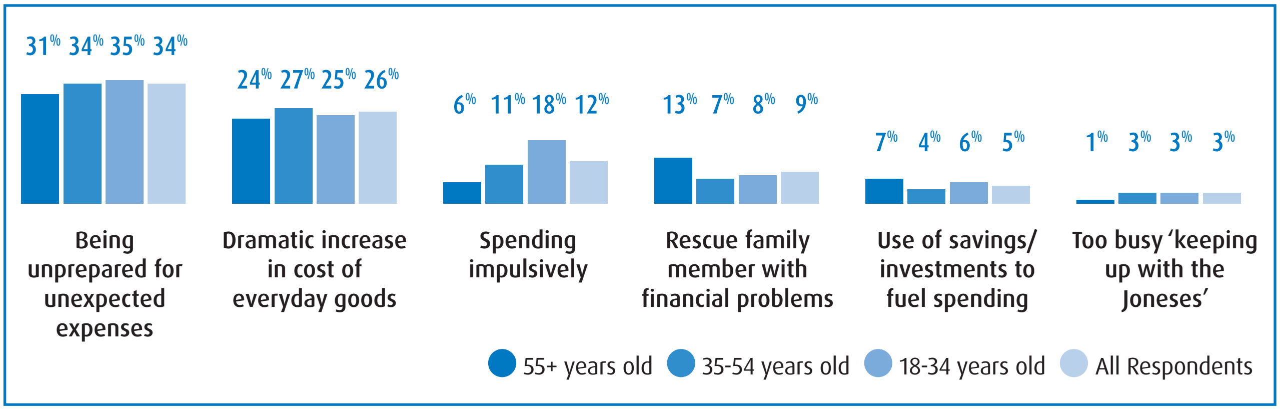


Source: BMO Wealth Management survey by ValidateIt Technologies Inc., April 2016.

While moving towards retirement, many of the people surveyed still had concerns about their spending habits. Being unprepared for unexpected expenses was top of mind for 34% of those surveyed, and a dramatic increase in the cost of everyday goods worried 26%. Spending impulsively was less of a concern as only 6% of those aged 55 and up raised this issue. But three times as many (18%) millennials (survey respondents age 18–34) worried about impulse spending.

The main spending concern for Canadians is **being unprepared for unexpected expenses.**

Main spending concern when thinking about preparing for the future



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., April 2016.

Being at a stage in life where there is an intention to have less debt on the balance sheet provides an opportunity to refocus the use of income from reducing debt to saving and investing for the future. When combined with the likelihood that these years also provide the potential for earning higher income[12], this is an opportunity to work with your financial professional to build a financial plan that will put steps in place to meet your longer term financial goals.

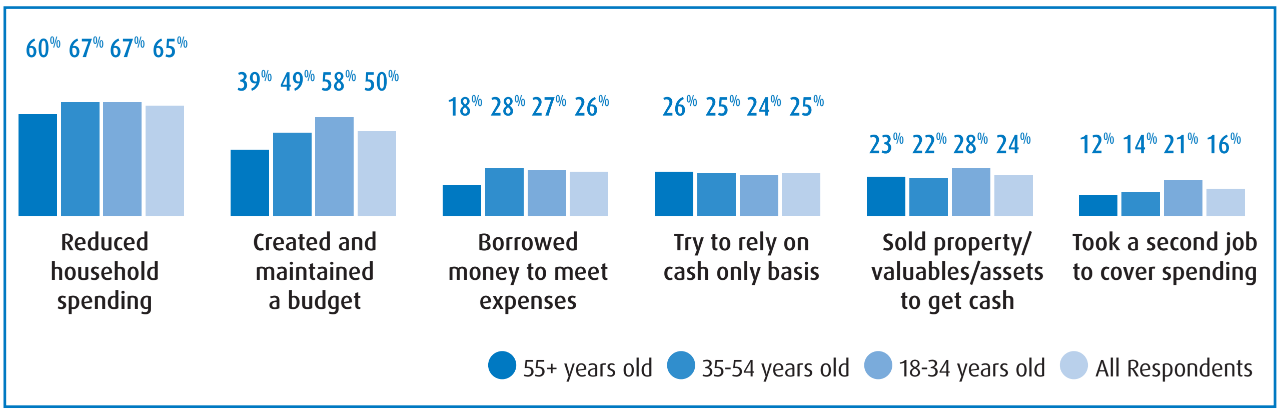
As retirement approaches

People approaching retirement may be earning more income at this stage in life than is needed to pay ongoing required expenses. The choice of how to allocate this excess income between saving, investing, borrowing and spending is important because the ability to earn income from employment generally stops or is significantly reduced at the point of retirement. It is at this point where people may have to look at reassessing their spending, borrowing, saving and investing prior to retirement.

When asked about what they have done with their spending, survey respondents most frequently said that they have reduced household spending (65%) and created and maintained a household budget (50%). Interestingly adherence to these two strategies is highest with those aged 18–34. People age 55 and older were much less likely to create and maintain a budget (39%) as compared to the younger generation (58%).

To take charge of spending, **2 in 3 Canadians have reduced** their household spending.

Actions taken with spending

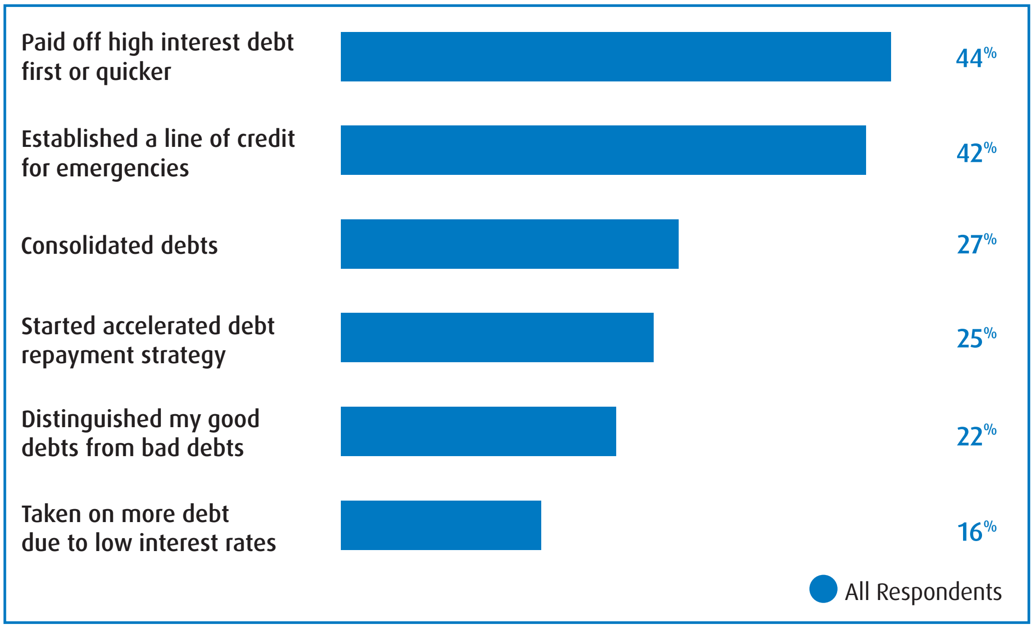


Source: BMO Wealth Management survey by ValidateIt Technologies Inc., April 2016.

Many good strategies are also employed by those surveyed when it comes to how they treat their borrowings. Prioritizing the paying of high interest debt is done by 44% of those surveyed, putting in place a line of credit for emergencies by 42%, consolidating debts to reduce interest costs by 27%, accelerating debt repayment by 25%, and understanding the difference between good debt and bad debt by 22%. All of these good practices help to lower the interest costs associated with borrowing and provide additional benefits to the personal balance sheet through reduced debt costs.

To take charge of debt obligations, **nearly half have prioritized paying off high interest debt first** or quicker.

Actions taken with debt



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., April 2016.

Additionally, there are a number of strategies that can help achieve greater tax efficiency when investing, including: taking advantage of RRSPs, spousal RRSPs, and RESPs to earn tax deferred income, and maximizing allowable contributions to TFSA accounts to earn tax free income. TFSAs are especially attractive for family income splitting because there is no earned income requirement to be able to contribute, as there is with an RRSP account. Once a Canadian resident is at least the age of majority, a TFSA can be opened.

Earning tax efficient income, such as dividends from Canadian companies and capital gains also helps to reduce the taxation on investment income. It is most important that tax efficient strategies be part of an overall financial plan to help you reach your financial goals.

In retirement the balance sheet starts to shrink

One of the goals of retirement is to have a consistent cash flow or income stream that will help meet ongoing financial requirements. Reducing expenses in retirement is also important to help make accumulated savings last for your lifetime. To this end, the majority of Canadians homeowners age 65 to 74 (71.3%) are mortgage free[13]. This is also a time to consider scaling back on financial support paid to younger family members by the Bank of Mom and Dad,[14] especially if funds are limited and the financial plan indicates that large size distributions may result in running out of retirement assets.

Early in retirement spending on travel is often a priority, whether for personal enrichment or to visit family members who have moved away. According to a survey by BMO Financial Group in June 2015, the average monthly amount spent on travel was $282 (or $3,384 annually).[15] Financial plans should be built with this expectation in mind, including the cost of travel medical insurance. Having appropriate travel medical insurance is important to try to minimize the possibility of unexpected major expenditures that was highlighted earlier.

As assets are typically converted into an income stream to fund retirement, the size of the balance sheet starts to shrink over time. Hence the decisions that many retirees make – paying down debts (especially mortgages) is often a priority given reduced cash flows. Also, asset amounts are reduced as these assets are used to meet current expenditures. Where sufficient assets are still available, planned gifts are often made to family members and loved ones to reduce the future size of the personal balance sheet, thereby reducing taxes, probate fees, and the complexity of the future estate.

Conclusion

While no two individuals experience the same sequence of life events, it is important to plan for likely events and be ready to adjust your financial plan to changing circumstances.

Plan for the likely events in life and be ready to adjust your financial plan.

When surveyed about the type of financial advice that they would seek from a financial professional now or in the future, the results showed a variety of ways that a financial professional could assist them in making sound decisions for their financial future.

Most frequently, advice would be sought related to investment management (54%), cash flow management and budgeting (28%), debt management (28%), estate planning (26%), health and long term care needs assessment (19%), and insurance needs assessment (18%). Cash flow management and debt management are higher priorities for survey respondents age 18–34 (35%) as compared to people age 55 and older (only at 19%). Furthermore, the need for estate planning becomes more of a high priority for those aged 55 and older (30%) than those between the ages of 18–34 (22%).

Each of these advice areas highlights how important it is to manage all aspects of your personal balance sheet, including balancing saving, investing, borrowing and spending activities over your lifetime. By working together with your BMO wealth management professional it will be possible to better monitor your personal balance sheet, make good financial decisions, and adapt when necessary to help you better achieve your financial goals.

Footnotes

[1] BMO Life Events Survey Canada, conducted by ValidateIt for the BMO Wealth Institute between April 13–18, 2016. The online sample size was 1,018 Canadians aged 18 and older. Overall probability results for a sample of this size would be accurate to within +/– 3.07% 19 times out of 20.

[2] Why millennials go on holiday instead of saving for a pension. Williams, A., Financial Times. February 12, 2016. www.ft.com

[3] Once you have covered your essential living expenses, which of the following statements best describe what you do with you spare cash? Statista. 2016. www.statista.com

[4] The Myth of Having It All. Hassler, C. Huffpost Healthy Living Blog. November 17, 2011. www.huffingtonpost.com

[5] Wealth Generation: The Financial Challenges for Generations X & Y. BMO Wealth Institute. January 2014. www.bmo.com

[6] The Family Bank – A Source of Comfort for Everyone. BMO Wealth Institute. December 2015. www.bmo.com

[7] Annual State of the Residential Mortgage Market in Canada. Dunning, W. Mortgage Professionals Canada. December 2015. www.caamp.org

[8] The Biggest Life Events That Can Derail Your Financial Plan. BMO Wealth Institute. May 2013. www.bmo.com

[9] Family Life – Divorce. Government of Canada Website. well–being.esdc.gc.ca

[10] The Evolution of Wealth Over the Life Cycle. Lafrance, A. and La Rochelle–Cote, S., Statistics Canada. June 22, 2012. www.statcan.gc.ca

[11] Housing for Older Canadians: The Definitive Guide to the Over–55 Market. Canada Mortgage and Housing Corporation. Revised Version 2015. www.cmhc–schl.gc.ca

[12] Earnings Growth Over a Lifetime: Not What It Used To Be. Kong, Y.C., Ravikumar, B., Federal Reserve Bank of St. Louis. April 2012. www.stlouisfed.org

[13] Housing for Older Canadians: The Definitive Guide to the Over–55 Market. Canada Mortgage and Housing Corporation. Revised Version 2015. www.cmhc–schl.gc.ca

[14] The Family Bank – A Source of Comfort for Everyone. BMO Wealth Institute. December 2015. www.bmo.com

[15] BMO Wealth Management Study: Canadian Retirees Spend an Average of $2,400 a Month on Expenses. BMO Financial Group. June 25, 2015. newsroom.bmo.com

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