Building a Strong Foundation for Your Financial Plan

Having a well-built plan can allow you to optimize opportunities as they emerge

Financial planning is an ongoing process, and it's important to begin by building a strong foundation upon which the rest of your plan can grow. The foundation of your plan is designed to provide financial stability and protection.

Key takeaways

- Financial planning is a process, and the first step is to build a solid foundation.
- With a sturdy foundation in place, your plan can help provide stability and protection for your loved ones now and in the years ahead.
- Even if you feel the framework of your plan is solid, it's important to explore opportunities that may arise from various economic and legislative conditions.

Key building blocks

The following are fundamental to establishing a healthy financial plan:

- **Ensure emergency reserve of cash.** These funds can cover three to six months of your living expenses. In the event that someone in your household can no longer work, even temporarily, this reserve of cash can help maintain your budget and make liquidating assets from your investments unnecessary. Another liquidity option that may be worth considering is to use the equity in your home to obtain a home equity line of credit. This option would provide you with cash when needed, with the opportunity to pay back the funds at some point in the future.
- **Maintain an accurate budget.** Building your plan based on a true understanding of your living expenses helps you know exactly how much cash you should have on hand as well as improve the accuracy of projections that your financial plan can meet your long-term goals.
- **Keep estate documents up to date.** A regular review of your estate planning documents—such as your will, revocable trust, durable power of attorney, health care proxy, and living will—can ensure they account for any life changes.
- **Coordinate beneficiary designations.** Make sure you know who is listed in your beneficiary designations for your various accounts, such as retirement accounts or life insurance plans.
- **Review and update life insurance policies.** Bring together all of your life insurance policies to ensure you know how much coverage you have, and whether it is adequate to protect all members of your family and achieve your estate goals.

Additional portfolio components

Once established, a strong financial plan will look toward the future—aligning your risk comfort, tax considerations, and growth strategies to support your long-term goals.

Determining your personal risk tolerance
An important first step is to determine your appetite for investment risk. Understanding your risk tolerance can assist you and your investment advisor in developing your portfolio.

Your comfort with risk may vary based on what each portion of your wealth is meant to support. For example, you may have a different risk appetite for investments intended to meet your short-term goals, such as buying a house or funding a wedding, as opposed to long-term goals, like retirement. Evaluating the risk of your portfolio based on the timeframe of the goal is a common way to approach allocation decisions.

Understanding tax diversification
There are different types of investment accounts with varying tax treatments. Taxable investment accounts are funded with after-tax dollars, and returns can generate taxable income in the form of dividends, interest, and capital gains. Tax-deferred accounts, such as individual retirement accounts (IRAs) and 401(k)s, provide the benefit of tax-deferred growth, which does not generate taxable income to the account owner until the assets are ultimately distributed. Tax-free accounts, such as Roth IRAs, provide the advantage of tax-free distributions, but are funded with after-tax dollars. From a tax perspective, diversifying your investments may allow flexibility as you begin to draw from these accounts.

Strategies to help enhance your plan

There are several savings strategies that you may consider implementing to help enhance your financial planning efforts.

Contribute to tax-advantaged plans, as appropriate
In a calendar year, taxpayers have until April 15 in the following year to contribute to an IRA or Roth IRA. As previously described, an IRA helps you save on a tax-deferred basis, or on a tax-free basis with a Roth. Contributions to a traditional IRA offer the additional benefit of an income tax deduction for the tax year of the contribution.

Establish or contribute to a 529 college savings plan
A 529 plan allows you to save on a tax-free basis for college education expenses, and in some instances, for K–12 schooling, provided that you use the funds in the account for a qualified expense (tuition, room, board, etc.). This is a popular savings strategy for parents or grandparents who want to save on a tax-advantaged basis for their children's or grandchildren's future education. Contributions to a 529 plan may also enable you to receive an income tax deduction (state tax benefit only) in the year of the contribution.

Establish or contribute to a health savings account
A health savings account (HSA) allows for tax-advantaged savings for medical costs. Any funds withdrawn from the account will be tax-free if used for a qualified medical expense. In addition, once you hit age 65, the funds in the HSA can be used for any purpose without penalty (income tax would be owed if not used for a qualified medical expense, however). Note that you must be covered under a high deductible health plan in order to establish and fund an HSA.

If you have an HSA, explore whether you can invest the funds in the account rather than hold them in cash.

Even a strong plan benefits from a fresh look—because economic shifts can open doors to new possibilities.

Optimization strategies

Even though you may feel that you have a solid plan in place that doesn't require any changes, it's important to explore opportunities that may arise from various economic or legislative conditions. The following are a few strategies that you may want to consider implementing to optimize the effectiveness of your plan. Many of these strategies require you to keep your long-term goals in mind, and perhaps make a financial sacrifice today that may benefit you in the future.

Consider a Roth IRA conversion

The potential for higher tax rates in the future underscores the importance of a tax-free source of income. For this reason, a Roth IRA can be an effective planning tool.

The benefit of a Roth IRA is that it is essentially an income-tax-free vehicle. While assets in a traditional IRA benefit from tax-deferred growth, future distributions are taxed at ordinary income rates. Alternatively, Roth IRA accounts not only grow on a tax-free basis while in the account, but distributions are also tax-free in the future. Furthermore, there are no required minimum distributions from Roth accounts unless they are inherited accounts.

Converting a traditional IRA to a Roth IRA is a taxable event where the tax is based on the fair market value of the traditional IRA at the time of conversion. However, if the traditional IRA is undervalued, then the resulting conversion tax would be lower as well. Additionally, once converted, any rebound of value inside the Roth IRA would be tax-free.

As with all tax strategies, there are many variables that factor into the decision to make the conversion, such as the expected future tax rate and investment growth, the age of the account holder, and aggregation rules. A detailed analysis of these various factors is highly recommended.

Look for tax-loss harvesting opportunities

During challenging market conditions, if your portfolio is experiencing a loss, you might consider harvesting that loss now. This way, if you have any existing gains, or when there are gains on your investments in the future, you can use your harvested loss against those future gains.

The IRS offers taxpayers a way to ease the pain of a losing stock investment: sell the security to offset capital gains incurred on redeemed "winning" securities (short- and long-term losses against short- and long-term gains, respectively). You can, in general, stay invested in the market or even the same type of company, but still harvest any losses (e.g., sell Home Depot, then realize the loss and buy Lowe's, or opt into an index fund to maintain equity exposure). However, there is a caveat. If you buy back the same or substantially the same stock 30 days before or 30 days after, you will trigger the "wash sale rule" established by the IRS, and the loss will be disallowed.

You can also harvest losses for individual bonds, which may be particularly relevant going forward as bond prices typically decline when interest rates rise. Either way, it's important to be alert to portfolio pain points and opportunities to turn around a loss to your tax advantage.

Create a philanthropic giving plan

If you are charitably inclined, there are certain income tax benefits that you may claim by gifting to the charity. In addition, any property that you gift to charity will be excluded from your estate and escape estate taxation (as well as any appreciation from that property). There are trust strategies that can be implemented, such as charitable remainder or charitable lead trusts, that will not only provide you and the charity with a benefit but could also benefit your family members in the form of income or remainder assets from the trust.

Review your risk management and asset protection plan

Having the right asset titling and proper insurance coverage can be key in protecting your balance sheet. Regularly reassessing life changes, identifying risks to reveal potential coverage gaps, and then exploring options to optimize plans are important steps to help ensure protection against unforeseen events. Lapsed or insufficient coverage may be missed if you are not doing regular insurance reviews. It's vital to not wait until something happens to understand how you are protected.

If you've successfully built your foundation and explored the many layers of planning, be sure to review your plan at least annually to affirm you are still on track, considering your current lifestyle and financial goals. The best financial plan is one that is customized to your particular situation.