Going With the Flow

Advisors who help clients use effective cash flow management can greatly improve their lives, but it can take a lot of work to set up.

BY INGRID CASE

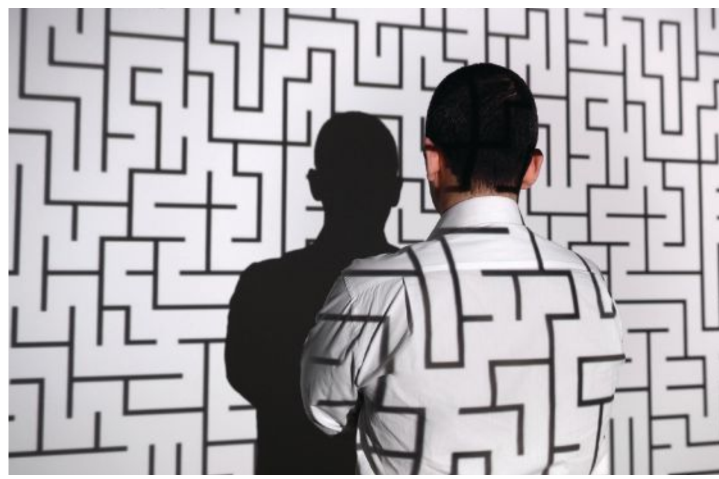
FROM PAYING DOWN DEBT TO FUNDING RETIREMENT, planners guide clients through a vast maze of financial choices. Yet all that work rests on a single discipline: cash flow management.

"Cash flow is the foundation on which financial planning is based," declares Douglas A. Boneparth, COO and vice president of Life and Wealth Planning in New York.

It's tempting for planners to rely on clients to handle their own cash flow planning, but that can be a mistake that unravels all their other hard work.

"You could outperform the benchmarks every year and that might not matter, because the client's spending is too high," says Jacob D. Bond, an advisor at True Capital Management in San Francisco. "If you're not able to manage cash flow, you may not make it to the finish line,"

Yet, when planners teach clients effective cash flow management, their portfolio returns often improve and many other common issues are easier to manage.



EXPENDITURES AND SAVINGS GOALS

Most financial advisors work backward to determine savings goals, calculating how much clients will need to live on in retirement, and then determining how much they need to save to generate sufficient income. It's impossible to know how much money a client will need once he or she retires, however, without knowing how much money the client spends now.

"People are so disconnected from their expenditures," laments Amy Jo Lauber, president of Lauber Financial Planning in West Seneca, N.Y. "I can't do any retirement planning until I know how you live."

To extract that information, Lauber asks clients to track their spending for several months, using anything from an app to a pocket notebook. "Engineers are really good at this," she observes.

Once a planner knows that a client isn't saving enough to support his annual spending, analyzing the client's cash flow can uncover sources of additional savings. "If you need to save more, we will go into cash flow to find that money," says Michael P. Black, CEO of Michael Phillips Black Wealth Management in Scottsdale, Ariz.

Even if clients are on track with their retirement savings, improved cash flow management can reveal how well they're pursuing their priorities.

Eric Roberge, a CFP and founder of Beyond Your Hammock in Salem, Mass., recalls clients in their late 30 who despite a household income of $230,000 a year were having cash flow troubles. "We got their cash flow on paper, and it turned out that they were spending maybe $20,000 a year on clothes, toys and books," Roberge says. "They had no idea."

A cash flow management plan can allow for discretionary spending, while helping clients manage upfront expenses and still save for their long-term goals. One way to do this is to have clients put money into separate buckets, says Andrew Sivertsen, a CFP at the Planning Center in Moline, Ill.

The first bucket contains money for fixed expenses like mortgage payments and utility bills. It isn't going to change very much.

The second bucket holds money earmarked for variable expenses that are variable month to month. Examples are gas, restaurant meals, personal care and clothing.

Rather than asking clients to think about how much they spend each month, Sivertsen suggests that they think about how much they need to spend per week. "You may not know how much you spend on groceries in a year, but you can probably estimate what you spend in a week," he says

A third bucket is devoted to future needs and wants: home repair, major medical expenses, travel or a new car, for instance. "These are amounts that we usually think of in annual terms," Sivertsen says.

LINKED BANK ACCOUNTS

To track expenditures, Sivertsen recommends that clients set up a variety of bank accounts and then link them, which banks are often happy to do at no additional charge.

"People typically have one master checking account, and their money goes directly into that account," he says. The clients' static expenses — the first bucket — can be automatically paid from this account, which should include a one-month reserve to cover unexpected developments. No debit cards should be linked to the master account.

Separate debit accounts should be set up for each member of the family, including older children, and discretionary funds — the second bucket — should be automatically deposited to those accounts each week. The family members and account holders should be clear about what expenses this money is expected to cover.

Split the third bucket into separate savings accounts for each savings goal. For example, if annual traveling is one of those goals, a client would set up a separate travel account. Now, Sivertsen says, "you're preparing for your future needs and wants."

Clients with unpredictable income can also use the bucket system, as long as they add another account to the top of the pyramid into which they deposit all of their income. Then, says Sivertsen, "you dole out a monthly amount to your master checking account and proceed as before."

What's the right amount of money to keep in each of the three buckets? That varies by client, but Sivertsen says that he tries to allocate less than 50% of a client's income to the first bucket. "When a huge chunk of your paycheck goes to your fixed expenses, you don't have a lot to live on day-to-day and you're not really saving for future wants and needs," he says.

The third bucket should contain at least 20% of a client's income, leaving the remaining 30% for the discretionary bucket. In retirement, clients typically place about a third of their income into each bucket.

It takes time for clients to adjust, but the system usually works. "We have seen some huge success stories," Sivertsen reports.

A PERSONAL CFO

Evelyn M. Zohlen, president of Inspired Financial in Huntington Beach, Calif., takes another approach for clients with large but variable incomes. Her firm acts as their personal CFO.

To smooth these clients' cash flow, Zohlen gathers all their compensation into a trust account and determines, based on an expense review, how much the client needs to maintain his or her standard of living. This amount is sent to the client every two weeks, regardless of how much income comes in, while Zohlen allocates the rest among fixed expenses and long-term savings. For clients like lawyers who practice and pay taxes in multiple states, the personal CFO approach can make their financial lives much more predictable.

Regardless of the method, good cash flow management can be challenging for clients. "It takes time to turn a budget into good cash management, says Life and Wealth Planning's Boneparth. "You shouldn't expect to hit a rhythm in the first or second month."

But learning the discipline is clearly worth it, he adds. "My clients who are masters of cash flow never have to worry about making a frivolous purchase." **FP**

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