DISCCUSSION:

1. How do the external and internal environments in which financial planning

occurs differ?

A client's success in financial planning is influenced by both internal and external environmental

factors. Internal environmental forces include a client’s current and projected financial

situation, tolerance for risk, discipline regarding savings and investments, consumption

patterns, and financial goals. The external environment is made up of a variety of external

factors, or subenvironments, that are broad in scope but have at least some direct or indirect

influence on the financial planning process. The external environment includes economic,

legal, social, technological, political, and taxation factors. For the financial planner, the purpose

of studying and monitoring the external environment is to scan for opportunities and

threats that may relate to particular clients and their particular financial goals. The financial

planner may forecast external trends (or use experts to forecast trends) to help achieve client

goals and avoid external risks.

2. What are some examples of how each external environmental factor might affect

clients from different economic levels?



3. Why is external environmental analysis so important?

External environmental analysis is important for a variety of reasons.

■■ External trends and particular events play a significant role in effecting change in the

world and in the behavior of individuals.

■■ C hanges in external forces affect beliefs, economics, unemployment, inflation, and a society’s

well-being.

■■ The external environment shapes the way people live, work, spend, save, and think.

4. How is the external environment analyzed?

External environmental analysis is the process of identifying and monitoring the environment

in which a client exists and the opportunities and threats that are present. In performing

the external environmental analysis, the financial planner must determine the relevance

of one or more external environmental factors for a particular client. The relevance of such

factors may be dependent on the client’s age, goals, net worth, or income. The regular observation

and monitoring of the external environment by the financial planner is essential to

providing high-quality financial planning services. Financial planners may study the external

environment formally or informally. Formal study usually includes university-level courses in

economics, taxation, political science, sociology, and the legal environment. The external

environment may be studied informally by using a variety of sources, such as general economic

and business periodicals, books, academic and professional journals, newspapers, and

government statistical studies, and by obtaining environmental briefings from various information

providers. Financial planners also take continuing professional education courses to

stay abreast of the ever-changing external environment.

5. Why is the economic environment so important to financial planning?

Of all the external environments, the economic environment has the most direct influence

on personal financial planning. The economic environment includes many factors, such

as gross domestic product, inflation rates, interest rates, trade payments, consumer income/

debt/spending, unemployment, population age, and the index of leading economic indicators.

Many of these factors, namely interest rates, inflation, unemployment, and gross domestic

product, play a key role in real investment returns and, therefore, in the accomplishment

of financial goals. Professional financial planners must understand the economic environment

to better forecast the economic future. By identifying the opportunities and risks that

lie ahead, planners can help clients adapt to that future. The planner needs an understanding

of the current economy’s general condition, the current interest rate environment, the

current rate of inflation, and recent changes in monetary and fiscal policy. It is essential for

a planner to have the ability to anticipate each element’s behavior and its potential effect

on a client’s financial plan.

10. How do interest rates, taxes, and inflation affect areas of financial planning?

The interest rate is the price of money. Decreases in interest rates are often followed by periods

of economic expansion, whereas increases are generally followed by economic contractions.

Investment returns and purchasing power are two areas that are affected by the rise

and fall of interest rates. Taxation, in its myriad forms, leaves the taxpayer with less disposable

income. In that sense, all taxes—income taxes, estate transfer taxes, payroll taxes, property

taxes, and sales taxes—have a dampening effect on consumer spending and consumption.

Inflation is another important element affecting the economic environment. Inflation

is an increase in price level. These are three of the main factors affecting financial planning

in the external environment that must be recognized by the financial planner.

11. What are the components of the business cycle, and how do they affect the

economy?

The business cycle consists of two general phases, expansion and contraction, and two

points, peak and trough. The expansion phase leads to the peak point. During the expansion

phase, business sales rise, gross domestic product (GDP) grows, and unemployment

declines. The peak point appears at the end of the expansion phase when most businesses

are operating at full capacity and GDP is increasing rapidly. The peak is the point at which

GDP is at its highest and exceeds the long-run average GDP. Usually employment levels

also peak at this point. The contraction phase leads to the trough point. During the contraction

phase, business sales fall, GDP growth falls, and unemployment increases. The trough

point appears at the end of the contraction phase where businesses are generally operating at

their lowest capacity levels. The trough point is characterized by GDP growth at its lowest.

Unemployment is rapidly increasing and finally peaks when sales fall rapidly.

26. How do the external environmental factors—social, technological, political, and

taxation—affect a client’s financial plan?

Financial planners must accurately assess the social environment and forecast the threats

and opportunities that change will bring. Perhaps the most rapidly changing environment

is that of technology. Success will come from keeping a constant vigil on the characteristics

that make up the technological environment. The political environment is especially important

to risk analysis in investments. This analysis becomes more important as we move to a

global economy and try to diversify investment portfolios with worldwide investments. If a

professional financial planner is to assist clients in minimizing their legal taxes, thus giving

them more disposable income for consumption, savings, and investments, the planner must

have a basic education in taxation and must find ways to remain current in the field.

***EXERCISES***:

3. What action might the Federal Reserve take if it wanted to lower interest rates?

The Fed could lower the discount rate, reduce the reserve requirement, or purchase government

securities on the open market.

19. What actions taken by the Fed will lead to increased money supply?

Lowering the discount rate, decreasing required bank reserves, or buying securities on the

open market.

21. In a typical business cycle, which phases exhibit periods of increasing employment

and increasing output?

Expansion. An expansion is where employment and output are rising. When employment

and output are no longer rising, the phase is at its peak. If employment and output begin to

decrease, this indicates a contraction phase. Finally, when employment and output are no

longer decreasing, the cycle has reached a trough. The intensity indicates the highest and

lowest points of the peak or the trough.