The Lee Case Study Questions

PART TWO—MANAGING BASIC ASSETS

After reviewing their financial statements, Megan and Kevin were pleased with their financial situation, but they were shocked to see the cost of their goals and how implementing those goals would affect their budget. Before they make any decisions, they want to analyze some of their savings and spending strategies.

1. Megan and Kevin currently do not have 3 month's net salary in liquid assets (money market accounts, money market mutual funds, and savings accounts) to meet their emergency fund goal. How many month's of net salary do Megan and Kevin currently have in these accounts? If they agreed to include the balances in their checking accounts as part of this goal, how many month’s of net salary do they have in liquid assets? Evaluate their current liquidity level and recommend to them whether their liquidity level is acceptable, whether they should designate annual savings to increase liquidity, or whether they should sell other assets and put the funds in a liquid account. Remember Megan and Kevin's 2002 budget, tax considerations, their goals, and their risk tolerance when making your recommendations.

2. If you recommended that Megan and Kevin designate annual savings to increase their emergency fund reserves, what type of account would you recommend for their emergency fund savings assuming they want to make monthly contributions to the account?

If you recommended that Megan and Kevin sell existing assets and put the funds in a liquid asset, what would you recommend selling, what would the tax implications of that sale be, and where would you recommend they put the funds?

3. Kevin has just received his December, 2001 bank statement for his checking account. It contains the following information:

   ending balance.................................................................$4,351.60
   service charge.................................................................$0.00
   ATM fees...........................................................................$12.00

His checkbook ledger shows a final balance of $4,809. However, the following checks and deposits are still outstanding:

   check #1588.................................................................$108.95
   check #1590.................................................................$13.26
   deposit made on December 27.................................$580.00
   ATM withdrawal made January 1...............................$50.00

Reconcile Kevin's December bank statement. How much difference, if any, is there between the bank statement balance and the ending balance in his checkbook after reconciliation? If there is a large discrepancy, what practices should Kevin improve so that he will have better control of this account?
Chapter 5

Megan and Kevin plan on using the funds in Megan’s Fidelity Magellan mutual fund for the down payment and closing costs to purchase a home within the next 5 years. Although they are not sure they want to make the purchase this soon, they would like to know how much home they could afford and to consider the pros and cons of renting vs. buying a home now.

1. Megan and Kevin visited with the loan officer at a local savings and loan association and learned that mortgage lenders typically require a minimum down payment of 10% and require that total monthly mortgage payments (including taxes and insurance) do not exceed 28% of gross monthly income (not including investment income). The average interest rate on 30-year mortgages is now 7%, and they estimate that taxes and insurance would be $275 each month. In addition, closing costs are assumed to consume 1/3 of the funds available for making the down payment and closing costs. Given these assumptions and Worksheet 5.3, what is the maximum home purchase price Megan and Kevin could afford?

2. The loan officer also informed Megan and Kevin that most lenders require that the home buyers’ total monthly debt payments (the mortgage payment including taxes and insurance, all types of consumer loans, and minimum credit card payments) not exceed 36% of their monthly gross income (not including investment income). Applying this criteria in addition to the information from the previous question, what is the maximum home purchase price Megan and Kevin could afford?

3. Complete the rent-or-buy analysis for Megan and Kevin assuming they would buy a $135,000 house with a 10% down payment using a 7%, 30-year, fixed-rate mortgage. Closing costs would be $4,000. Property taxes, homeowner’s insurance, and maintenance would be 2%, 1/2%, and 1/2% of the purchase price of the home, respectively. Megan and Kevin estimate the after-tax cost of investment income on the down payment and closing costs would be 8% and the annual appreciation on their home would be 3%. Use the rental information from Megan and Kevin’s current apartment and their marginal tax rate calculated in Part 1 of the project. Assume they would be able to itemize deductions. Based on this analysis, should Megan and Kevin continue renting or purchase a home now? Why?

4. What other things in addition to the financial rent-or-buy analysis do Megan and Kevin need to consider in making their decision about buying a home now? Using all the information you have to date, would you advise Megan and Kevin to purchase a home now or to wait a few years? Why?