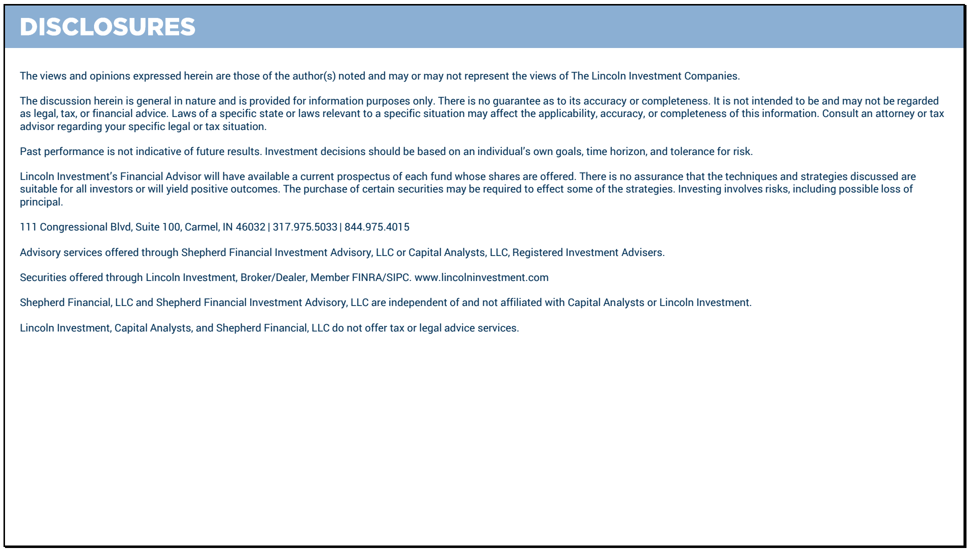
Slide 1

BUDGETING & DEBT ELIMINATION

February 16, 2023

Shepherd
FINANCIAL

Slide 2



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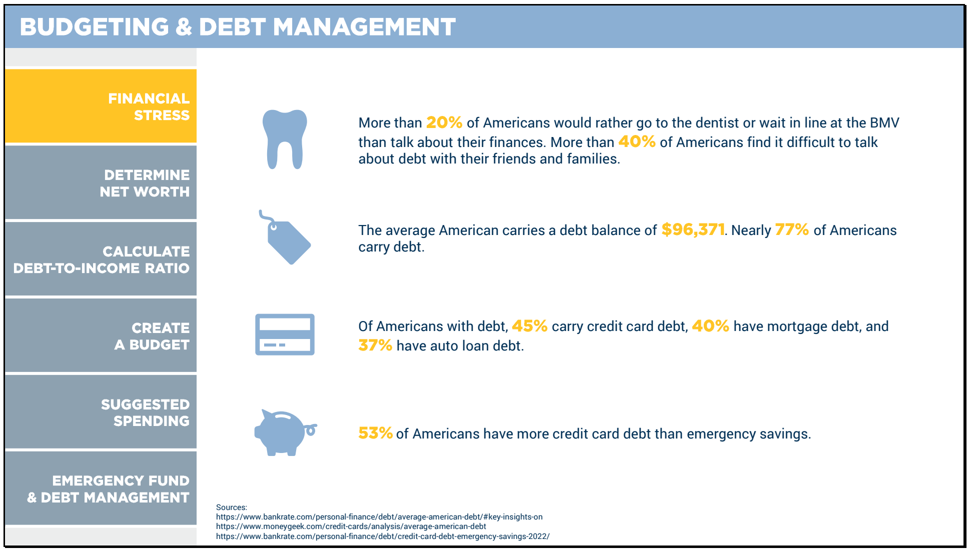
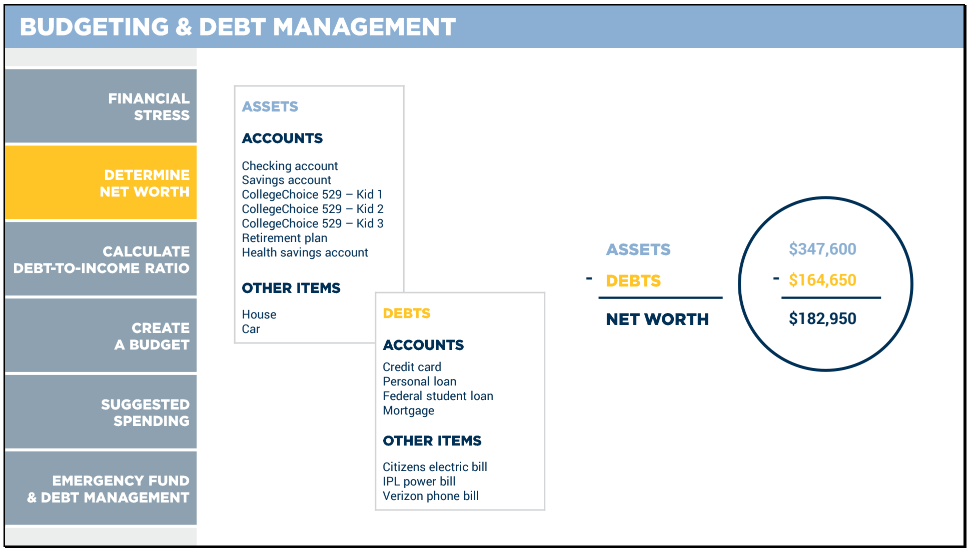
Slide 3



We have always been dealing with financial stress on some level, but the past few years have hit pretty hard in a number of ways. Since COVID-19 started, 62% of American workers have experienced moderate to extreme financial stress. It's a big deal. And if you look at some of these stats on the screen, we know it's only gotten worse because of the pandemic. People struggle to talk about their finances. They don't want to open up to family and friends about their debt. But it's a real issue. At least 80% of Americans have debt, so if you're one of them, you're not alone, and it doesn't mean something is wrong with you. Finances are a challenge for many, many people.

We're here to help you. So if you want to make positive changes, you have to start thinking and talking about your financial reality. Today is all about getting you on that solid path. And sure, I know some of you are out there thinking you don't need this information. Maybe your partner handles all the bills. But what if something happened to themtomorrow? I'm sure you'd have a lot of questions and face uncertainty. This will help you take the first right step. So stick with us. Step by step, we're going to beef up your financial literacy, which is just an understanding of the skills and knowledge you need to make informed and effective decisions with your financial resources.

Slide 4



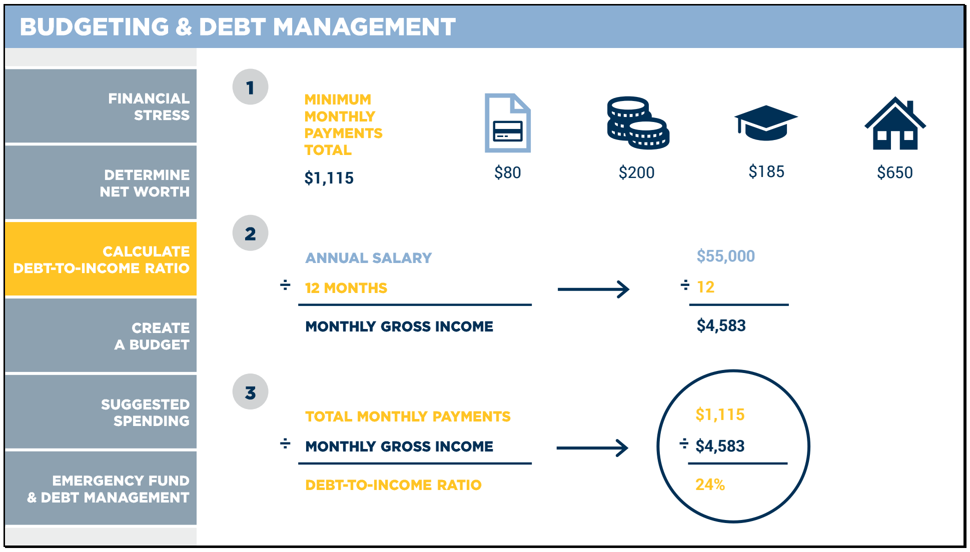
Step one is to conduct a financial inventory. Creating a financial inventory is like prepping to do a jigsaw puzzle – you gather all the things, get them sorted, and create your structure. Think about all the places you have money going in or out of your life. How often you write checks. When and where and how you pay bills. The first area we'll think about is determining your net worth, which is your assets minus your debts.

If you look at the screen, you can see we made a sample person. Her assets include a checking account, savings account, 529 college savings accounts for her three kids, her retirement plan, a health savings account, her house, and her car. She will write down the balance of each account and the market value of other items, like the house and car. This is also a good time to think of other things that can be considered assets, like jewelry. Next up, let's think about debts, or liabilities. Let's look at the sample employee's debts here: a credit card, a personal loan, a federal student loan, and a mortgage. Why would the house be considered both an asset and a debt? That's because it has value, but she also owes money on it.

As with the asset accounts, pull about three months' worth of statements for the credit card. Those other accounts most likely have fixed payments, so you'd just needs to know the payment amount and the current balance for each one. You'll also want to make note of the interest rate on each of these accounts. And you'll see we have an 'Other Items' section here. This is where you'll put any kind of recurring bills you have. In our example, she has a Citizens bill for water and electricity, an IPL bill for power and light, and a Verizon phone bill. I'm sure most of you have something similar to those as well.

Now that we’ve collected all the puzzle pieces and sorted them into a few different piles, we need to start making the border of the puzzle. Calculating net worth is important for two reasons. One, it lets you understand your current financial situation, and two, it gives you a reference point for measuring progress toward your goals. This isn’t complicated, either. As I said, all you’re really doing is taking your debts and subtracting them from your assets. In other words, what you have minus what you owe. This is a number that changes over time. Hopefully, the debt number goes down and the asset number goes up! That is how net worth increases. Of course, it works in the opposite direction, too, so if debts go up and assets go down, net worth will decrease. Again, we are just building our framework here, and we will use this net worth number to help set goals and track progress.

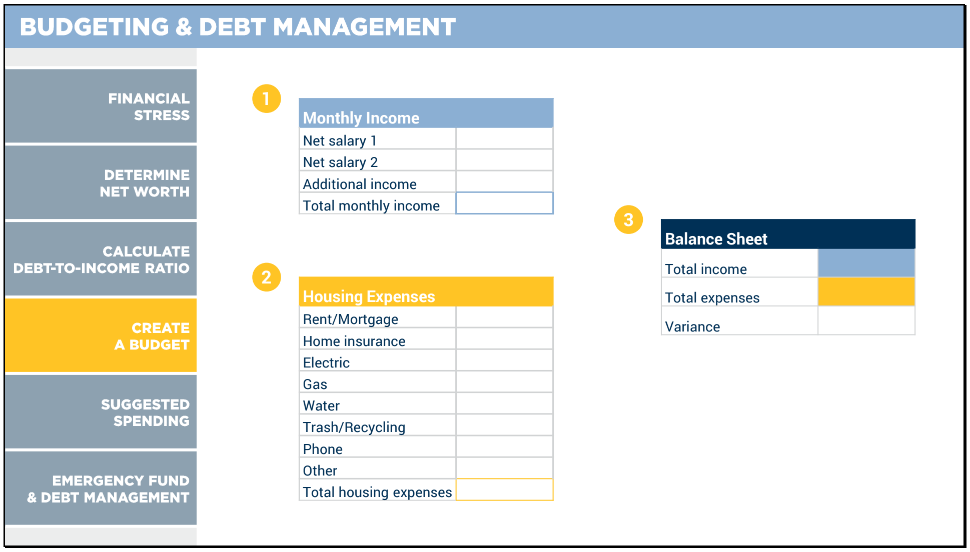
Slide 5



We just figured out the total debts, but now we need to determine the monthly debt payments. And for our example's sake, I'll just be talking about the minimum monthly payments owed. Let's start with that credit card! The monthly payment is $80. The personal loan monthly payment is $200. The student loan payment is $185, and the mortgage payment is $650. Now that we know those numbers, we'll add them all together. Then we take the total amount of monthly loan payments, which is $1,115, and divide them by gross monthly income – that's before taxes and things are taken out. Assuming her annual salary is $55,000, we'll divide that by 12 to get the monthly gross income, and you get $4,583. The debt-to-income ratio is $1,115 divided by $4,583. That comes out to about 24%.

This is important because it's a primary factor in your credit score and getting new credit. Most lenders are looking for a debt-to-income ratio of 30% or lower, so this sample employee is doing ok. Once you've calculated your debt-to-income ratio, hang on to that number. Remember, you don't need to judge it or feel overwhelmed, especially if it's a high percentage. We are going to address how to deal with debt.

Slide 6



Don’t you feel more excited and energized when you have a purpose to the work you’re doing? Well, money needs a purpose, too. Budgeting is just making a plan for what you’re going to do with your money. You’re telling your money exactly where it should go and what it should do. Creating a budget helps you feel secure in knowing you are meeting all your financial obligations, crushing debt, creating emergency savings, and finding financial independence. That’s why budgeting is so important for everyone to do – it puts control back in your hands, rather than letting money dictate your life. If you’ve never made or followed a budget, I’m not surprised. Only about 32% of Americans maintain a household budget, and only 28% have a long-term financial plan that includes savings and investment goals.

Our financial worksheets are certainly not the only way to budget – you have to find the method that works best for you. Maybe that’s online, using mint.com, or it could be in a spreadsheet. But the budgeting process is generally the same, no matter what method you’re using. When you budget, you’re writing out income and expenses – what you make and what you spend. Once we’ve done that, we’ll be able to see how the numbers compare to suggested spending percentages. Of course, these are just suggestions, but I think they give a helpful gauge for how you’re doing, financially-speaking. That will also allow us to see where there could be some areas that need work – you might spot areas where you could be saving some money. But you also might to figure out some changes that need to be made, whether they are quick fixes or long-term fixes.

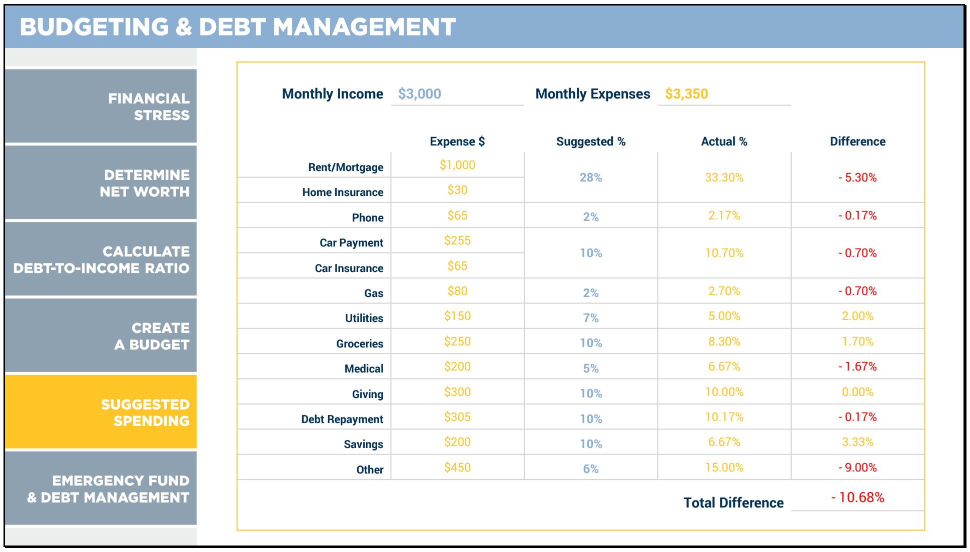
The kind of budgeting I am going to propose to you is called zero-based budgeting. That means we will assign every dollar of income and every dollar of expenses to its own category.

The goal here is for income minus expenses to equal zero each month. But let's be very clear: this does not mean your bank account will be at zero dollars. Zero-based budgeting just means every single dollar has a purpose and is working as it should.

First, write in your income – your paychecks and any other money that comes into your bank account. This can be a little tricky if you have inconsistent income, like if it's commission-based. I would recommend writing your average income here. You'll add up all those rows and put the amount in total monthly income. Next, we're going to write down expenses. These can be broken into two types – fixed and variable. Fixed means the amount is the same every month – like your rent or mortgage payment. And variable means the amount may change based on what's going on in the month. For example, groceries or gas. If you're using the past three months to figure out those variable expenses, average out the numbers for each of your categories. You'll want to go through each expense category and make sure you itemize all the things you spend money on even if they don't fit in these exact categories.

Total each section. Each of those expense totals will be added together and put as the number in total expenses in the balance sheet section. Your total monthly income number will be put in the total income cell. The difference between these two numbers is the variance – either you have more income than what you are spending each month, or you have a deficit – you're spending more than you're bringing in. Do you know how to determine if you're overspending in a particular category, though? Take a look at suggested spending.

Slide 7



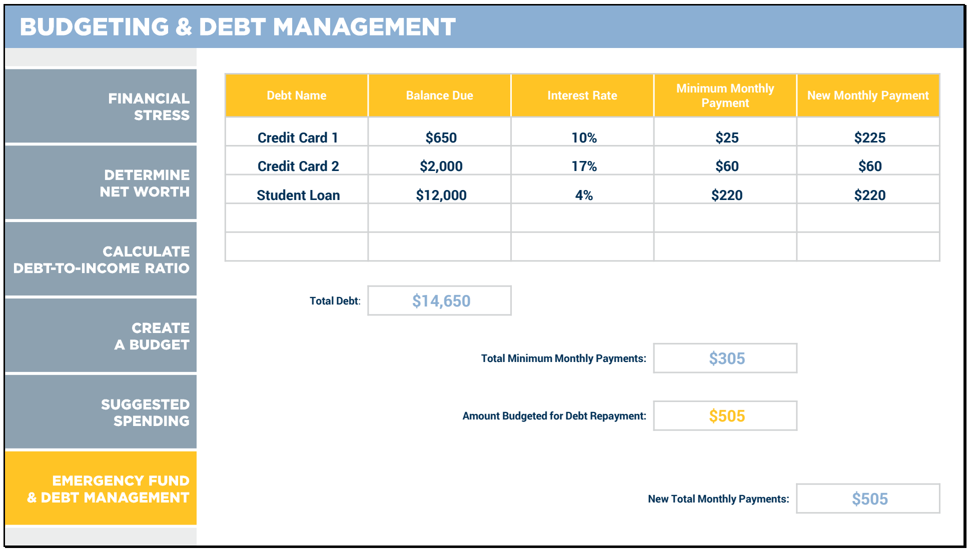
This worksheet allows us to take the numbers we just added up and calculate what percentage of the monthly income is being spent in the various categories. In fact, if you're using the pdf version and completed the Monthly Finances worksheet, you'll notice all these numbers get filled in for you automatically. This worksheet takes the suggested spending percentage and subtracts your actual spending percentage. Positive numbers mean you're spending less in these categories, so you have some money to potentially move around. That means if there is a negative number in the difference column, there's some work to be done to tighten up your budget.

A couple of thoughts for you here. You can do a bit of research to cut back in some of these categories. For example, if your insurance costs are too high, consider getting a quote to see if you can lower your monthly payments. Another area that can be quick to trim is groceries. Putting a little thought into a meal plan and grocery list can prevent you from overspending at the store and wasting food later. When it comes down to it, you might have to cut back on your necessary expenses. And keep in mind that while you're trying to save money, you may need to completely cut some other expenses – areas that usually stick out are gym memberships, cable subscriptions, apps that you pay for, etc. It's not fun to hear, but the fact is you may be living an overinflated lifestyle. If your mortgage or car payment are crushing you, then it may be time to downsize. I get it. There can be a lot of pressure to maintain a particular lifestyle. But part of taking responsibility for and control of your finances means being honest about what you can actually afford.

This is really important to be realistic about as you try and set financial objectives. It just means setting goals and then prioritizing them. And the key to goal-setting, especially when it comes to financial goals, is to be clear and specific. Write down exactly what the goal is and how long you intend to take to reach it. It's so important, too, to share these goals with someone. Talk about it with your spouse. Maybe you want to share it with friends or relatives. But then again, maybe the thought of talking about finances with your loved ones feels stressful or embarrassing. If so, talk to us at Shepherd. We're happy to discuss what you're working toward and share the tools we have at our disposal to help get you there.

You may have noticed a section on your monthly expenses sheet for saving and debt repayment. Did you write anything there? I hope so. As you are building your budget and setting goals, the first two questions you need to answer are: one, do you have an emergency fund with at least $1,000 in it? And two, do you have debt? Building an emergency fund and eliminating debt are the primary tools to get you out of the paycheck to paycheck cycle, help you be prepared for financial emergencies, and lower your overall financial stress.

Slide 8



If your emergency fund is currently at $0, I understand that any number might feel intimidating. But there's hope. You can save $1,000 methodically. We just talked about identifying areas where you might be able to cut back on your expenses. Let's say you've decided to cut cable and switch to Netflix. So instead of $100 per month, you're paying $13. Bank that extra $87 a month and stick it in your emergency fund. In one year, you'll have over $1,000 saved! Once you're at that number, you want to aim to increase your emergency fund. I know we don't like to talk about it, but it's important to have a cushion if something happens to your primary source of income. In general, focus on accumulating three to six months of living expenses in this account. For single people or families living on one income, consider bumping that up to 12 months of living expenses.

I have a few more points about this emergency fund. If possible, automate it. Make it a regular part of your budget, and set it so the money goes out of your checking and into a savings account of some kind. Second, this account should be accessible during the actual emergency, so we're not talking about a retirement account that would have withdrawal penalties. Finally, if you draw from your emergency fund – which you should only be doing for actual emergencies – make it a priority to build it back up as soon as you are able.

Next up is paying off debt. If you've only been making minimum payments on your debt balances, you need to know that you just won't get out of debt that way. Interest payments will keep adding up, and we want interest to work for us, not against us. Write down each of your debts, their current balances, interest rates, and minimum monthly payments. We're going to show you one of the ways to smash that debt by walking you through the snowball method.

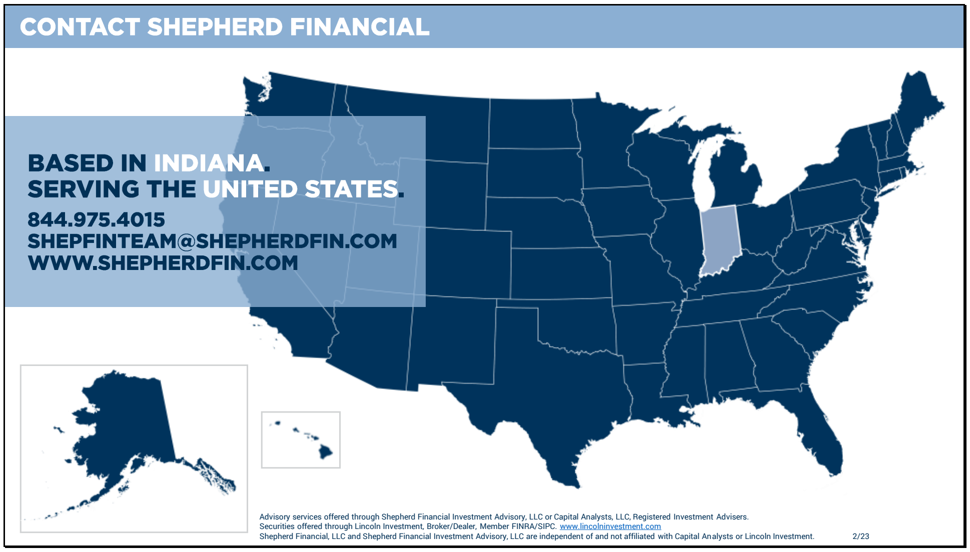
This is a very popular method. Here, the sample employee has two credit cards with balances, as well as a student loan. The credit cards have $650 and $2,000 on them, and the student loan is at $12,000. So the total debt right now is $14,650. You can see that she'll have to pay $305 each month to cover these minimum payments, which she has been doing. But to truly eliminate debt, you have to pay more than the minimum. In fact, if you're only paying the minimum, the interest will build so quickly that you won't be able to get out of debt.

The debt snowball method attacks the smallest debt first, then the next one, then the next one. You build momentum, just like a snowball going down a hill. Instead of the minimum payment of $25 on the first credit card, let's say she's going to pay $225, while still making minimum payments on the other two debts. By doing this, she will pay off that $650 credit card debt in three and a half months. It's going to take that long because interest keeps building on it while she is paying it off. Once she has paid off that debt, she can take that $25 minimum payment plus the extra $200 payment and move it to the next debt. Adding that to the $60 she was already paying, she will be putting $285 toward that second credit card debt each month, starting in month four. Once she has paid off that second credit card debt, she can focus my energy and that extra money toward the student loan. I love to see how she gained momentum by continuing to reallocate money toward the next debt!

The debt snowball method is great, but it's not the only way to handle debt. Another method focuses on paying off the highest interest debt first. In this case, we'd focus on the second credit card because it has a higher interest rate. Then she'd pay off the first credit card, then all her attention would go to the student loan. I have one last note here. As you are working on crushing your debt, you have to follow your budget to make either of the repayment plans work for you. That means not accumulating more credit card debt by overspending. Sticking to your budget allows you to shrink the debt and eventually become debt-free. If you need to look at other debt repayment options, it's a great idea to sit down with a Shepherd Financial team member.

I want to remind you that it's important to evaluate your progress, because you want to keep your goals in front of you to know <u>why</u> you're doing <u>what</u> you're doing. Budget maintenance should be happening at least monthly to make sure you're on track. Once you have built up your emergency fund and paid off your debts, consider reallocating that money toward some savings goals. That same debt snowball principle can work in a positive way. Once you've hit one savings goal, you can shift that money to save for other things. And one last, important note. Be patient with yourself. Deciding to behave differently when it comes to your finances is just as hard as starting to eat well or working out. Acknowledge you won't do this perfectly, and remember: you have a system in place to help you get back on track if that occurs.

Slide 9



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