10-1 Reasons for Saving and Investing

OBJECTIVES
- ***Explain the difference between saving and investing.***
- ***Describe reasons for saving and investing.***
- ***Describe the concept of financial security.***
- ***Explain what is meant by retirement planning.***

You will now consider how saving and investing can help you achieve your goals. You will learn about saving and investing options and strategies. You will explore sources of data that can be helpful to investors. You will learn how to buy and sell securities. You will also learn about several agencies that protect and assist consumers and investors.

Chapter 10 focuses on saving and investing. Some aspects of saving and investing overlap. However, there is a difference between saving and investing. Saving and investing can help you accomplish short-term and long-terms goals. You will want to consider the risk involved and the amount you can expect to earn when choosing investments. In this chapter, you will learn the difference between saving and investing. You will also explore some reasons for saving and investing and some strategies for getting the most from your investments.

SAVING AND INVESTING

The purpose of saving is to accumulate money for future use. Saving money is important because it means you are planning for future needs and wants. When you are saving money, the emphasis is on safety. In Chapter 5, you learned about various methods for saving money. A savings account, a certificate of deposit, and a money market account are all good, safe ways to save. Because these types of accounts are insured by the FDIC, you can be assured that money you place in such an account is safe.

Investing money is another way to plan for future needs. The purpose of investing is to make your money grow. Investing is sometimes explained as using money to make more money. For example, you may use money to buy real estate such as a house. You might also buy stocks, which are shares of ownership in a corporation. Your hope is that the house and stocks will be worth more several years later when you sell them than when you bought them. If so, you will have more money when you sell the investments than when you bought them.

Money in a savings account or money market account that you plan to leave there for a long time can be considered a type of investment. However, the interest rate and the money earned in such an account are typically low compared to other types of investments. As mentioned earlier, safety is the primary advantage of a savings account. Other types of investments involve risk. The amount of money that can be made and the risk involved are issues of concern with investments.

With many investments, you do not know how much the money you invest will earn. You could even lose the money you invest. For example, when you buy stocks, you are buying a share of a corporation. The company may do well, and the value of the stocks may grow. However, the company could fail. In this case, you might lose the money you invested in stocks. When investors think the chances of making money are good, they accept the risk involved with investments. The goals you want to accomplish with money you save may be short-term or long-term goals. Investments are often long-term and may be part of a plan to accomplish long-term goals. Some short-term and long-term reasons for saving and investing are discussed in the following sections.

SHORT-TERM NEEDS

Saving is a good way to have money to handle short-term needs or wants that are not part of your regular spending. For example, you may want to save money to pay for a trip or to purchase a home theater system. Savings can also be used to handle unexpected expenses, such as repairs to a roof that is damaged by a storm. Savings accounts are considered liquid assets. Liquidity is a measure of the ability to turn an asset into cash quickly.

CONTINGENCY PLANNING

Contingencies are emergencies or other unplanned or possible events. For example, suppose you are driving home from work and a tire blows out. You need money to pay for a new tire, towing, or other related expenses. You may not have enough cash on hand to pay these expenses. You need to get to money quickly without borrowing (using credit and paying interest charges). Having enough savings available so that you can pay for emergencies is critical. An emergency fund is an amount of money you set aside for unplanned expenses. A fund of $500 is enough to cover many types of emergencies. You might keep this sum as the minimum in your checking account. In other words, you typically do not allow the account balance to fall below $500. However, you can spend that $500 in case of an emergency.

VACATIONS

Taking vacations is a healthy thing to do. Many people want a break from time to time—to get away from the usual stresses in life. A vacation also helps refresh tired minds and bodies so that people are ready to go back to school or work. Vacations can be simple and inexpensive, such as going camping or hiking. Vacations can be elaborate and expensive, such as flying to Europe for a 2-week stay in a resort. Setting aside money for vacations allows you to plan for the kind of vacations you would like to take. One type of plan might involve taking short and inexpensive vacations for 2 or 3 years and then taking one expensive vacation every third or fourth year. As you earn more (and save more), you can plan more expensive vacations.

MEETING GOALS

You may have short-term goals that saving money can help you accomplish. These goals may involve things you want to get done within the next few weeks or months. For example, you may wish to attend a wedding or go to a special event, such as a concert. You may want to buy a new car and need to save money for the down payment. To meet your goals, you may need to start setting aside money well ahead of the event.

LONG-TERM NEEDS

Both saving and investing can help meet long-term needs and wants. For example, parents may start investing money when a child is young to pay for the child's college education. Many people want to own a home. They may save money for a down payment and then buy a house as an investment. Everyone needs to think about retirement and how to pay for expenses when no longer working.

In Chapter 4, you learned about basic needs (such as food and shelter), other needs (such as education and transportation), and wants (such as a vacation trip). You also studied how to create a financial plan. Such a plan has personal goals that relate to your wants and needs. Your financial goals relate to the money or assets needed to achieve personal goals. The plan includes a timeline for each goal. Selecting saving and investment options can be an important part of creating a financial plan. To think about your needs and goals, you could create a plan (see chart to the right). The plan should list short-term and long-term goals and set a timeline for meeting each goal. You should also think about how much money you will need and how to save or invest for each goal. The amount that an investment grows is called the return. You may need to choose investments with a high rate of return to meet your goals.

Personal Goal	Financial Goal	Steps to Take	Timeline
Short-Term Goals			
Take a camping trip next summer	Own camping gear and have money for transportation and supplies	Save $50 per month	6 months
Attend a concert in a nearby city	Have money for a ticket, hotel room, food, and transportation	Save $75 per month	4 months
Long-Term Goals			
Travel in a motor home	Own a motor home and have money for gas and traveling expenses	Invest $200 per month at a high rate of return	10 years
Swim in my own pool	Have a swimming pool constructed at my home	Invest $125 per month at a high rate of return	6 years

EDUCATION

College expenses can be met with a plan that includes loans, scholarships, spending savings or money from investments, and working. Many students work during the summers and save money to pay for some of their college expenses. Some students work part-time and go to school full-time. Others work full-time and go to school part-time. Working to help pay for college lowers the amount of money you may need to borrow. You could start saving now to have money for this need. Parents of young children can invest money that will grow while the children grow. Money from the investment can be used to pay for education when the children reach college age.

BUYING A HOUSE

A house can be a good investment that grows in value over several years. Buying a house may require using savings. Savings may be used to buy a home or to make a down payment on a home. Many lenders require buyers to make a down payment of 5 percent or more of the purchase price when buying a house. For example, suppose you buy a house for $180,000. You may be required to have a down payment of $9,000 to get a loan for 95 percent of the purchase price. You may need to save money for a few months or years to have the down payment amount. You may also need to save money to pay for closing costs on a home mortgage.

PROVIDING FOR A FAMILY

Many people plan to have children in the future. These people need to plan for the expenses involved in raising children. Housing, food, clothing, medical care, and child care are examples of expenses parents must meet for at least 18 years. According to a U.S. Department of Agriculture report, a parent in the United States can expect to spend about $130,000 or more to raise a child from birth through age 17. Having children will affect daily living expenses, vacations, and even how parents plan for retirement. For example, when children are young, parents need life insurance to take care of their children's needs if something happens to the parents. As children get older, plans shift to providing the children with money for education and helping them get started living on their own. When children are adults and leave home, many people move into a new phase of their lives. This often involves retirement or part-time work, moving to a smaller house, or moving to a different area. Investments made during a person's working years can help provide money for activities in later life.

FINANCIAL SECURITY

Financial security is the ability to prepare for future needs and meet current expenses to live comfortably. For most people, financial security is built on saving and investing. It means having enough resources so that you will have enough to eat, proper clothing, a safe and comfortable place to live, medical care, and other items that you need. Government agencies and other organizations provide information about financial security online. People desire to be financially secure throughout their lives. For many people, however, financial security must be built over time. When you first begin working and living on your own, you may need to spend most of your earnings to cover current expenses. As you save and invest, you start to build the resources that will provide for your future security.

RETIREMENT PLANNING

Many people want to retire from working full-time and enjoy more leisure time. They may want to take more vacations and see new places. They also want to be able to live comfortably without worrying about how their bills will be paid. Some people want to retire as soon as they can afford to do so. Others enjoy their work or need the money earned and want to work as long as they can. Retirement planning should begin the day you start working. You can begin thinking about retirement even earlier, as you choose a career. Think about what you would like to do and how you would like to live when you retire. Then think about the amount of monthly income you will need to support this lifestyle. Many people, especially the elderly, require long-term medical care at some time during their lives. Retirement plans should include how to pay for long-term care if it is needed. You should begin saving and investing money for retirement at a young age. The sooner you begin investing, the longer your money will have to grow.

10-2 Saving and Investing Principles

OBJECTIVES

- ***Discuss the concept of risk versus return.***
- ***List some types of risk that savers and investors may face.***
- ***Describe the possible tax advantages of long-term saving and investing.***

GROWTH OF PRINCIPAL

When money is set aside for savings, it should be growing. That is, the principal amount on which interest is computed should get larger over time. The principal grows when you deposit more money into the account. The principal can also grow through compounding interest. With compound interest, the interest amount is calculated for the first period. For example, the period might be 1 month or 1 year. The interest amount is added to the principal amount that was deposited in the account. This becomes the new, higher principal amount. Interest is calculated on the adjusted principal amount for the next period. This cycle continues, with the interest being added to the previous principal amount each time the interest is calculated. As the principal increases over time, the value of the investment grows.

RETURN ON INVESTMENT

When you put money into savings or an investment, you expect the value of the savings or investment to grow. The amount that the savings or investment grows is called the return. Return on investment (ROI) is a measurement of return given as a percentage. ROI tells how much you will receive, either in cash (such as interest on a savings account) or in increased value (such as with real estate). When you compare the ROI on several investment options, you can pick the one that has the highest return. Computing ROI is simple. To find the ROI, divide the amount you gained (either in interest or in increased value) by the amount you invested. The gain could also include other amounts you received, such as dividends. A dividend is money paid to stockholders when a corporation makes profits. When you compare the ROI for different investment choices, you can see which has the best return. Based on the return and the risk involved, you would choose an investment option.

RISK AND RETURN

When selecting an investment, the buyer must weigh the risk involved against the possible return expected. The higher the risk you are willing to take, the greater your possible return may be. If you are not willing to take much risk, then you cannot expect high returns. Risk-free investments are guaranteed by the U.S. government. For example, savings accounts that are insured by the FDIC have no risk. As a result, the guaranteed rate of interest is low compared to rates for other investments. Other ways of saving and investing have more risk. As the risk rises, so does the possibility of a high return.

The ideal investment would have all of these features:

- The principal is safe (no risk).
- The rate of return (earnings) is high.
- The investment is liquid (you can get your money quickly without a penalty).
- You can invest quickly and easily.
- There are no costs of investing, and you can buy in with small amounts.
- The investment is tax-free (both the earnings and the long-term gains) or tax-deferred.

Unfortunately, there are no investments that meet all of these criteria. So you must decide how much risk you are willing to take and what rates of return will meet your goals.

INVESTMENT RISK

Investment risk (also known as financial risk) is the potential for change in the value of an investment. For example, when you buy stock in a company, you risk having the stock price fall. If the company goes out of business, the stock may become worthless. In this case, you may lose the money you invested. The value of an investment can go up and down over time. Poor management or unexpected events may affect how well a company performs. For example, a company may discover that a product must be recalled because it is defective. Replacing the product or paying consumers for the recalled product may cost the company a lot of money. When this happens, the price of the company’s stock may fall. Your investment may temporarily lose value. The price of the stock may go up again when the company announces the release of a new product. These changes in stock prices are to be expected. Natural disasters may also affect the value of an investment. When a storm, earthquake, hurricane, or flood occurs, it creates damage. The event may destroy crops, buildings, businesses, and lives. A disaster can cause prices to rise or fall. If crops are destroyed, stock prices for companies in that industry may fall. Shortages caused by these events may lead to prices rising in some industries. Other industries benefit because work is created in rebuilding or repairing damage. Few investments go up in value all of the time. With investment risk, you are looking for investment choices that, on the whole, go up more than they go down. The goal is to have your investments be worth more at the end of the year than they were at the beginning of the year.

INFLATION RISK

When prices are rising rapidly in the economy, your investment may lose value. Inflation risk is the chance that the rate of inflation will be higher than the rate of return on an investment. When this occurs, your investment loses value. For example, assume you bought a bond. A bond is a debt instrument that is issued by a corporation or government. The issuer must pay the bondholder the principal (the original amount of the loan) plus interest when the bond matures. Suppose the bond has a fixed interest rate of 5 percent. If inflation is lower than 5 percent, your investment is holding its value. If inflation rises to 7 or 8 percent, however, your investment is losing value. Even though you may have more dollars, you will not be able to purchase as many goods or services with those dollars.

INDUSTRY RISK

Industry risk is the chance that factors that affect an industry as a whole will change the value of an investment. For example, suppose you invest in a company that is in the oil industry. If oil prices and profits are rising, then your investment is likely to gain in value. If alternate energy sources are found, however, then investments in the oil industry could lose value. People might start buying other types of fuel, and the price of oil could drop. Industry risk occurs in all types of businesses.

POLITICAL RISK

Political risk is the chance that an event in politics (laws, policies, wars, or elections) will affect the value of an investment. For example, when a new President is elected in the United States, the stock market sometimes reacts positively, and stock prices go up. One political party may seem to be more pro-business than another. When candidates from this party are elected, stock prices may rise. The opposite may also be true. Political events in this country, as well is in other countries, affect markets. Wars, terrorist activities, and radical shifts in governments can affect markets significantly. When the news is good, stock prices tend to rise. When the news is bad, prices tend to fall. Political events are out of your control. However, you must consider how political events will affect your investment choices. Some investments are more vulnerable than others.

STOCK RISK

Stock in a company can go up or down in value. Stock risk (also known as market price risk or volatility) is the chance that activities or events that affect a company will change the stock price of that company. For example, the employees of a company might go on strike. When this happens, fewer products may be produced than planned. Sales and income may be lower than expected. This may cause the price of the company's stock to fall. During later periods, the company may do well, and stock prices may increase. Many companies do not perform well all of the time. Companies that show steady growth and strong overall performance over time are good investments.

TAX ADVANTAGES

When you set aside money for future retirement, such as in an IRA (individual retirement arrangement), the money may be tax-deferred. Tax-deferred means that there are no taxes on gains until the money is taken from the account. Also, you may not have to pay taxes on the amounts placed in the account until later. This tax advantage allows your investment to grow for years without being taxed. When you retire and take money from the account, you may be in a lower tax bracket. You are taxed only on the portion you take out of the account. Some savings and investments are tax-free. For example, interest earned on Series EE and Series I U.S. savings bonds is tax-free in some instances if it is used for education. Information about the tax benefits of U.S. savings bonds is provided online. Interest earned on municipal bonds (bonds issued by local cities and counties) may be free from federal income tax. Tax-free choices protect your gains and earnings. People with higher incomes may choose tax-deferred or tax-free investments because their tax rates are high. Suppose a person is in a 35 percent tax bracket. That means each dollar earned is taxed at this rate. If $1,000 is earned on an investment, $350 is paid in tax. If, however, this person invests in a tax-free bond and earns $1,000 in interest, there is no tax. Thus, interest rates on tax-free choices are often lower than market rates. However, the tax-free investment may be the better choice.

10-3 Saving and Investing Strategies

OBJECTIVES

- ***Explain how to use a systematic strategy for saving and investing.***
- ***Explain the dollar-cost averaging strategy.***
- ***Explain how a diversification strategy can lower risk.***
- ***Explain the difference between a bull market and a bear market.***
- ***Discuss buying and selling strategies in times of economic growth and decline.***

SYSTEMATIC SAVING AND INVESTING

Systematic means regular, orderly, or done according to a plan. Systematic saving is a strategy that involves regularly setting aside cash that can be used to achieve goals. Once money is set aside in savings, ideally it should remain there until used to meet a planned goal. The amount should be the most you can comfortably afford to save each pay period. Some people find it convenient to have a set amount withheld each month from their paychecks. Others make a monthly payment to a savings plan, just like paying a bill. Some people find that they can set aside a portion of any raise they receive at work. That way, the amount is not money they depend on to meet current expenses.

Systematic investing is a strategy that involves a planned approach to making investments. For example, when you first start investing, you may wish to buy safe and liquid investments. In later years, you may want to take more risk so your principal can grow faster over time. When you get extra cash, such as a bonus, you might wish to buy a high-risk investment in the hope of getting high returns. Systematic saving and investing is important for building financial security in the long term.

LONG-TERM FOCUS

A saving and investing plan is designed for growth in the long run, not for short-term results. Investors may need to hold investments for 20 or more years to get the returns they want. In any given year, investments may actually lose money. Over time, however, gains exceed losses on sound investments. For example, suppose investments in the stock market have grown at an annual rate of more than 7 percent over any 20-year period of time. This does not mean that, in any given year, stocks earned 7 percent. In fact, in some years, the return may have been very low. In other years, the return may have been more than 20 percent. Investors must plan to hold investments for the long term to achieve substantial growth over time. As a young person, you should set investing and savings goals that focus on the future. You can track prices of stocks and other investments using Internet sites. Stock prices are also shown in many newspapers. You might want to track a stock that interests you for several weeks to see how much the price changes.

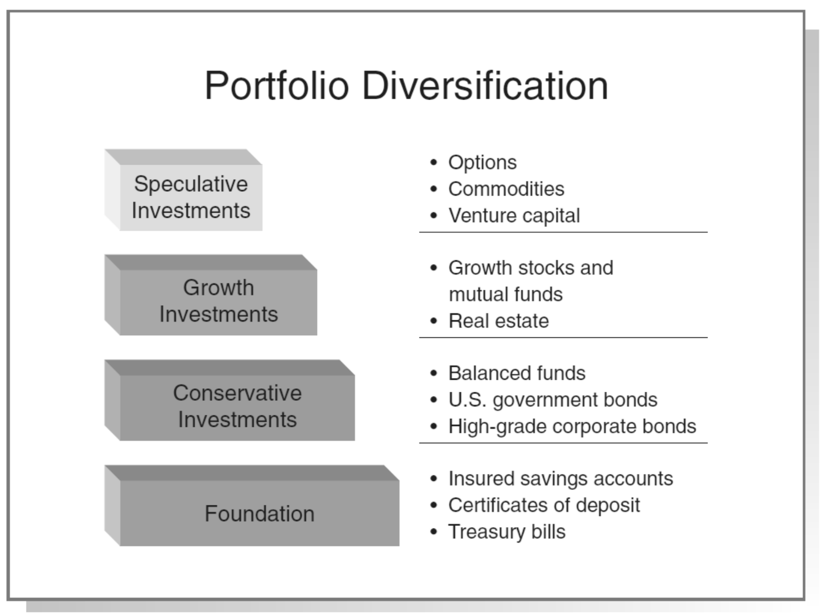
DOLLAR-COST AVERAGING

One strategy for buying stocks or other investments is dollar-cost averaging. With dollar-cost averaging, a person invests the same amount of money on a regular basis, such as monthly. The amount is invested regardless of whether prices are high or low. Sometimes the investor pays more and gets fewer shares. Sometimes the price is low and more shares are purchased. Overall, the dollar cost per share may be less than the average price. Using this strategy, investors do not have to study the stock market and try to determine the best time to buy stocks.

DIVERSIFICATION

Diversifying is a very important saving and investing principle. Diversification is holding a variety of investments for the purpose of reducing risk. When one type of investment goes down in value, there may be others that go up. Thus the losses of one area are offset by the gains in others. It is important for investors to choose more than one type of investment. This is to avoid "having all your eggs in one basket." If a company fails, the investor could lose everything if he or she has only that one investment.

All of a person's savings and investments make up that person's investment portfolio. An investment portfolio is a collection of assets, such as certificates of deposit, stocks, bonds, real estate, and other holdings. In order to lower risk over time, the portfolio should be diversified. A portfolio should have a strong foundation of safe investments. For example, insured savings accounts and certificates of deposit are safe investments. The portfolio should have some relatively safe, low-risk investments. These might include U.S. bonds and conservative mutual funds. A mutual fund is operated by a professional investment firm. The firm sells shares in the mutual fund and invests the money in a variety of stocks, bonds, and other investments. Mutual funds have specific objectives, such as growth (high earnings) or balance (good earnings with acceptable risk). Mutual funds allow investors to have diversified holdings within one investment.



A portfolio could include some higher-risk choices that have the potential for high returns. Growth stocks and real estate are examples. Some people also include speculative investments. These options have high earnings potential. However, they are also high-risk. For this reason, some people include only a few or no speculative investments in their portfolios. Over time, the portfolio should gain in value at a rate greater than the rate of inflation. Each investor must decide how much of each type of investment to include. A sample portfolio is shown to the right. Investment choices will vary based on the person's age, income, family situation, goals, and attitude toward risk. You will learn more about various types of investments in Chapter 11.

UNDERSTANDING THE MARKET

Having a basic understanding of the market will help you make better investing decisions. The market refers to any place where investments are bought and sold. There are stock markets and bond markets. There are real estate markets and markets for precious metals such as gold and silver. For most things that an investor may want to buy or sell, a market exists. The term market is also used to refer to price levels or other market conditions. For example, the statement "The market was off today" may mean that prices in the stock market were low compared to prices on other recent days.

BULL MARKET

A bull market exists when stock prices are steadily increasing. A bull market may last a few months to a few years. During a bull market, price advances are often followed by profit-taking. Profit-taking occurs when people who own stocks that have increased in price sell those stocks. This selling activity may cause prices to drop for a while. The bull market does not end, however, because a few stocks drop in price. As long as the general trend is toward increasing stock prices, it is still considered a bull market. When prices are rising, this may be a good time to sell certain stocks. Suppose a company in which you have stock has been performing poorly in recent months. This could be a sign that the company is poorly managed. It could mean that the demand for products that this company makes is falling. There could be some other problem that you do not know about. If stock prices in the market overall are rising, the price of this one stock may also go up. This could be a good time to sell a stock that you expect to do poorly in the future.

BEAR MARKET

A bear market exists in the stock market when prices are steadily decreasing. Bear markets may last from a few months to a year or more. This is a good time to buy stocks that are sound investments because prices are lower. At times in a bear market, there is a lot of buying activity. This can cause a temporary rise in stock prices. The bear market does not end, however. As long as the general trend is toward declining stock prices, it is still considered a bear market.

ECONOMIC CONDITIONS

Investors should consider economic conditions when forming an investment strategy. There will always be the rising and falling of the economy that causes prices to rise and fall. It is a normal part of the market and how it works. When the economy is in a period of general growth, the market for many investments is growing. Economic growth is often defined as a period of time when people are working (low unemployment rate), profits are good, wages are rising, and people are optimistic. When a company's profits are rising, its stock prices often rise as well. When this happens with many companies, overall prices in the market rise. Investors who think that the market will continue in a growth trend may choose this time to buy stocks. They think the stocks will grow in value. Investors who think the growth trend is about to end may choose this time to sell stocks. They want to sell at the current high prices before the market begins a downward trend.

When the economy is in a period of general slowdown, the market for investments is declining. Prices may be falling. Economic decline can be a good time to buy stocks that you think are sound investments. You can buy while prices are low. This increases your chance of making profits when you sell at some future date. Some investors think it is important not to spend (or invest) everything during an economic growth period. Instead, they wait for a period of decline and buy then, taking advantage of lower prices.

FOCUS ON: Market Timing

In investing, the old saying goes, "Buy low, and sell high." The question is, How do you know when prices have reached their lowest point (so you can buy)? How do you know when prices have reached their highest point (so you can sell)? The answer is simple. You do not know; you can only make an educated guess. To be good at investing, you have to choose timing principles that you follow. For example, you may own a certain stock or another investment and check it every day or week to see what its price is. When you see a downward trend in price, it might be the time to sell. Some experts say, however, that when prices are falling, that is the time to buy stocks that you think are a sound investment. You can get more shares of stock for less money when you "buy low." When prices for stocks that you own are rising, this may be the time to sell. If you have owned the stocks for a long time and they have gained in value, you can take some of the profits by "selling high." When to buy and when to sell is up to each investor. Some people leave those decisions to the experts. They buy shares in a mutual fund rather than buying individual stocks or other investments. Experts at the investment firm decide when to buy and sell the individual investments that make up the fund.

Chapter Summary

- ***The purpose of saving is to accumulate money for future use with an emphasis on safety of the money. The purpose of investing is to use money to make more money. The emphasis is on growth with acceptable risk.***
- ***Saving and investing begin with meeting short-term needs, such as emergencies, vacations, and current goals.***
- ***Liquidity is the ability to turn an asset into cash quickly and without penalty.***
- ***To meet long-term needs, such as building financial security, you must plan carefully for saving and investing.***
- ***The principal amount of an investment can grow when you add more money to your investment. It can also grow through compounding interest.***
- ***Return on investment (ROI) is a measurement of return given as a percentage. Looking at ROI allows you to compare investment choices.***
- ***Risk and return are related: the more risk you are willing to accept, the higher the return you may be able to earn.***
- ***All investors take risks such as investment risk, inflation risk, industry risk, stock risk, and political risk.***
- ***Saving and investing can provide tax advantages when gains are tax-free or tax-deferred (taxed later).***
- ***Systematic saving is a strategy that involves regularly setting aside cash that can be used to achieve goals according to a planned investment schedule.***
- ***A saving and investing plan is designed for growth in the long run, not for short-term results.***
- ***Using a dollar-cost averaging strategy, a person invests the same amount of money on a regular basis regardless of market conditions or prices.***
- ***Diversification means owning a variety of investment choices to lower risks. A portfolio is a collection of these choices.***
- ***The market refers to any place where investments are bought and sold.***
- ***In a bull market, prices are steadily increasing over time. In a bear market, prices are steadily decreasing over time.***
- ***Economic growth often leads to rising prices and increased buying.***
- ***Economic decline often leads to falling prices and decreased buying.***
- ***Both conditions can present good opportunities for investors.***