Before You Begin

Learning Outcomes

Once you've completed this chapter's videos, you will be asked to return to this list and place a checkmark next to the items you've mastered.

Section 1: Investing 101

- ☐ Explain how investing builds wealth and helps meet financial goals.
- ☐ Examine the relationship between diversification and risk.
- ☐ Identify regulatory agencies and their functions.

Section 2: Types of Investments

Evaluate investment alternatives: money markets, bonds, single stocks, mutual funds, annuities and real estate.

- ☐ Explain the Rule of 72.
- ☐ Identify different types of retirement plans.
- ☐ Explain how taxes affect the rate of return on investments.
- ☐ Understand how pre-tax and after-tax investments work.
- ☐ Understand how the stock market works.
- ☐ Be familiar with the various retirement account tax treatments.
- ☐ Develop a plan for investing; describe how to buy and sell investments.

Section 3: Employer Benefits & Retirement Plans

- ☐ Analyze the components of an employer benefits package.
- ☐ Explain how compound interest works.

Key Terms

Get to know the language of money.

» **Diversification:** The practice of dividing the money a person invests between several different types of investments in order to lower risk

» **Investing:** The process of setting money aside to increase wealth over time for long-term financial goals such as retirement

» **Investment:** Account or arrangement in which a person puts his/her money for long-term growth; invested money should not be used for a suggested minimum of five years

» **Liquidity:** Quality of an asset that permits it to be converted quickly into cash without loss of value; availability of money

» **Portfolio:** A list of your investments

» **Risk:** Degree of uncertainty of return on an asset; in business, the likelihood of loss or reduced profit

» **Risk-Return Ratio:** Relationship of substantial reward compared to the amount of risk taken

» **Share:** Piece of ownership in a company, mutual fund or other investment

» **Stocks:** Securities that represent part ownership or equity in a corporation

» **Tax-Favored Dollars:** Money that is invested, either tax deferred or tax free, within a retirement plan

Measure Your Progress

Before watching the video, read each statement below and mark whether you agree or disagree in the "Before" column. Then, after watching the video, do it again using the "After" column to see if you changed your mind on any statement.

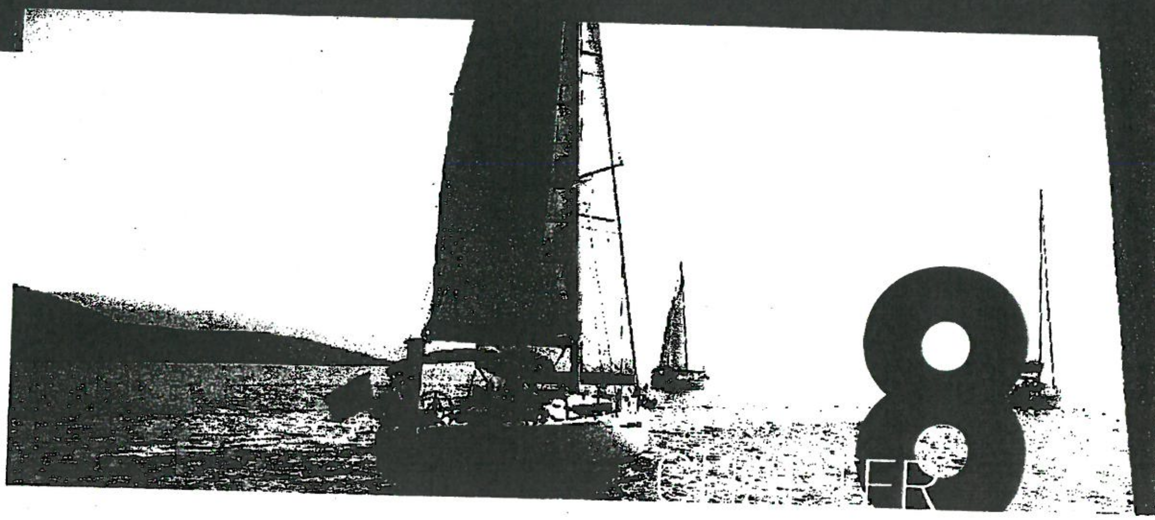
BEFORE			AFTER	
Agree	Disagree		Agree	Disagree
☐	☐	1. You can start investing with a small amount of money.	☐	☐
☐	☐	2. The more sophisticated the investment, the more money you get in return.	☐	☐
☐	☐	3. With virtually all investments, as the risk goes up, so does the potential return.	☐	☐
☐	☐	4. It's difficult to find an investment with a long-term record that averages 12%.	☐	☐
☐	☐	5. It is okay to borrow money if you are going to invest it.	☐	☐

List your initial thoughts about investing. What do you want to learn about investing?

____

____

____



NGS TO CONSIDER
smartest investment
can make is in yourself.
young adult, you
ıld have two goals:
inue your education
stay out of debt.

: 79% of American
ınaires use brokers
idance, they make
ɔwn investment
ons.
lionaire Next Door

Section 1: Investing 101

5 THE FIFTH FOUNDATION
Build Wealth and Give

REMEMBER, the goal is to build wealth. You can and should save money for your emergency fund and for purchases. Then, once you're sure that you have your post-secondary education paid for, you should begin to invest a portion of your income. How does investing build wealth? Investing allows your money to work for you. You'll be amazed at how your money, when invested wisely, can begin to grow!

Investing will help you reach your long-term financial goals, such as retirement. In this chapter, we are going to give you the tools to achieve lifelong financial well-being.

Basic Rules of Investing

» **Keep it** Simple**, stupid!** Investing doesn't have to be complicated, and there is really no trick to it. Never invest money in anything you do not understand!

As a young adult, what is the most important thing you can invest in?

____

____

____

THROUGHOUT THE STOCK MARKET'S HISTORY

100% of 15-year periods made money.

Basic Rules of Investing *(Continued)*

» **Never invest purely for** tax savings**.** If what you are investing in is primarily a tax deal, then it is probably not a good investment. Your motivation should be to make money, not save on taxes.

» **Never invest using** borrowed **money.** Never borrow money, period. Borrowing money is a particularly bad idea for an investment because it increases the risk of the investment. And if you lose the money, you are still left with payments on it.

"Diversification is a protection against ignorance."

WARREN BUFFETT
Famous American investor

People with a bachelor's degree or higher unemployment r that are about half the unemployment rate of people with just a high school diploma.

Bureau of Labor Statistics

A bachelor's degree on average increases lifetime income by $1.2 million as compared with a high school diploma.

Journal of Student Financial Aid

Diversification

Here's the thing to remember: Money is like manure. Left in one pile, it stinks—spread around, it will grow things."
DAVE RAMSEY

» Diversification is a risk-management technique that mixes a wide variety of investments within a portfolio. The rationale behind this technique is that having a variety of investments will yield higher returns and lower risk.

Risk Return Ratio and Liquidity

» The risk return ratio is used by investors to compare the expected return of an investment to the amount of risk they take to get the return. This ratio is calculated mathematically by dividing the amount you stand to lose if the price goes down (risk) by the amount of profit you expect to make (return). With virtually all investments, as the __risk__ goes up, so does the potential return.

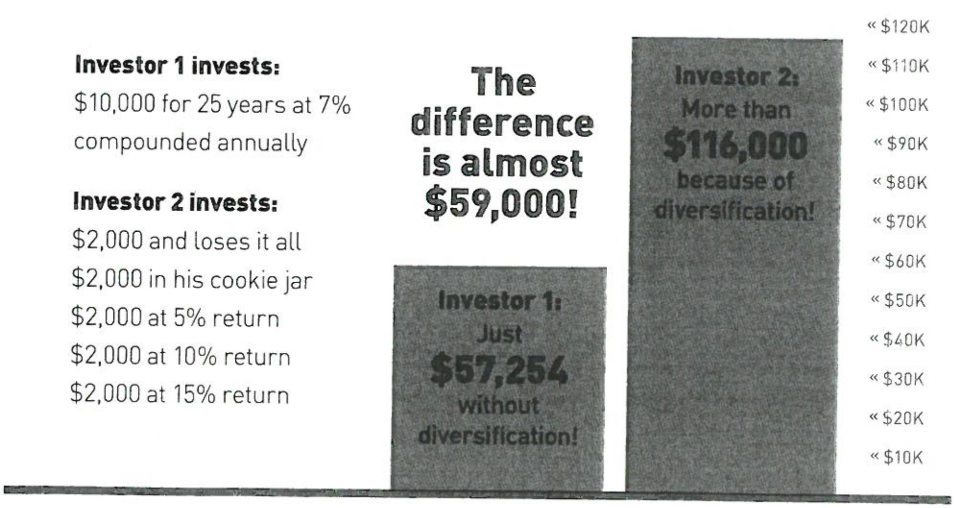
» Liquidity refers to assets that can be easily bought or sold (liquid assets). When discussing investments, __liquidity__ is availability. As there is more liquidity, there is typically __loss__ return.

The Power of Diversification

What would happen if two people each invested $10,000—one diversifies, the other does not—and left it alone for 25 years?

Investor 1 invests:
$10,000 for 25 years at 7% compounded annually

Investor 2 invests:
$2,000 and loses it all
$2,000 in his cookie jar
$2,000 at 5% return
$2,000 at 10% return
$2,000 at 15% return



If you were giving advice to a friend, what would you say are the most important things to know about investing?

____

____

____

Section 2: Types of Investments

Money Markets

» A market in which short-term financial instruments such as certificates of deposit (CD), Treasury bills, commercial papers and bank deposits are traded. New York is the major money market, followed by London and Tokyo.

» A CD is a certificate of deposit, typically at a bank. It is a savings account with a slightly higher interest rate because of a longer savings commitment (i.e. six months, one year, etc.).

» A money market account is a low -risk bank savings account with check-writing privileges.

U.S. SECURITIES AND EXCHANGE COMMISSION (SEC): The government agency responsible for regulating the stock market. It was created in 1934 to increase public trust after the 1929 stock market crash and the years of the Great Depression.

FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC): The U.S. federal agency that insures deposits in commercial banks. It was created to restore public trust in banks after the 1929 stock market crash. FDIC replaced the former Federal Savings and Loan Insurance Corporation in 1989.

FEDERAL RESERVE: The central (federal) banking system of the United States

INTERNAL REVENUE SERVICE (IRS): A U.S. federal agency responsible for collecting taxes and for the interpretation and enforcement of the Internal Revenue Code (laws)

E STUDY
y, a bright young man, fresh out of college
ı Bob approached vith an investment rtunity that sounded ood to pass up.

ot some property on ential oil field," Bob "For only $750 you uy a share of the You'd be crazy not to on this investment." ın expert salesman, ised Harry would ne rich and sealed al with a simple l: "Harry, this is a way to diversify your lio."

r, after umped arry still hadn't ny money from /estment." It turns t Bob was offering o land that he ıave the right to amming people by "phantom shares." risky attempt to y cost him $750.

ould have ed if he had put ney in a mutual h a 12% return ? He would now 2,469.

Money Markets *(Continued)*

» These are great for your emergency fund due to their **liquidity** (accessibility) and **stability.**

» Money market investments are low-risk, and therefore, have low returns.

Single Stocks

» Single stock investing carries an extremely high degree of risk.

» When you buy stock, you are buying a small piece of ownership in the company.

» Your return comes as the company increases in value or pays you, its owner, some of the profits (dividends).

Bonds

» A bond is a debt instrument by which the company owes you money; a form of I.O.U. The company that issued the bond makes regular interest payments to the bond holder and promises to pay back or redeem the face value of the bond at a specified point in the future (maturity date).

» Your return is the fluctuation in price and the interest rate paid.

» Few individuals do well with single bond purchases.

» Examples include **Treasury bonds** (a bond issued by the U.S. government that bears fixed interest) and **savings bonds** (in the United States, a bond that can be bought from the federal government).

» Bonds are typically low risk and low return on investment.

Explain why single stocks carry a high degree of risk.

____

____

____

WAR BONDS (ALSO KNOWN AS DEFENSE BONDS): The last time the United States issued war bonds was during World War II. Issued by the U.S. government, they were named war bonds after the Japanese attack on Pearl Harbor, Dec. 7, 1941. The purpose of war bonds was to finance military operations during war time. The bonds yielded a mere 2.9% return after a 10-year maturity.

DIVIDEND: Distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders; generally distributed in th form of cash or s

Mutual Funds

» A mutual fund is an investment vehicle made up of a pool of ___money___ collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets.

» Portfolio managers manage the pool or ___fund___ and attempt to increase the value of the fund in order to produce capital gains and income for the fund's investors.

» A mutual fund portfolio is structured and maintained to match the investment objectives stated in its prospectus.

» Your ___return___ comes as the value of the fund is increased.

"October. This is one of the peculiarly dangerous months to speculate in stock. The others are July, January, September April, November, May, March, June, December, August, and February."

MARK TWAIN
American author

TANDARD
RSIFICATION PLAN

rowth Stock Mutual
Mid-Cap): Fund that
tock in medium-
ompanies that have
enced some growth
e still expanding

owth and Income
Mutual Fund (Large-
und comprised of
vell-established
ies

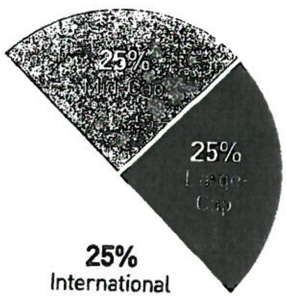
gressive Growth
utual Fund
Cap): Fund that
provide maximum
m capital growth
cks of primarily
es; the

rnational Stock
und: Fund that
international or
companies

Mutual Funds *(Continued)*

» The main advantage of mutual funds is that they give small investors access to professionally managed, diversified portfolios of stocks, bonds and other securities.

» Mutual funds are good long -term investments.



» A mutual fund portfolio that is properly diversified will have investment dollars spread equally among four different classes of financial assets. Remember, the overall diversification of your mutual fund portfolio means lower risk. We recommend 25% in each of these four classes. Compared to other investments, if you use this strategy, you would have moderate risk.

Which are a better investment, stocks or mutual funds? Explain your answer.

____

____

____

Qualified Plans

A **qualified plan** is a tax-favored investment (which means it has special tax treatment).

Examples of qualified plans include:

Individual Retirement Arrangement (IRA)

When it comes to IRAs, everyone with an earned income is eligible.

Remember: IRA is not a type of investment at a bank. It is the tax treatment on virtually any type of investment.

Roth IRA

» The Roth IRA is funded with after-tax money, which allows you to use the money in your Roth tax free in retirement.

» After five years, you can make tax-free, penalty-free withdrawals of earnings under these conditions:

1. Over 59 and a half years old
2. Because of death or disability
3. First-time home purchase

Investing money pretax is different than investing money after tax. There are no taxes when you cash out a Roth, so it forces you to invest more.

✱ **NOTE:** There are limits (based on total household income) to the annual contribution amounts. These amounts can change based on inflation. Go to **foundationsU.com** to check out the current contribution phase-out limits. As an adult, you should invest 15% of your household income into Roth IRAs and pretax retirement plans.

KNOW THE RULE OF 72! The Rule of 72 is a quick way to calculate the length of time it will take to double a sum of money. Divide 72 by the expected interest rate to determine the number of years (i.e. 72 divided by 8% = 9 years).

THE ROTH IRA is named for Sen. William Roth of Delaware, who authored this section of the Taxpayer Relief Act of 1997.

Make the Most of Your Inheritance

"I'm 21 and currently in college. Next month, I'll be receiving an inheritance of about $40,000. I don't know anything about stocks, mutual funds or CDs, but I don't want to lose all this money. I don't have any debt, so what should I do?"

DAVE'S ANSWER: I'm glad you're asking questions. One of the fastest ways to lose money is to put it into an investment that you don't understand.

You don't need to change your major to finance to make this happen, but you do have a $40,000 responsibility that you didn't have before. For now, a simple savings account is fine. I'd park $30,000 in there and just forget about it for a while. Then use $5,000 to set up an emergency fund and maybe blow $5,000 on some things just for you. After all, spending and having fun with money is still important!

But here's something to think about once you've educated yourself on investing. If you put that remaining $30,000 in a good growth stock mutual fund, by the time you're ready to retire you'll be looking at about $5.5 million.

Talk about being able to retire with dignity and change your family tree!

IN SAVINGS
PLAN]: A savings
ted by a state
nal institution
help families set
for future college
named after
of the Internal
de, which created
of savings plans

RRED: The
age of stashing
tax-deferred
account isn't
u'll pay less to
nent this year,
r investments
und faster than
account. The
ually a larger
nest egg even
ds are taxed
awal.

Annuities

» An **annuity** is a Savings account sold by an insurance company, designed to provide payments to the holder at specified intervals, usually after retirement.

» The holder is taxed at the time of distribution or withdrawal, making this a tax-deferred arrangement.

» Fixed annuities have a low interest rate of around 5%; they have high fees and are a bad investment option.

» Variable annuities are mutual funds sheltered by the annuity, which allows the mutual fund to grow tax deferred

Real Estate

» You should have lots of cash before using real estate as an investment. Real estate is usually held as part of a larger portfolio and is generally considered an alternative investment.

» Real estate is land plus anything permanently fixed to it, including buildings and natural resources.

» Real estate is the least liquid consumer investment.

» Benefits of investing in real estate include higher returns for a given level of risk. By adding real estate to a portfolio, you could maintain your portfolio returns while decreasing risk.

» Another benefit of real estate is your ability to influence its value. As a tangible asset, an investor can increase the value of the property through a variety of improvements.

» Other special considerations when investing in real estate:

- It is costly to buy, sell and maintain.
- It requires management.
- It can be difficult to acquire.
- The investment market is cyclical based on supply and demand.

62% of those who make financial investments rarely change their strategy.

Survey by 24/7 Wall St./Harris

ULATIVE:
ıasing risky
:ments that present
ıssibility of large
s, but also post a
r-than-average
ɔility of loss

Horrible Investments

» **Gold**: Gold has a 50-year track record of 4.1% returns. That's about the rate of inflation.

» **Commodities**: Commodities are agricultural or mining products. All commodities are traded, but since no one really wants to transport all those heavy materials, what is actually traded are commodities *futures contracts*—an agreement to buy or sell a commodity at a specific date in the future at a specific price. Both commodities and futures are bad investments because they result in price distortions and are highly volatile.

» **Day trading**: This is the buying and selling of stock purchases each day through the practice of **speculation**. Evidence shows the vast majority of investors lose money in day trading.

» **Viaticals**: This is when someone with a terminal disease sells his life insurance policy for less than face value. The buyer then cashes in the full amount at the original owner's death. There are a lot of scam artists surrounding this type of investment, and investors often incur legal risks.

What Is the Stock Market?

The stock market is a generic term that encompasses the trading of securities. This trading takes place in stock exchanges. There are three major stock exchanges in the United States:

1. Formed in 1792, the New York Stock Exchange (NYSE) is the largest organized stock exchange in the United States.

2. The American Stock Exchange (AMEX) was known before 1951 as the American Curb Exchange. That's because trading was conducted on the curb of Wall and Broad streets in New York City. The American Stock Exchange has less stringent listing requirements than the NYSE, so it attracts many smaller companies.

3. Another of the major stock exchanges, NASDAQ stands for the National Association of Securities Dealers Automated Quotation System. Unlike the NYSE and the AMEX, there isn't any physical location for the exchange; trading is done by computer. The American Stock Exchange and NASDAQ have merged but maintain their own names and identities.

The overall performance of the stock market is evaluated in many different ways. **The Dow Jones Industrial Average** is one measure of the stock market.

A **security** is a financial asset (such as a stock or bond) that can be bought and sold; a tradable financial asset.

"Bear vs. Bull Market"

The terms bull market and bear market describe upward (bullish) and downward (bearish) market trends.

What is real estate? Why is it considered an investment?

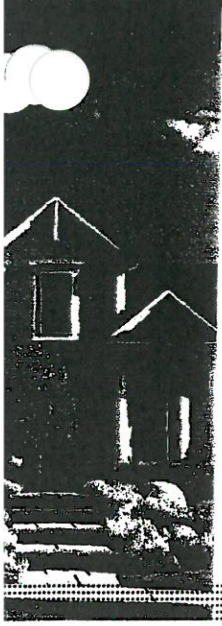
____

____

____

TIPS ON BUYING AND SELLING INVESTMENTS

1. Set your investment goals and consider a time frame (ie: getting married and buying a house, five years; having kids and buying a bigger house, 10 years; college tuition for kids, 18 years; retirement, 40 years).
2. Learn the different types of investments.
3. Choose an investment broker. Remember, they work for you! We recommend one with the heart of a teacher. NEVER invest in something you don't completely understand.
4. Understand b[illegible] investment stra[illegible] and identify ones that will help you reach your goals.
5. Build your portfolio and be sure to diversify so that all your eggs are not in one basket!
6. Stick to your investment strategy. Remember: 100% of the 15-year periods in the stock market's history have made money.



Anticipating the Future

"I am 19 years old and working in my family's business. I live at home with my parents, I'm not in college, and my car is completely paid for. How should I start saving for a house and retirement? I want to make sure I am doing everything I can to avoid financial problems in the future. What do I need to do?"

DAVE'S ANSWER: Your first goal should be to save three to six months of your income (since you don't really have any expenses). This will be your full emergency fund. Then you should save for anything you plan on doing in the next few years, like getting married or buying a home. On top of that, you should invest into a Roth IRA. The current contribution limit is $5,500 per year, which comes out to about $458 per month. You can do less than that, but not more. If you start that now, you will be extremely wealthy when you retire.

Section 3: Employer Benefits and Retirement Plans

FERENCE
...VING
NVESTING?

oney set aside
years or less is
ered saving.

set aside for
han five years is
ered investing.

As you enter the workforce, it's a good idea to be familiar with the components of an **employee benefits package**. Employee benefits are various non - wage compensations provided to employees in addition to their normal wages or salaries. The purpose of employee benefits is to increase the financial security of staff members, and in doing so, improve worker retention across the organization.

Common employee benefits are retirement plans, savings plans, insurance, leave (sick, vacation, etc.), stock purchase, educational reimbursement, incentive plans and cafeteria plans. In addition to considering salary when you are offered employment with a company, you should also evaluate the employer's benefits package.

Employer Retirement Plans

- **Simplified Employee Pension Plan (SEP):** A self-employed person may deduct up to 15% of their net profit on the business by investing in a SEP.
- 401K is a retirement savings plan offered by a corporation to its employees. The employee contributes money to the 401(k) from his/her gross pay, and the money in the account grows tax deferred. In some cases, employers will match the employee's contribution, but you should fund your plan whether your company matches or not.
- **403(b)** is found in non profit organizations such as churches, hospitals and schools.
- **457** is deferred compensation, which means you are deferring or putting off compensation. Usually this is available for government employees.
- Do not use a **Guaranteed Investment Contract (GIC)** or bond funds to fund your plan. This is like a CD inside of your 401(k). You will only make about 3–4%, and it will not help you win long term.
- **Pre-tax contributions** are taken from your gross income before taxes. Taxes are due upon withdrawal.
- **After-tax contributions** are taken from your net income after taxes. No taxes are due upon withdrawal.

WHERE DOES THE TERM 401(K) COME FROM?

401(k) refers to the section of the tax code that discusses this sort of retirement plan, as do 403(b) and 457.

NING THE LOTTERY
not guarantee peace
nd when it comes to
financial future.

t, Ellen Goodstein of
rate.com reported
ıst the opposite
ened to some lottery
ers—they went broke.

g and investing have
ıg to do with the
nt of money you make
. It is about making it
rity and being smart
our money.

Rollovers

If you leave a job and have money saved in your employer's retirement plan, always roll that money into an IRA using a direct rollover, which allows you to avoid taxes and penalties.

Retirement Loans

Never borrow on your retirement plan. *Never!* Even though you pay yourself back some interest, it is nowhere close to what you would have earned if you had left the money in the investment.

Can Anyone Become a Millionaire?

The Power of Compound Interest

Whether you have never stepped foot in a bank or you are actively saving and investing for your future, all it takes is a little effort and a lot of patience to become confident in your financial decisions. One awesome thing that you can take advantage of is compound interest. It may sound like an intimidating term, but it really isn't once you know what it means. Here's a little secret: Compound interest is a millionaire's best friend. It's really free money. Seriously. But don't take our word for it!

Let's take another look at the story of Ben and Arthur from Chapter 2. Remember that Ben invested $16,000 over eight years, and Arthur invested $78,000 over 39 years. Believe it or not, Ben came out ahead . . . $700,000 ahead! How did he do it? Starting early is the key. He put in less money but started eight years earlier. That's compound interest for you! It turns $16,000 into almost $2.3 million! Since Ben invested earlier, the compound interest kicked in sooner.

What You Can Do Now

The trick is to start as soon as possible. You should start investing as soon as you have your college education funded. A survey by Charles Schwab found that 24% of young adults believe that because they are young, saving money isn't important. Looks like we just blew that theory out of the water! That same survey also discovered that only 2% of young adults say they know how to invest money to make it grow. Why not change that statistic and learn how to become a smart investor with your money? Remember, waiting just means you make less money in the end. So get moving!

Why do you think it is important to consider both salary and benefits when applying for a job?

___

___

___

Budget Builder

So you're ready to invest? Your investment goal will need to be part of your monthly budget. Go to to update your budget!