

INSIDE

- *Saving and investing are different. Learn about the variety of options available to you.*
- *How much should you save? It depends on your goals.*
- *Learn tips about how and where to save.*
- *Evaluate your savings options to meet your savings objectives.*
- *Identify your investment objectives.*
- *Learn how to choose an investment, and where to invest.*

Before you consider an investment program, make certain you've covered the basics. Can you manage your current debt load? Do you have an adequate emergency savings fund? Does your insurance program meet your needs? If you've set a goal of owning a home, do you have the down payment? You may want to give careful consideration to a retirement program, even though that may seem far-off at the present time.

SAVING VERSUS INVESTING

Traditionally, saving has been viewed as quite different from investing. In most savings alternatives, the initial amount of capital or cash remains constant, earning guaranteed rates of interest. The "fixed-dollar" feature of savings contrasts with the "variable-dollar" nature of investments. The capital value of investments can go up or down. Returns are not guaranteed.

However, creation of money market funds and deregulation of the banking industry have resulted in a variety of savings options that earn variable rates of return.

HOW MUCH TO SAVE

Think through your reasons for saving and set specific goals. One goal may be to have some "rainy day" money put aside. Set the

amount of this emergency fund at whatever makes you feel the most comfortable. A general rule is to have two or three months' take-home pay saved for this purpose.

Other goals may be more specific, such as replacing a car or financing a child's education. Calculate how much money needs to be put aside to achieve these goals. The *Savings Plan Worksheet, Pm-1462b*, will help you determine how much to save each month to accumulate the necessary cash by a certain date.

For example, you'll need \$10,000 in five years to replace a car. You must put \$154.17 each month in a 4 percent savings account to reach your goal in five years. If you want to have \$10,000 accumulated in a college fund 10 years from now, you must save \$60 monthly at a 7 percent rate of return.

In order to achieve your goals, it's important to add to savings on a regular basis. One guideline is to save 10 percent of take-home pay each month. That goal may be unrealistic for many young families today. Perhaps saving 4 or 5 percent of your monthly income is more feasible. Once savings goals are met, excess funds can be moved from savings instruments to investments.

TIPS FOR SAVING

■ **Pay yourself first**—Consider savings as a fixed expense similar to the house payment and utility bill. Put away some money before you do anything else with your paycheck. One alternative is to have an amount automatically deducted from your paycheck and put into a savings plan. If you wait until the end of the month to save, chances are there won't be anything left. Saving in regular, smaller amounts is usually more successful than putting aside larger amounts sporadically.

■ **Save windfall income**—The theory is simple. You got along without the unexpected bonus, tax refund, overtime pay or gift, so why not keep on that way and save the extra money? A similar tip is to save monthly loan payments after a loan is repaid.

■ **Try frugality**—Cut out or cut back on eating out, entertainment, or pleasure drives. A period of frugality can help you save money quickly and perhaps eventually change your lifestyle. Once you adjust to a “no-frills” spending plan, add back just a few of your previous expenses. You may discover others weren't really necessary. Living frugally may be more satisfying than continuing past habits that left few dollars at the end of the month.

WHERE TO SAVE

Once you have decided how much to save, the next question is where. Savings options generally are characterized by low risk on the principal and high liquidity. Listed below are common savings alternatives.

■ **Savings accounts and certificates of deposit** are insured savings alternatives offered by institutions such as commercial banks, savings and loan associations, and credit unions. In addition to the traditional passbook savings account, higher yielding variable-rate accounts now are available. These are designed to compete with the money market mutual funds. Minimum deposits, interest rates, checking privileges,

and service charges vary widely on the accounts. Certificates of deposit (CDs) also vary in the requirements for minimum investment, rates of return, and length of maturity. Early withdrawal penalties are assessed if the certificates are cashed before maturity.

■ **U.S. government securities** offer low-risk savings options. Series EE and HH savings bonds, Treasury bills, notes and bonds, and federal agency bonds reach maturity within a stated number of months or years. Interest yields and minimum investments vary widely among these alternatives. Contact your financial adviser, banker, broker, or the nearest branch of the Federal Reserve for more information.

■ **Money market mutual funds** generally provide competitive rates of return and liquidity. The funds invest in money market instruments such as Treasury bills, bank certificates of deposit, and commercial paper. They are managed by private corporations that charge a small annual fee for their services. There generally is no commission charge (referred to as no “load”) for making deposits. Initial minimum deposits are commonly \$1,000 to \$2,500. Interest is compounded daily.

The rate of return varies daily, depending on the earnings from the fund's investments. Deposits are not federally insured, although the investments generally are quite safe. To the extent that the monies are held in U.S. securities, there is little risk of loss. Most funds offer a free check-writing privilege. There often is a minimum check limit of \$500.

EVALUATE SAVINGS OPTIONS

No particular savings alternative is “best” for a particular family. Maybe a combination of options would help you meet your savings objectives. Some characteristics about a savings option may be more important to you than others. To help you find out, here are some questions to consider.

- Is the principal safe?
- Is the return guaranteed?
- Can funds be withdrawn without penalty or loss of interest?
- How will inflation and taxes affect the purchasing power of dollars saved?

Remember, no single savings option will have all of these characteristics.

INVESTMENT OBJECTIVES

The first step in investing is to identify your objectives. This sounds obvious, but many investors make decisions based on a tip from a friend without any consideration of investment goals. Listed below are common investment objectives. Rate their importance to you (1 = very important; 2 = somewhat important; 3 = not important). Take into account your family's current life cycle stage and financial circumstances.

- ___ To increase current income
- ___ To receive some income with some growth of capital
- ___ To increase long-term capital growth
- ___ To achieve aggressive (risky) capital growth
- ___ To tax-shelter investment dollars

Of course, these objectives are not mutually exclusive. You can achieve several objectives by dividing investment dollars among different investments or by choosing those that meet more than one objective.

CHOOSING AN INVESTMENT

There are many investment alternatives. You'll want to evaluate each one completely before choosing the best ones for you. Seven criteria, as described next, are considered.

Degree of Risk

Whenever you invest, there's the risk that you won't make any money and you might even lose the principal. Saving instruments insured by the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration (NCUA) are about as safe (risk-free) as any alternative. This insurance guarantees up to \$100,000 in an account. In comparison, consider an investment of stock in a small company whose future depends heavily on an upswing in the economy. Certain events might lead to bankruptcy or a dramatic increase in the stock's value. In general, the greater the risk, the greater the prospects for a higher return.

Another type of risk is psychological. Declines in the capital value of your investment may be depressing and result in sleepless nights. If the risk of emotional stress is too great, you may want to avoid making variable dollar investments.

There are two ways to minimize risk. First, you can become more knowledgeable about investment alternatives; and second, you can diversify your investments.

Rate of Return

Returns usually are expressed as an annual percentage rate of the original investment. The total return from an investment includes earnings from the principal plus growth of principal.

For example, assume that \$1,000 was invested in 10 shares of common stock paying 6 percent cash dividends each year. After 10 years, earnings from the principal would be \$600. If the stock is then sold for \$1,500, the total return would be \$1,100—this represents \$600 from dividend earnings and \$500 from growth of principal—or 11 percent average annual return. A \$300 capital loss on the stock sale would result in a \$300 return over the 10 years or a 3 percent average annual return.

Liquidity

Liquidity is the ease with which an investment can be converted to cash. For example, savings accounts are liquid assets, but an investment in real estate generally is not. It can take considerable time to sell property. Funds in stocks or mutual funds are liquid assets and can be traded anytime. However, the market price may be depressed at the time you need the cash.

Management Requirements

Certain investments take time and skills, such as personally managing an apartment building or a portfolio of common stocks. For these investments, you can hire a professional manager. Other investments require little time or skills after the initial investment decision is made.

Maturity

Many savings options take a certain time period before reaching the expected rate of return. Investments such as real estate or common stocks won't have a specified maturity date, but time is needed to generate earnings and increase the capital value.

Inflation Hedge

The degree of protection an investment provides against inflation is an important consideration. Equity investments—where you own something such as common stock or land—historically have shown a growth of principal that has outpaced the rate of inflation.

In contrast, putting your money in a savings account or certificate of deposit offers earnings on the principal but no increase in the value of the principal.

Tax Consequences

Returns from investments are taxed either as income from the principal or as growth of the principal.

Income from principal, such as interest or dividends, is usually taxed as ordinary income. However, some investments yield

income that is tax exempt or tax deferred. For example, interest received from municipal bonds is free of federal income tax. Earnings of funds in a traditional, tax-deferred Individual Retirement Account (IRA) are taxed when income is withdrawn. Earnings from the new Roth IRAs are tax-exempt upon withdrawal.

The growth of principal is taxed as capital gains income in the year the investment is sold. Under current tax law, for assets held more than 12 months, capital gains are taxed at a rate of 20% (10% for taxpayers in the 15% tax bracket). Gains on assets acquired after the year 2000 and held by the taxpayer for more than five years are taxed at 18% (8% for taxpayers in the 15% tax bracket).

The higher your tax bracket, the more attention you will want to give to the tax consequences of an investment. People in high tax brackets minimize tax liability by seeking tax-exempt or tax-deferred income.

Yields on investments are most accurately compared on an after-tax basis. The after-tax yield is calculated by multiplying the taxable yield by 1 minus your highest (marginal) income tax rate. For example, if your highest tax rate is 28 percent, an investment yielding 7 percent would provide the following after-tax yield:

$$\begin{aligned}\text{After tax yield} &= \text{taxable yield} (1 - \text{tax rate}) \\ &= 0.07 \times (1 - 0.28) \\ &= 0.07 \times (.72) \\ &= 0.05, \text{ or } 5 \text{ percent}\end{aligned}$$

To calculate what you would have to earn on a taxable instrument to be equivalent to a tax-exempt return on an alternative investment, use this formula:

$$\text{Equivalent taxable yield} = \frac{\text{tax-free yield}}{(1 - \text{tax rate})}$$

For example, if you are in the 28 percent tax bracket, a tax-exempt yield of 7 percent would be equivalent to a taxable return of 9.72 percent; that is, $7 \div (1 - .28) = 9.72$ percent.

WHERE TO INVEST

Once you have determined your investment objectives, you can use the criteria just described to evaluate investments according to your goals. Listed below are common investment options.

■ **Common and preferred stocks**—The purchase of shares of stock represents ownership of a corporation. An investor can benefit in two ways. First, the value of the shares of stock may increase. Second, dividends, which represent a return on your investment, also may be paid. The two major types of stocks are common and preferred. If a corporation has limited dividends or is liquidated, preferred stockholders hold first claim on dividends and assets, but unlike common stockholders, do not have full voting rights in the affairs of the company. No guarantees are made about repayment of the purchase price or receipt of dividends.

■ **Bonds**—A bond represents a promise to repay a bond holder in full at a designated maturity date. For the use of your money, you receive a fixed amount of income, called interest. Borrowers, the issuers of bonds, include federal, state, or municipal governments, or corporations. Although the interest rate on bonds is predetermined, the value of a bond can vary over time, depending on current interest rates.

■ **Mutual funds**—Mutual funds are, in effect, large holdings of investments that are formed by many individual investors collectively pooling their resources. Many different types of funds exist, with varied investment objectives. For the small investor, mutual funds provide diversification, professional management, and convenience.

■ **Real estate**—Family businesses, farms, and commercial property are all examples of real estate investment. Such investments

have sizable purchase prices and lack liquidity. If you had to sell in a hurry, it's likely you would take a loss or, at best, receive less than the real value of the property.

SEEK ADVICE

The adage “investigate before you invest” is old but not out-of-date. Consider these sources:

■ The library has extensive information on saving and investing. In addition to understanding the basics of investing, become familiar with business trends. *The Wall Street Journal*, *Barron's*, and such popular magazines as *Money*, *Kiplinger's Personal Finance Magazine*, *Business Week*, and *Fortune* are useful sources. The PBS television program, *Wall Street Week*, provides many provocative investing ideas. Three helpful Internet sites are sponsored by the National Association of Investors Corporation (<http://www.better-investing.org>), the American Association of Individual Investors (<http://www.aaii.com>), and the Cooperative Extension System (<http://www.investing.rutgers.edu>).

■ A reputable brokerage house or advisers at your financial institution are good sources of information. It's your job to take that information, examine it, and make your own decision based on your goals.

If an investment opportunity sounds too good to be true, it probably is. Check with the Consumer Protection Division of the Iowa Attorney General's Office (1305 E. Walnut, Des Moines, Iowa 50319) to see if there have been any complaints against the company. The phone number is 515 281-5926. The Iowa Securities Bureau of the Iowa Department of Commerce (340 Maple St., Des Moines, Iowa 50319) also provides answers to consumer inquiries and complaints. Call 800-351-4665.

FOR MORE INFORMATION

Other titles in this series include the following.

Pm-1452a	<i>Record Keeping</i>
Pm-1452b	<i>Net Worth/Record of Income and Expenses Worksheet</i>
Pm-1453a	<i>Communication</i>
Pm-1453b	<i>Talk About Money Worksheet</i>
Pm-1454a	<i>Spending Plans</i>
Pm-1454b	<i>Spending Plans Worksheet</i>
Pm-1455	<i>Income Taxes</i>
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Pm-1461b	<i>Calculating Your Car Costs Worksheet</i>
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