Chapter 10-Basics of Saving and Investing

Section 2-Principles of Saving and Investing

Ideal Investments

- Ideal investment would have these features:
  - Principal is safe (no risk)
  - Rate of return (earnings) is high
  - Investment is liquid (can get to your money quickly without penalty)
  - Invest quickly and easily
  - The cost of investing is low, both in terms of amount invested, and investment fees
  - Earnings and long-term gains from the investment are tax-free or tax-deferred

Risk

- The probability of losing all or part of an investment.
- The higher the risk in an investment, the higher the return
- The lower the risk in an investment, the lower the return.
- Risk-free investments
  - Investment guaranteed by the government
    - Treasury Bills and U.S. Savings Bonds
  - Investments FDIC insured
    - Savings accounts, money market accounts, certificates of deposit
      - Low rate of return
      - Low interest rates

Growth of Principal

- Money set aside for savings—should be growing
- Principal grows through interest and through money added to the balance
- As principal grows the value of the investment grows

Return on Investment

- A measurement of return expressed as a percentage (ROI)
- The amount that the savings or investment grows is called the return
- To calculate ROI—divide the amount gained by the amount invested
- A dividend is an example of a gain-it is a portion of a corporation’s profits distributed to stockholders

Investment Risk

- The potential for change in the value of an investment
- Look for investments that go up more than they go down
- Investments should be worth more at the end of the year than they were worth at the beginning of the year

Inflation Risk

- The chance that the rate of inflation will be higher than your investment rate of return
- Investments lose value when inflation rate is higher than rate of return
- Example: A bond purchase (a bond is a debt instrument that is issued by a corporation or government)
  - The bond issuer is borrowing money from an investor
  - The issuer must pay the bondholder the principal plus interest when the bond matures
  - If the bond has a 5 percent interest rate and the rate of inflation is 7 percent—you are losing money on your investment

Stock Risk

- Stock—An ownership interest in a publicly held company
- Stock risk- The chance that activities or events that affect a company will change the value of an investment in the company.
- Stocks can go up or down for many reasons, including:
  - Poor management
  - Unexpected events, such as product recall
  - Employee strikes
  - Natural disasters (earthquake, hurricane or flood)
  - Crop failure

Tax Advantages of Investing

- Tax deferral—a postponement of taxes paid
  - No taxes are paid on gains until the money is withdrawn from the account
  - This allows an investment to grow for years without being taxed
  - People most often withdraw this investment in retirement, when they are in a lower tax bracket
  - Example: IRA accounts, 401(k) accounts
- Tax-exempt—gains from an investment are not subject to taxation
  - Examples: interest earned from Series EE and Series I savings bonds are tax-free if used for education
  - Municipal bonds (bonds issued by local cities and counties) may be tax free from federal income tax
- Interest rates paid on tax-free investments are usually lower

Investing with Employer-Sponsored Plans

- Employer Sponsored plans—company retirement plans in which money is set aside on behalf of employees
- Part of an employee's compensation package
- Provides significant tax advantages for employers
- Money is not taxed until an employee actually receives it (in retirement)
- Money-match—when an employer matches the amount of money an employee contributes to a retirement plan
- Vested-the right to claim employer contributions in a retirement plan
  - Plans are usually vested after 3-5 years with an employer
    - After that time if you leave a job you may take the employer contributions
    - If put into a rollover account, the funds will continue to grow tax deferred until it is withdrawn for retirement