

The Basics of Investing

Would you like to be able to purchase a house in a few years? Travel around the world? Retire before you are 90? Unless you won the lottery, chances are that you will need to save and invest to obtain many of the things you want. This module covers what you need to know to get started:

- The Power of Investing
- Establish a Healthy Foundation
- Investment Classes
- Risk Management
- Research and Purchasing

Chapter 1: The Power of Investing

Investing is the act of putting your money in a financial vehicle with the goal of making a profit. Basically, you are making your money work for you. Successful investing requires both a commitment to regularly setting aside money and choosing appropriate investment options based on your goals. Many people fall into the trap of playing it too safe, parking all of their savings in a savings account. Savings accounts and other zero risk options are a great choice for an emergency fund and short-term goals. However, they are not the best choice for goals with a longer timeframe. That is because the return they provide is extremely low, usually less than the rate of inflation (the general rise in the cost of goods and services over time). If the return is less than the rate of inflation, that essentially means you are losing money over time.

With stocks and bonds, the risk of losing some or all of your investment is higher but generally, so is your return. The higher your return, the less you have to invest each month to hit your goal. Compound interest (interest earned on interest) can help your earnings to increase significantly, especially when the return is high. The chart below shows the interest earned on an investment of \$2,000 a year with a return of 1% and 5%.

Years Invested	Total Interest Earned (1%)	Total Interest Earned (5%)
3	\$60	\$305
6	\$304	\$1,604
9	\$737	\$4,053
12	\$1,365	\$7,834

Investing Is Not Gambling

When you invest, it is important to keep in mind that you are taking on some risk. However, there is a difference between investing and gambling. Gambling is making a bet on an outcome that is largely or completely determined by luck and hoping you will get a big payoff in a short period of time. Investing

is committing money for the long-term in order to gain a reasonable financial return. A wise investor does research and makes risk-managed decisions instead of relying on luck.

Start Now!

It is easy to say you will start investing tomorrow, but procrastination will cost you. The earlier you begin to set money aside, the longer your savings has time to grow. If you started investing \$200 per month in a vehicle earning an average of 5% a year, in 20 years, you would have \$79,358 (\$48,000 in contributions and \$31,358 in interest earned). If you waited five years to start, you would have \$51,789 (\$36,000 in contributions and \$15,789 in interest earned).

Chapter 2: Establish a Healthy Foundation

Budget

The key to being able to save is to spend less than you earn. If your income is \$1,700 a month and your expenses are \$1,800, you will be worried about paying your bills, not saving. To figure out if you are spending less than you are earning, use the Budget Worksheet to list what your current expenses and income are. To determine a monthly amount for periodic income or expenses, calculate the per year amount and divide by 12.

- **Complete the Budget Worksheet (Monthly Income, Expenses, Bottom Line) on pages 7-9**

Once you have completed your budget, total up your expenses and subtract them from your income. If your expenses are less than your income, great! If not, look over your plan and think about what changes you can make to improve your cash flow. Can you bring your lunch to work instead of buy it? Nix the land-line and just use your cell-phone? Give up your tap dancing lessons? Be honest about what is truly a necessity and what can be reduced, postponed, or cut out completely. Put any adjustments you plan to make the Goal Per Month column of the budget.

Delete Debt

In most cases, the interest charged on credit cards and personal loans exceeds the interest earned from investments. If you owe \$10,000 on a credit card with a 20% annual percentage rate, it makes more financial sense to direct your extra cash toward that than a bond with a 4% return. Once you pay off your debt, then you can dedicate your attention to investing. One caveat – you should always have an emergency fund containing at least three to six months worth of essential living expenses, even if you have debt. (This allows you to pay your bills without relying on credit if the unexpected happens.) If you have less in savings currently, at least a portion of your spare cash should go toward building an emergency fund.

Set Goals

Setting goals is crucial to figuring out how much you need to save to get what you want. It is also a good motivator to save. Let's be honest – going out to eat at a nice restaurant is more fun than buying stocks. But if you know that money is going toward a fabulous vacation or a down payment on a house, it will be easier to tuck it away and pop a frozen pizza in the oven.

Use the Financial Goals Worksheet to list your goals. Financial goals should be specific and measurable. For example, a desire to be rich is not a goal, but a desire to have \$300,000 saved in twenty years for retirement is. There are three basic types of goals: short-term (achieved in under a year), mid-term (achieved in one to five years), and long-term (achieved in more than five years).

Whether a goal is short-term, mid-term, or long-term can influence where you put your savings (discussed more later).

- **Complete the Financial Goals Chart on page 10**

The easiest way to determine how much you need to set aside each month is divide the current cost by the number of months until your achievement date. So if you want a \$1,200 laptop in 12 months, you should set aside $\$1,200/12 = \100 a month. However, doing the calculation this way ignores inflation and the return that you earn on your savings. Inflation and return don't have much of an influence on goals that will be achieved in the immediate future, but you may want to take them into consideration for long-term goals. A financial expert may be able help you come up with figures or you can use your best guess.

After you determine how much you need to save each month for your goals, you should add it to your budget. If it puts you in the red, go back to the drawing board and consider if you can make any further reductions in expenses. If not, consider if any goals can be adjusted. Is there a cheaper alternative available (e.g., a local amusement park instead of Disney World)? Can you extend the timeframe? Are there any goals that are less important that can be dropped? Maybe you would really love to buy a \$5,000 garden gnome to put in your front lawn, but having enough money for retirement is a bigger priority.

Chapter 3: Investment Classes

There are three basic types of investment classes.

Stocks

A share of stock represents a percentage of ownership in a corporation. In other words, if a company is divided into a million shares and you buy one share, you would own one millionth of the company. You can make money from receiving dividend payments (a payout to stockholders from the company's earnings) and/or selling the stock for more than you bought it for.

Most stocks are common stocks. Having common stocks typically allows you to vote for the board of directors, which is responsible for managing the company. With common stocks, the dividend payments are not fixed, and the company is not required to pay them. The other type of stock is preferred. With preferred stocks, you have no voting rights, but regular dividend payments are usually guaranteed (although the amount may be less than what the common stockholders are paid).

Stocks are often classified as one of the following:

- **Blue-chip:** Stocks issued by large companies with a solid financial history.
- **Growth:** Stocks issued by companies that exhibit strong sales and earnings growth. The companies typically direct earnings back into themselves instead of paying dividends.
- **Income:** Stocks issued by companies that generally pay high dividends and experience little growth.
- **Speculative:** Stocks issued by companies that do not have a solid financial history. These stocks carry more variability and risk than other stocks.

- **Cyclical:** Stocks issued by companies whose earnings mirror movements in the economy.
- **Defensive:** Stocks issued by companies that are not significantly affected by changes in the economy.

Historically, over the long term, stocks have provided the highest return. However, there are no guarantees – one day your stock may be worth more than what you paid for it, the next, less. The price of a stock is typically influenced by the performance of the company and general economic conditions, but it can also be influenced by investors' expectations and emotions, which are not always rational.

Bonds

While stocks are an ownership investment, bonds are a lending investment. You give the bond issuer money, and, in most cases, they pay you interest in return, just like you pay interest to a creditor. Generally you receive the principal (called the par value) at maturity of the bond and interest periodically while you are holding the bond. You make money both from interest payments and purchasing the bond at less than its par value (although bonds sometimes trade at or higher than their par value).

Zero coupon bonds, unlike other bonds, pay no interest but are typically sold at a deep discount. They can be any of the types of bonds listed below and are usually long-term, with a maturity date of ten-plus years.

Types of bonds include:

- **Corporate:** Bonds that are issued by non-government companies. Corporate bonds can vary considerably in length, yield, and risk.
- **Municipal:** Bonds offered by the state or local government. In general, the interest received on municipal bonds is exempt from federal income tax, as well as state tax if you live in the state you purchased the bond from.
- **Federal:** Bonds issued by the federal government. The biggest issuer of federal bonds is the U.S. Department of the Treasury. Electronic Series EE and I bonds are sold at face value and can be purchased for as little as \$25. EE bonds pay a fixed-rate of interest, while I bonds come with a variable rate. The interest earned is exempt from state tax. It is also exempt from federal tax if used to pay for qualified higher-education expenses. Treasury bonds can be purchased directly from the government at www.treasurydirect.gov.

Bonds are usually safer than stocks since the bond issuer has a legal obligation to pay them, and as a result, the return is usually lower. However, they are not completely risk-free, as the issuer may choose to breach their obligation or be able to have it discharged through bankruptcy. Also, if you sell a bond before the maturity date, there is a risk you won't be able to get as much for it as you bought it for.

Cash Equivalents

Cash equivalents are assets that can be readily converted into cash. They tend to be low-risk, with little or no danger that you will lose the money you deposit. Because they are safe, cash equivalents provide a low return, which may not even keep up with inflation. There are many types of cash equivalents:

- **Savings and checking accounts:** With savings and checking accounts, you deposit money in a financial institution and receive interest or dividends in return. You can withdraw your money at any time. The interest rate is usually low or may even be non-existent for some checking accounts. Savings and checking accounts are insured, meaning you will still be able to access your money in the unlikely event your financial institution goes out of business.
- **Certificates of deposit (CDs):** With CDs, you also deposit your money in a financial institution, but you are required to leave it there for the term of the CD. If you withdraw early, you will have to pay an early withdrawal penalty in most cases. CDs are insured and generally have a higher interest rate than savings or checking accounts.
- **Money market deposit accounts:** Money market deposit accounts are similar to savings accounts, but the interest rate is typically variable (and higher as well). They are insured and may come with limited check writing privileges.
- **U.S. Treasury bills:** Treasury bills are short-term debt obligations of the U.S. government.

Chapter 4: Risk Management

As discussed in Chapter 1, because inflation eats away at the value of your savings and the power of compound interest is greater the higher your return is, you don't want to put all your savings in cash equivalents. Investing in stocks and bonds means taking on the risk that you will lose some or all of the money you invest. But there are ways you can minimize this risk.

Diversification

One of the best risk management tools is diversification. Ever heard the expression Don't put all your eggs in one basket? If all your money is invested in the stock of Company A and Company A goes out of business – poof, there goes all your money. But if your money is invested in many different places, the loss of stock from Company A will not affect you as much. A well-balanced portfolio contains investments in all three investment classes and has diversity within each investment class. For example, you can purchase stocks from manufacturing companies, technology-oriented companies, and financial services companies.

What percentage of your savings should be invested in stocks vs. bonds vs. cash equivalents will depend on the timeframe of your goals. The closer you are to a goal, the more conservative (i.e., higher percentage of savings in cash equivalents and lower in stocks) your investments should be. Allocation may also vary due to risk tolerance. Some people have absolutely no problem investing in the stock market. Others pace nervously and go online once a day to see what their stocks are trading at. While your risk tolerance may dictate that you prefer one type of investment over another, remember that it is rarely a good idea to have your entire investment portfolio in just stocks, bonds or cash equivalents.

A simple way to get diversity is to purchase shares in a mutual fund. In a mutual fund, money from several investors is pooled to buy different stocks, bonds, and/or cash equivalents. Index funds in particular are recommended by many financial experts – instead of having an advisor that picks what investments are included, index funds track a particular index, such the S&P 500. This keeps the costs, and therefore the fees you are charged, lower.

Remember to Adjust

Once you set up an investment portfolio, you cannot just sit back and forget about it. You will probably need to make adjustments periodically as you get closer to your goals. The asset allocation for the retirement fund of a 30 year old should not be the same as a fund for a 60 year old. Your goals may change in the future as well. While you should not buy and sell too frequently, don't be afraid to make changes to meet your needs. Some time-sensitive retirement funds will automatically adjust your portfolio toward more conservative allocation as you get closer to your projected retirement date.

Dollar Cost Averaging

Some financial experts also recommend dollar cost averaging as a way of minimizing risk. Under dollar cost averaging, you invest a fixed amount at set intervals, e.g., \$600 every three months. By doing this, you avoid "chasing" financial markets - the natural but counterproductive instinct to invest more when prices go up and invest less when prices go down. However, some financial experts believe that if you have a long timeframe, it is best to invest all that you can as soon as possible because, in general, the value of investments rises over time. By delaying investing, you may miss out on profits.

Chapter 5: Research and Purchasing

Getting advice from a professional and doing your own research can help you determine what specific investments to buy. The internet is a great place to get information, but pay attention to the credentials of the person giving advice. If you are interested in purchasing stocks from a particular company, you can read their annual report to see how profitable the company has been. There are many publications on the stock market as well, including the Wall Street Journal, Forbes, Fortune, and BusinessWeek. You do not necessarily need to purchase them – you may be able to find them at the library or view content on-line for free.

If you are investing in a mutual fund, it is extremely important to pay attention to the fees the fund charges. The "load" is the commission charged by the broker or advisor selling you the shares. (There are many no-load funds available that do not have this fee.) The "expense ratio" shows the annual percentage of the fund's assets that are used to pay for ongoing expenses. The higher the fees, the less money that goes to you. You may think that funds with higher fees perform better, but, for the most part, this is not actually the case.

You probably already have experience opening a checking and savings account, but you may not know where you can get stocks or bonds. Many credit unions and banks offer investment services. (If you already have an account with them, you may be able to speak to an advisor for free.) Brokerage firms are another option. There are full-service brokerages that will provide you with advice in addition to facilitating the purchase, and discount/on-line brokerages that just provide bare-bones service with no advice. As the name implies, discount brokers are typically cheaper, but first-time investors may prefer to pay more to get advice from a professional. In some cases, it is possible to buy the investment directly from the entity that is offering it. For example, as mentioned previously, you can buy Treasury bonds directly from the Department of the Treasury. There are also several companies that offer a direct stock purchase plan.

As the old saying goes, a penny saved is a penny earned. And if you invest that penny today, you can have two pennies tomorrow.

Budget Worksheet

Monthly Income

Enter your gross and net (after taxes) income from all sources. For income received infrequently, such as bonuses or tax returns, calculate the annual income, then divide by 12 to find the monthly amount.

Source	Gross	Net
Job		
Spouse's job		
Part-time job		
Rental/room & board received		
Commissions/bonuses		
Tax refunds		
Investment income		
Government benefits		
Unemployment insurance		
Child support/alimony		
Support from family/friends		
Other		
Total		

Monthly Expenses

Since many expenses are variable, such as utilities and groceries, it is important to average these expenses. Other expenses are periodic (such as insurance or vehicle registration). Again, calculate the annual amount and divide by 12.

Category	Expense	Average Per Month	Goal Per Month
Housing	Rent/Mortgage		
	2nd Mortgage/Equity Line		
	Homeowner's/Renter's Insurance		
	Condo Fees/HOA Dues		
	Home Maintenance		
	Gas/Electric		
	Water/Sewer/Garbage		
	Telephone		
Food	Groceries/Household Items		
	At Work/School		
Insurance (Exclude Payroll Deducted Amounts)	Health/Dental/Vision		
	Life/Disability		
Medical Care (Exclude Payroll Deducted Amounts)	Doctor/Chiropractor		
	Optometrist/Lenses		
	Dentist/Orthodontist		
	Prescriptions		
Transportation (Exclude Payroll Deducted Amounts)	Car Payment #1		
	Car Payment #2		
	Auto Insurance		
	Registration		
	Gasoline/Oil		
	Maintenance/Repairs		
	Public Transportation/Tolls/Parking		
Child Care (Exclude Payroll Deducted Amounts)	Daycare		
	Child Support/Alimony		
Savings	Emergency		
	Goals		
Income Taxes	Prior Year		
	Estimated Tax Payments (Self-Employed)		
Unsecured Debt	Loan payment		
	Credit Card #1		
	Credit Card #2		
	Credit Card #3		
	Credit Card #4		

Category	Expense	Average Per Month	Goal Per Month
Personal	Beauty/Barber		
	Clothing/Jewelry		
	Cosmetics/Manicure		
Entertainment	Cable/Satellite		
	Movies/Concerts/Theater		
	Books/Magazines		
	CD/Tapes/Videos/DVD		
	Dining Out		
	Sports/Hobbies		
	Vacation/Travel		
Miscellaneous	Banking Fees		
	Laundry		
	Union Dues		
	Internet Service		
	Pet Care		
	Gifts for Holidays/Birthdays		
	Cell Phone/Pager		
	Postage		
	Cigarettes/Alcohol		
	Contributions to Church/Charity		
	Other		
	Other		
	Other		
	Other		
Other			
TOTALS (include totals from page 10)			

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Bottom Line

Once you have determined the total of your take-home pay and expenses you are ready to determine your bottom line. Subtract the total of all expenses including debt payments from your net income. If the result is a positive number, you can add the extra money to your savings to reach your goals sooner. If your expenses exceed your income, you'll need to make some adjustments to bring your finances back into balance.

Total Monthly Income	Total Expenses	Balance
	-	=

Financial Goals Chart

Your financial goals are specific things you want to do with your money within a certain time period. Short range goals are accomplished within one year, mid-range goals are accomplished within 1 to 5 years and long range goals generally take more than 5 years to achieve.

	Target Date	Total Needed	Current Savings	Additional Savings Needed	Pay Periods Until Target Date	Savings Needed Per Pay Period	Savings Needed Per Month
Short-term Goals							
Mid-term Goals							
Long-term Goals							