FINANCIAL LITERACY

BUILDING WEALTH OVER THE LONG TERM Name: _____ Period: _____

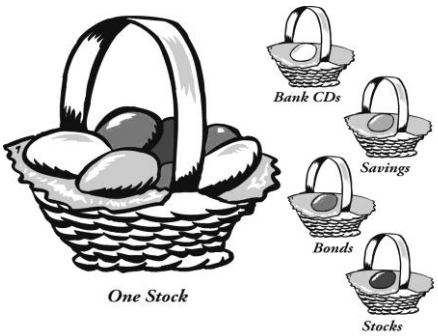
What are the *Three Rules for Building Wealth*?

1.	**2.**	**3.**

The Magic of Compounding

When you save, you _____ _____. When you take the interest out and spend it, it _____ _____. But if you leave the interest in your account so it can _____, you start to earn _____ on the interest you earned previously. Interest on interest is _____ you _____ _____ _____. It is money your money _____ _____ _____! Over time, interest on interest can _____ your _____ _____ greatly.

Why shouldn't you "put all your eggs in one basket"?



Forms of Saving and Investing: Some Benefits and Costs

Savings Accounts:	Certificates of Deposit (CDs):	Bonds:
Stocks:	Real Estate:	Mutual Funds:

Activity 9.2
Forms of Saving and Investing

Below are some of the assets you can choose when you're thinking about where to put your money. We'll start with the safest kinds and then proceed down the list to some riskier ones.

- Savings Accounts. These accounts are kept at banks. They are insured by the federal government, and no one has ever lost even a penny of federally-insured individual savings deposits. Your money will be safe in a savings account. There are two other things to know about savings accounts, however. The first is that the money won't be as easy to spend as cash or money in a checking account. You'll have to make a separate transaction to withdraw the money from a savings account before you can spend it. The second is that the money will not earn a high return. The interest paid on savings is small but steady.
- Certificates of Deposit. Just like savings accounts, certificates of deposit (often called CDs) are made available by banks and are federally insured. When you buy a certificate of deposit, you're tying your money up for a specified period—from one month to a number of years. That means it's harder to spend than money from a checking or savings account. Before spending it, you have to wait until the term is up—or be assessed interest penalties for an early withdrawal. In return for giving the bank greater use of your money, you earn interest at rates somewhat higher than the rates paid on a savings account.
- Bonds. When you buy a bond, in effect you're making a loan. You're lending your money to the organization that issued the bond. The bond will specify under what terms you get your money repaid and what the interest will be. Some bonds are very safe, such as those issued by the federal government.

  Some bonds have medium safety, such as those issued by major corporations. Almost certainly, you'll get your money back with interest, but there's a chance that a major corporation could fail. Some bonds are known as "junk bonds." Junk bonds are high-risk investments. There is a real probability that the companies issuing them may not be able to pay investors back.
- Stocks. When you buy a stock, you're actually becoming a part-owner of a corporation. Ownership is easy to see when four people contribute equally to a new corporation and each owns a fourth of the venture. All four would share in the profits of the business and all four would have a fourth of the decision-making authority. Ownership is harder to see in today's corporations. But while modern corporations issue millions of shares, the principle is the same. If a corporation issues 200 million shares of stock, then buying a share makes you a 1 200-millionth owner of the corporation. You have a claim on 1 200-millionth of the worth of the corporation, and you have 1 200-millionth of the decision-making authority in the corporation. More importantly for investors, some corporations make payments to shareholders, called dividends. You can earn money with stocks by getting dividends, and also by the increase in the value of the stock over time, if the company does well. Of all the assets mentioned so far, stocks carry the highest risk. Some stocks are considered safe or conservative—such as stocks of well-established companies in stable markets. Other stocks are more speculative, such as those of new and growing companies. But there is always risk in holding stocks, along with the possibility of a high return.

- Real Estate. When you own your own home for a long time, it's a relatively safe investment. You pay on the home and you get a place to live. Over time, its value will likely go up and you'll pay down the amount of the loan. But it's also possible to invest in real estate as a landlord. You might buy half of a duplex and rent it out, for example. Being a landlord can be rewarding, but you should know that there are risks that come with investing in real estate (other than your own home). You are responsible for the upkeep on a rental property you own, and also for finding renters who will pay their rent on time. If something breaks, you have to fix it or hire someone to fix it. If a renter is late with a monthly payment, that doesn't excuse you from making payments to the bank on any loans you used to buy the property.

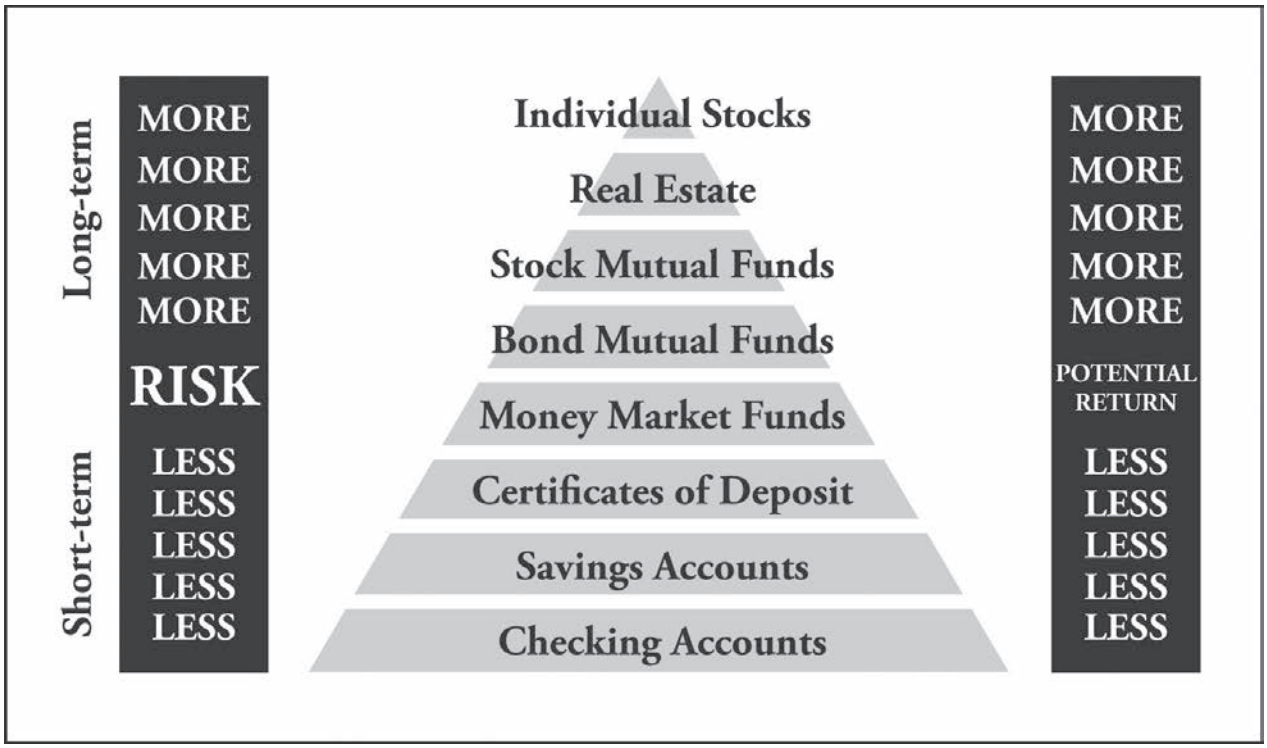
Risk and Return

You may have noticed a relationship in reading about different forms of investing. Safe investments don't offer a big return. If you choose the safety of a bank account for your money, you won't earn a lot of money on your account.

The other side of the coin is that riskier investments offer the possibility of a larger return. If they didn't, nobody would invest in them. As we move from bank assets to bonds to stocks and real estate, we're moving toward assets with many possibilities for things to go wrong—and for things to go right. A company whose stock you buy may succeed wildly or go bankrupt, or anything in between. You take that risk when you own a single company's stock.

Look at the pyramid in the accompanying figure. Toward the bottom of the pyramid there are safe places to keep money. They offer lower returns than the riskier investments noted toward the top. In investing, you should build the bottom of the pyramid with safe investments like bank accounts and certificates of deposit first. Later you can venture into riskier choices, closer to the top of the pyramid.

The Risk-Return Pyramid



Mutual Funds

How do we get a high return while managing the risk? The answer lies in diversifying. When we diversify, we take a lot of small risks rather than a single large risk. The small risks don't add up to much, and they get smaller and smaller over time for an investor who buys and holds onto a variety of financial assets.

We might think of diversifying as a matter of buying small amounts of a lot of different stocks or bonds. But because it costs something to buy each asset, that approach would quickly get to be expensive. Fortunately, there are mutual funds that buy financial assets on behalf of individual investors.

A mutual fund gets a pool of money by accepting payments from thousands of individual investors. It invests its pool of money in a collection of assets. As that collection generates income, the mutual fund sends that income back to its investors in proportion to how much money they have put in. Because of its large size, a mutual fund can efficiently buy large numbers of different stocks and bonds. In the pyramid diagram we saw, mutual funds have lower risks than the individual stocks and bonds that make them up. For example, a single speculative stock has high risk near the top of the pyramid—but a mutual fund made up of speculative stocks has somewhat lower risks because it pools a variety of those stocks. A mutual fund made up entirely of government bonds has very low risks.

Charlayne, the accidental millionaire, owes much of her success to mutual funds. The money in her retirement fund—as is true for most retirement funds—was invested in diversified mutual funds. Charlayne indirectly owned stock in a wide variety of companies. Thus when technology stocks boomed, some of her money was in technology stocks. Also, when automotive company stocks lost value, she didn't lose nearly as much as she would have if she had owned only auto stocks.

Mutual funds are nowhere near as safe as bank deposits. When markets go down, mutual funds follow them down, depending on which stocks and bonds the funds are holding. Over time, however, mutual funds have been an excellent investment, far surpassing bank accounts and bonds in their long-term returns. Many ordinary people have become millionaires by starting early, buying and holding, and using mutual funds to diversify.

Questions for Discussion

What are the advantages and disadvantages of alternative forms of saving and investing?

- Saving Accounts
- Certificates of Deposit
- Bonds
- Stocks
- Real Estate