CHAPTER 10

Understanding Saving and Investing

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Chapter 10 focuses on saving and investing. Some aspects of saving and investing overlap. However, there is a difference between saving and investing. Saving and investing can help you accomplish short-term and long-terms goals. You will want to consider the risk involved and the amount you can expect to earn when choosing investments. In this chapter, you will learn the difference between saving and investing. You will also explore some reasons for saving and investing and some strategies for getting the most from your investments.

ONLINE RESOURCES

Personal Financial Literacy Web site:

- Data File
- Vocabulary Flashcards
- Beat the Clock: Saving and Investing
- Chapter 10 Supplemental Activity

Search terms:

- liquidity
- investment risk
- diversification
- dollar averaging
- bull market
- bear market

10-1 Reasons for Saving and Investing

OUTCOMES

- Explain the difference between saving and investing.
- Describe reasons for saving and investing.
- Describe the concept of financial security.
- Explain what is meant by retirement planning.

SAVING AND INVESTING

The purpose of saving is to accumulate money for future use. Saving money is important because it means you are planning for future needs and wants. When you are saving money, the emphasis is on safety. In Chapter 5, you learned about various methods for saving money. A savings account, a certificate of deposit, and a money market account are all good, safe ways to save. Because these types of accounts are insured by the FDIC, you can be assured that money you place in such an account is safe.

Investing money is another way to plan for future needs. The purpose of investing is to make your money grow. Investing is sometimes explained as using money to make more money. For example, you may use money to buy real estate such as a house. You might also buy **stocks**, which are shares of ownership in a corporation. Your hope is that the house and stocks will be worth more several years later when you sell them than when you bought them. If so, you will have more money when you sell the investments than when you bought them.

Money in a savings account or money market account that you plan to leave there for a long time can be considered a type of investment. However, the interest rate and the money earned in such an account are typically low compared to other types of investments. As mentioned earlier, safety is the primary advantage of a savings account. Other types of investments involve risk. The amount of money that can be made and the risk involved are issues of concern with investments.

With many investments, you do not know how much the money you invest will earn. You could even lose the money you invest. For example, when you buy stocks, you are buying a share of a corporation. The company may do well, and the value of the stocks may grow. However, the company could fail. In this case, you might lose the money you invested in stocks. When investors think the chances of making money are good, they accept the risk involved with investments.

The goals you want to accomplish with money you save may be short-term or long-term goals. Investments are often long-term and may be part of a plan to accomplish long-term goals. Some short-term and long-term reasons for saving and investing are discussed in the following sections.

SHORT-TERM NEEDS

Saving is a good way to have money to handle short-term needs or wants that are not part of your regular spending. For example, you may want to save money to pay for a trip or to purchase a home theater system. Savings can also be used to handle unexpected expenses, such as repairs to a roof that is damaged by a storm. Savings accounts are considered liquid assets. **Liquidity** is a measure of the ability to turn an asset into cash quickly.

Contingency Planning

Contingencies are emergencies or other unplanned or possible events. For example, suppose you are driving home from work and a tire blows out. You need money to pay for a new tire, towing, or other related expenses. You may not have enough cash on hand to pay these expenses. You need to get to money quickly without borrowing (using credit and paying interest charges).

Having enough savings available so that you can pay for emergencies is critical. An **emergency fund** is an amount of money you set aside for unplanned expenses. A fund of $500 is enough to cover many types of emergencies. You might keep this sum as the minimum in your checking account. In other words, you typically do not allow the account balance to fall below $500. However, you can spend that $500 in case of an emergency.

Vacations

Taking vacations is a healthy thing to do. Many people want a break from time to time—to get away from the usual stresses in life. A vacation also helps refresh tired minds and bodies so that people are ready to go back to school or work.

Vacations can be simple and inexpensive, such as going camping or hiking. Vacations can be elaborate and expensive, such as flying to Europe for a 2-week stay in a resort. Setting aside money for vacations allows you to plan for the kind of vacations you would like to take. One type of plan might involve taking short and inexpensive vacations for 2 or 3 years and then taking one expensive vacation every third or fourth year. As you earn more (and save more), you can plan more expensive vacations.


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Savings can be used to help pay for emergency expenses.

Meeting Goals

You may have short-term goals that saving money can help you accomplish. These goals may involve things you want to get done within the next few weeks or months. For example, you may wish to attend a wedding or go to a special event, such as a concert. You may want to buy a new car and need to save money for the down payment. To meet your goals, you may need to start setting aside money well ahead of the event.

LONG-TERM NEEDS

Both saving and investing can help meet long-term needs and wants. For example, parents may start investing money when a child is young to pay for the child's college education. Many people want to own a home. They may save money for a down payment and then buy a house as an investment. Everyone needs to think about retirement and how to pay for expenses when no longer working.

In Chapter 4, you learned about basic needs (such as food and shelter), other needs (such as education and transportation), and wants (such as a vacation trip). You also studied how to create a financial plan. Such a plan has personal goals that relate to your wants and needs. Your financial goals relate to the money or assets needed to achieve personal goals. The plan includes a timeline for each goal. Selecting saving and investment options can be an important part of creating a financial plan.

To think about your needs and goals, you could create a plan such as the one shown in Figure 10-1.1 on page 289. The plan should list short-term and long-term goals and set a timeline for meeting each goal. You should also think about how much money you will need and how to save or invest for each goal. The amount that an investment grows is called the return. You may need to choose investments with a high rate of return to meet your goals.

Education

College expenses can be met with a plan that includes loans, scholarships, spending savings or money from investments, and working. Many students work during the summers and save money to pay for some of their college expenses. Some students work part-time and go to school full-time. Others work full-time and go to school part-time. Working to help pay for college lowers the amount of money you may need to borrow. You could start saving now to have money for this need. Parents of young children can invest money that will grow while the children grow. Money from the investment can be used to pay for education when the children reach college age.

Buying a House

A house can be a good investment that grows in value over several years. Buying a house may require using savings. Savings may be used to buy a home or to make a down payment on a home. Many lenders require buyers to make a down payment of 5 percent or more of the purchase price when buying a house. For example, suppose you buy a house for $180,000. You may be required to have a down payment of $9,000 to get a loan for 95 percent of the purchase price. You may need to save money

FIGURE 10–1.1 *A financial plan should include saving and investing options to meet goals.*

Personal Goal	Financial Goal	Steps to Take	Timeline
Short-Term Goals			
Take a camping trip next summer	Own camping gear and have money for transportation and supplies	Save $50 per month	6 months
Attend a concert in a nearby city	Have money for a ticket, hotel room, food, and transportation	Save $75 per month	4 months
Long-Term Goals			
Travel in a motor home	Own a motor home and have money for gas and traveling expenses	Invest $200 per month at a high rate of return	10 years
Swim in my own pool	Have a swimming pool constructed at my home	Invest $125 per month at a high rate of return	6 years

for a few months or years to have the down payment amount. You may also need to save money to pay for closing costs on a home mortgage.

Providing for a Family

Many people plan to have children in the future. These people need to plan for the expenses involved in raising children. Housing, food, clothing, medical care, and child care are examples of expenses parents must meet for at least 18 years. According to a U.S. Department of Agriculture report, a parent in the United States can expect to spend about $130,000 or more to raise a child from birth through age 17.[1]

Having children will affect daily living expenses, vacations, and even how parents plan for retirement.

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Many people make investments to provide for future needs of their families.

[1] *Expenditures on Children by Families, 2005*, U.S. Department of Agriculture, Center for Nutrition Policy and Promotion, Miscellaneous Publication No. 1528-2005, April 2006, p. 12.

For example, when children are young, parents need life insurance to take care of their children's needs if something happens to the parents. As children get older, plans shift to providing the children with money for education and helping them get started living on their own. When children are adults and leave home, many people move into a new phase of their lives. This often involves retirement or part-time work, moving to a smaller house, or moving to a different area. Investments made during a person's working years can help provide money for activities in later life.

Financial Security

Financial security is the ability to prepare for future needs and meet current expenses to live comfortably. For most people, financial security is built on saving and investing. It means having enough resources so that you will have enough to eat, proper clothing, a safe and comfortable place to live, medical care, and other items that you need. Government agencies and other organizations provide information about financial security online, as shown in Figure 10-1.2.

People desire to be financially secure throughout their lives. For many people, however, financial security must be built over time. When you first begin working and living on your own, you may need to spend most of your earnings to cover current expenses. As you save and invest, you start to build the resources that will provide for your future security.

Retirement Planning

Many people want to retire from working full-time and enjoy more leisure time. They may want to take more vacations and see new places. They also want to be able to live comfortably without worrying about how their bills will be paid. Some people want to retire as soon as they can afford to do so. Others enjoy their work or need the money earned and want to work as long as they can.

FIGURE 10-1.2

Information about building financial security is provided online.

Source: U.S. Department of Agriculture, Cooperative State Research, Education, and Extension Service, Financial Security, http://www.csrees.usda.gov/ProgView.cfm?prnum=5379 (accessed July 18, 2006).

INVESTMENT EXAMPLES			
Amount Invested	Interest Rate	Investment Term	Maturity Value
$10,000 investment	6%	20 years	$ 32,071
$10,000 investment	6%	30 years	$ 57,435
$1,000 investment	8%	30 years	$ 10,063
$1,000 investment	8%	40 years	$ 21,725
$1,000 per year investment	5%	20 years	$ 33,066
$1,000 per year investment	5%	30 years	$ 66,439
$1,000 per year investment	5%	40 years	$120,800
$100 per month investment	7%	25 years	$ 81,007
$100 per month investment	7%	30 years	$ 121,997
$100 per month investment	7%	40 years	$262,481

FIGURE 10-1.3

The investment term and the interest rate have a big effect on the maturity value of an investment.

Retirement planning should begin the day you start working. You can begin thinking about retirement even earlier, as you choose a career. Think about what you would like to do and how you would like to live when you retire. Then think about the amount of monthly income you will need to support this lifestyle. Many people, especially the elderly, require long-term medical care at some time during their lives. Retirement plans should include how to pay for long-term care if it is needed.

You should begin saving and investing money for retirement at a young age. The sooner you begin investing, the longer your money will have to grow. Figure 10-1.3 shows comparisons of amounts invested at the same rate but for a different number of years.

Building Communications Skills

GOOD NEWS MESSAGES

A good news message is one that the reader will find favorable or be happy to receive. Good news messages are often written to inform people that their requests have been granted. Thus, the reader is looking for the answer and is expected to respond favorably. Often, the writer can use this opportunity to build goodwill with the reader. The reader will be feeling positive about the main message of the letter.

When writing a message that is good news, use a direct approach. The answer or main point of the message should be placed early in the message. Details should be presented in later paragraphs. For example, the opening of a good news letter might be, "Congratulations, Mr. Mendez. You have been selected to receive a $5,000 scholarship."

A good news message should be clear, leaving no doubt about the answer or point to be shared. The letter should be complete, giving all the details needed. The letter should also be concise. It should use enough words to sound friendly and courteous but not be too wordy.

10-1 Activity 1 Can You Recall?

Answer these questions to help you recall what you have read. If you cannot answer a question, read the related section again.

1. How is investing money different from saving money?
2. Why are savings accounts often safer than other investments?
3. List three short-term goals that could be reasons for saving.
4. What is an emergency fund, and why should you have one?
5. Why does meeting long-term goals often require saving and investing? Give two examples of long-term goals that can be met with money from investments.
6. What is financial security?
7. When should you begin retirement planning?

10-1 Activity 2 Goals for Saving and Investing

People have many purposes for saving and investing. These purposes can be defined in terms of goals, both short-term and long-term.

1. Create a table with four columns similar to the one shown in Figure 10-1.1. The column headings should be as follows:
   - **Personal Goals**
   - **Financial Goals**
   - **Steps to Take**
   - **Timeline**
2. List at least one short-term and two long-term personal goals in the table.
3. List a financial goal for each personal goal. Include steps to take and a timeline for each goal. Enter the total amount of money you think you will need to meet each goal.

10-2

Saving and Investing Principles

OUTCOMES

- Discuss the concept of risk versus return.
- List some types of risk that savers and investors may face.
- Describe the possible tax advantages of long-term saving and investing.

GROWTH OF PRINCIPAL

When money is set aside for savings, it should be growing. That is, the principal amount on which interest is computed should get larger over time. The principal grows when you deposit more money into the account. The principal can also grow through compounding interest. With compound interest, the interest amount is calculated for the first period. For example, the period might be 1 month or 1 year. The interest amount is added to the principal amount that was deposited in the account. This becomes the new, higher principal amount. Interest is calculated on the adjusted principal amount for the next period. This cycle continues, with the interest being added to the previous principal amount each time the interest is calculated. As the principal increases over time, the value of the investment grows. Figure 10-2.1 on page 294 shows interest compounded quarterly for 2 years.

RETURN ON INVESTMENT

When you put money into savings or an investment, you expect the value of the savings or investment to grow. The amount that the savings or investment grows is called the return. Return on investment (ROI) is a measurement of return given as a percentage. ROI tells how much you will receive, either in cash (such as interest on a savings account) or in increased value (such as with real estate). When you compare the ROI on several investment options, you can pick the one that has the highest return. Computing ROI is simple. To find the ROI, divide the amount you gained (either in interest or in increased value) by the amount you invested. The gain could also include other amounts you received, such as dividends. A dividend is money paid to stockholders when a corporation makes profits. Figure 10-2.2 on page 294 shows how ROI is calculated. When you compare the ROI for different investment choices, you can see which has the best return. Based on the return and the risk involved, you would choose an investment option.

FIGURE 10-2.1

COMPOUND INTEREST EXAMPLE

COMPOUND INTEREST (Annual Interest Rate 6%)				
Period (Quarterly)	Principal	Rate	Interest	Adjusted Principal
1	$5,000.00	0.015	$75.00	$5,075.00
2	$ 5,075.00	0.015	$76.13	$ 5,151.13
3	$ 5,151.13	0.015	$77.27	$5,228.39
4	$5,228.39	0.015	$78.43	$5,306.82
5	$5,306.82	0.015	$79.60	$5,386.42
6	$5,386.42	0.015	$80.80	$5,467.22
7	$5,467.22	0.015	$82.01	$5,549.22
8	$5,549.22	0.015	$83.24	$5,632.46

FIGURE 10-2.2

RETURN ON INVESTMENT EXAMPLE

RETURN ON INVESTMENT			
Purchase Price	Selling Price	Gain	ROI
$500.00	$525.00	$25.00	5.00%

Selling Price − Purchase Price = Gain
Gain/Purchase Price = ROI

RISK AND RETURN

When selecting an investment, the buyer must weigh the risk involved against the possible return expected. The higher the risk you are willing to take, the greater your possible return may be. If you are not willing to take much risk, then you cannot expect high returns. Risk-free investments are guaranteed by the U.S. government. For example, savings accounts that are insured by the FDIC have no risk. As a result, the guaranteed rate of interest is low compared to rates for other investments. Other ways of saving and investing have more risk. As the risk rises, so does the possibility of a high return. The ideal investment would have all of these features:

- The principal is safe (no risk).
- The rate of return (earnings) is high.
- The investment is liquid (you can get your money quickly without a penalty).
- You can invest quickly and easily.
- There are no costs of investing, and you can buy in with small amounts.
- The investment is tax-free (both the earnings and the long-term gains) or tax-deferred.

Unfortunately, there are no investments that meet all of these criteria. So you must decide how much risk you are willing to take and what rates of return will meet your goals.

Investment Risk

Investment risk is the potential for change in the value of an investment. For example, when you buy stock in a company, you risk having the stock price fall. If the company goes out of business, the stock may become worthless. In this case, you may lose the money you invested.

The value of an investment can go up and down over time. Poor management or unexpected events may affect how well a company performs. For example, a company may discover that a product must be recalled because it is defective. Replacing the product or paying consumers for the recalled product may cost the company a lot of money. When this happens, the price of the company's stock may fall. Your investment may temporarily lose value. The price of the stock may go up again when the company announces the release of a new product. These changes in stock prices are to be expected.

Natural disasters may also affect the value of an investment. When a storm, earthquake, hurricane, or flood occurs, it creates damage. The event may destroy crops, buildings, businesses, and lives. A disaster can cause prices to rise or fall. If crops are destroyed, stock prices for companies in that industry may fall. Shortages caused by these events may lead to prices rising in some industries. Other industries benefit because work is created in rebuilding or repairing damage.

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Natural disasters, such as a hurricane, can damage investment properties.

Few investments go up in value all of the time. With investment risk, you are looking for investment choices that, on the whole, go up more than they go down. The goal is to have your investments be worth more at the end of the year than they were at the beginning of the year.

Inflation Risk

When prices are rising rapidly in the economy, your investment may lose value. **Inflation risk** is the chance that the rate of inflation will be higher than the rate of return on an investment. When this occurs, your investment loses value. For example, assume you bought a bond. A **bond** is a debt instrument that is issued by a corporation or government. The issuer must pay the bondholder the principal (the original amount of the loan) plus interest when the bond matures. Suppose the bond has a fixed interest rate of 5 percent. If inflation is lower than 5 percent, your investment is holding its value. If inflation rises to 7 or 8 percent, however, your investment is losing value. Even though you may have more dollars, you will not be able to purchase as many goods or services with those dollars.

Industry Risk

Industry risk is the chance that factors that affect an industry as a whole will change the value of an investment. For example, suppose you invest in a company that is in the oil industry. If oil prices and profits are rising, then your investment is likely to gain in value. If alternate energy sources

Technology Corner

Internet Investment Research

Investors can find information about investment choices on the Internet. Many companies have Web sites that give information about the company. Such a site is a good source of information for investors. The U.S. Securities and Exchange Commission (SEC) publishes data about companies that investors can view. A link to the SEC Web site is provided on the Web site for this textbook.

The latest news about companies and conditions affecting them is also available on the Internet. News sites provide articles about business and economic events. A wide range of topics, from hiring practices to fraud alerts, is covered. This data can be helpful to investors. Using keywords in a search engine, investors can locate data about many topics that may affect investments.

Information and advice about saving and investing are also available at many Web sites. At some sites, information is free. Other sites charge a fee for giving investment advice. Readers should consider the source of any investing advice found on the Web. Not all sites provide reliable information. Some sites may have offers that are investment scams. Always investigate offers or companies well before investing money with them.

are found, however, then investments in the oil industry could lose value. People might start buying other types of fuel, and the price of oil could drop. Industry risk occurs in all types of businesses.

Political Risk

Political risk is the chance that an event in politics (laws, policies, wars, or elections) will affect the value of an investment. For example, when a new President is elected in the United States, the stock market sometimes reacts positively, and stock prices go up. One political party may seem to be more pro-business than another. When candidates from this party are elected, stock prices may rise. The opposite may also be true.


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Political events, such as elections, can affect the stock market.

Political events in this country, as well is in other countries, affect markets. Wars, terrorist activities, and radical shifts in governments can affect markets significantly. When the news is good, stock prices tend to rise. When the news is bad, prices tend to fall. Political events are out of your control. However, you must consider how political events will affect your investment choices. Some investments are more vulnerable than others.

Stock Risk

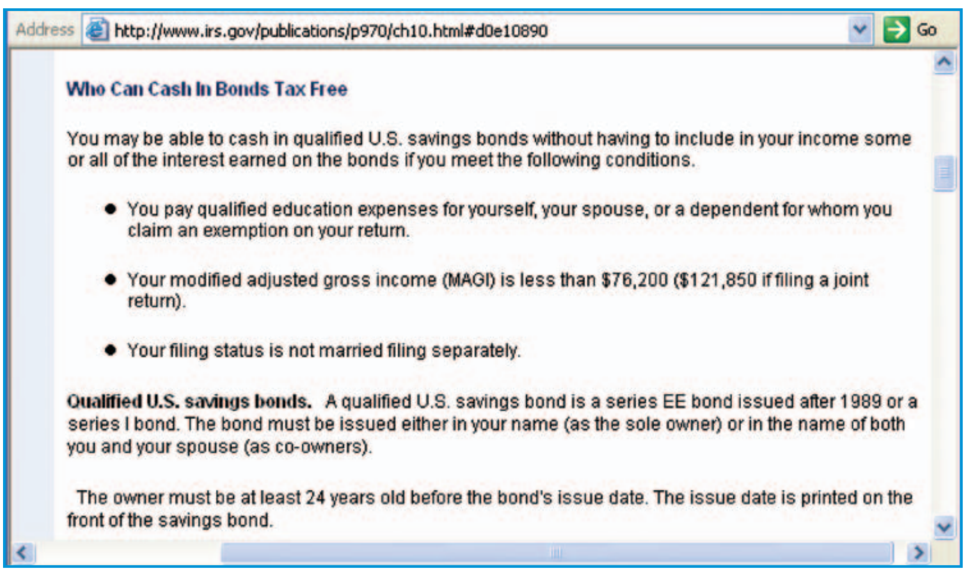
Stock in a company can go up or down in value. **Stock risk** is the chance that activities or events that affect a company will change the value of an investment. For example, the employees of a company might go on strike. When this happens, fewer products may be produced than planned. Sales and income may be lower than expected. This may cause the price of the company's stock to fall. During later periods, the company may do well, and stock prices may increase. Many companies do not perform well all of the time. Companies that show steady growth and strong overall performance over time are good investments.

TAX ADVANTAGES

When you set aside money for future retirement, such as in an IRA (individual retirement arrangement), the money may be tax-deferred. **Tax-deferred** means that there are no taxes on gains until the money is taken from the account. Also, you may not have to pay taxes on the amounts placed in the account until later. This tax advantage allows your investment to grow for years without being taxed. When you retire and take money from the account, you may be in a lower tax bracket. You are taxed only on the portion you take out of the account.

Some savings and investments are tax-free. For example, interest earned on Series EE and Series I U.S. savings bonds is tax-free in some instances if it is used for education. Information about the tax benefits of U.S. savings bonds is provided online, as shown in Figure 10-2.3. Interest earned on municipal bonds (bonds issued by local cities and counties) may be free from federal income tax. Tax-free choices protect your gains and earnings.

People with higher incomes may choose tax-deferred or tax-free investments because their tax rates are high. Suppose a person is in a


Address http://www.irs.gov/publications/p970/ch10.html#d0e10890 Go

Who Can Cash In Bonds Tax Free

You may be able to cash in qualified U.S. savings bonds without having to include in your income some or all of the interest earned on the bonds if you meet the following conditions.

- You pay qualified education expenses for yourself, your spouse, or a dependent for whom you claim an exemption on your return.
- Your modified adjusted gross income (MAGI) is less than $76,200 ($121,850 if filing a joint return).
- Your filing status is not married filing separately.

Qualified U.S. savings bonds. A qualified U.S. savings bond is a series EE bond issued after 1989 or a series I bond. The bond must be issued either in your name (as the sole owner) or in the name of both you and your spouse (as co-owners).

The owner must be at least 24 years old before the bond's issue date. The issue date is printed on the front of the savings bond.

FIGURE 10-2.3

Some U.S. savings bonds are good choices for saving to pay for education.

Source: U.S. Department of the Treasury, Internal Revenue Service, *Publication 970 (2005), Tax Benefits for Education*, http://www.irs.gov/publications/p970/ch10.html#d0e10890 (accessed July 20, 2006).

FIGURE 10-2.4

A tax-free investment may be the better choice, even though it pays a lower interest rate.

INVESTMENT COMPARISON

Taxable	Tax-Free
Corporate Bond at 7% Interest	Government Bond at 5% Interest
The investor pays federal tax at a rate of 35%. For the interest earned, 7% × 65% is the amount the investor keeps. The rest is paid in tax.	The investor keeps all the interest earned at 5%.
$0.07 \times 0.65 = 0.0455 = 4.55\%$	

35 percent tax bracket. That means each dollar earned is taxed at this rate. If $1,000 is earned on an investment, $350 is paid in tax. If, however, this person invests in a tax-free bond and earns $1,000 in interest, there is no tax. Thus, interest rates on tax-free choices are often lower than market rates. However, the tax-free investment may be the better choice, as shown in Figure 10-2.4.

Success Skills

Lifelong Learning

Lifelong learning means acquiring new skills and knowledge throughout your life. Information is growing more rapidly than our ability to keep pace. While you may not be able to keep pace with all there is to know, you can stay current in areas that are of interest to you.

One area in which lifelong learning is especially important is your career. In past decades, many people worked for the same company and even in the same job for their entire careers. That situation is no longer common. Today, many people are employed by several different companies and in several types of jobs during their working years. Continuing education is essential to be prepared for career changes.

Lifelong learning can also help you as you save and invest in an effort to build financial security. Being aware of changes in technology, science, medicine, political events, the environment, and business practices can help you make better investment decisions.

By practicing lifelong learning, you will:

- Be a more valuable employee.
- Be prepared for career changes.
- Be better prepared to make saving and investing decisions.
- Be more interesting to others.
- Know more about protecting yourself from all kinds of risk.

Lifelong learning involves reading about new and different things. It means being aware of events happening in your community, your country, and the world. It often involves learning new skills. You may take continuing education classes or college courses to learn skills. Training may be provided by your employer to teach new job skills. Whatever methods you use, lifelong learning can help you achieve financial success.

10-2 Activity 1 Can You Recall?

Answer these questions to help you recall what you have read. If you cannot answer a question, read the related section again.

1. Explain how risk and return are related to each other.
2. Describe the ideal investment.
3. What is investment risk? What are some factors that can affect investment risk?
4. What is a bond?
5. What is inflation risk?
6. Name some events that might affect political risk.
7. How are tax-free earnings different from tax-deferred earnings?
8. Describe the possible tax advantages of long-term saving and investing.

10-2 Activity 2 Investment Criteria

The criteria for an ideal investment appear in the following list. For each situation below, tell which two criteria you think would be the most important for choosing a savings plan or an investment.

- The principal is safe (no risk).
- The rate of return is high.
- The investment is liquid (you can get your money quickly without a penalty).
- You can invest quickly and easily.
- There are no costs of investing, and you can buy in with small amounts.
- The investment is tax-free (both the earnings and the long-term gains) or tax-deferred.

1. Joshua plans to create an emergency fund to pay for unexpected expenses.
2. Maria wants to see her money grow over several years. She has a separate fund for emergencies that is in a liquid, no-risk account.
3. Chin wants to save money for retirement. He has a separate fund for emergencies that is in a liquid, no-risk account. He has other investments to help achieve other long-term goals.
4. Ellen wants to save money to pay for a college education for her daughter, who is now 3 years old.

10-3

Saving and Investing Strategies

OUTCOMES

- Explain how to use a systematic strategy for saving and investing.
- Explain the dollar-cost averaging strategy.
- Explain how a diversification strategy can lower risk.
- Explain the difference between a bull market and a bear market.
- Discuss buying and selling strategies in times of economic growth and decline.

SYSTEMATIC SAVING AND INVESTING

Systematic means regular, orderly, or done according to a plan. Systematic saving is a strategy that involves regularly setting aside cash that can be used to achieve goals. Once money is set aside in savings, ideally it should remain there until used to meet a planned goal. The amount should be the most you can comfortably afford to save each pay period. Some people find it convenient to have a set amount withheld each month from their paychecks. Others make a monthly payment to a savings plan, just like paying a bill. Some people find that they can set aside a portion of any raise they receive at work. That way, the amount is not money they depend on to meet current expenses.

Systematic investing is a strategy that involves a planned approach to making investments. For example, when you first start investing, you may wish to buy safe and liquid investments. In later years, you may want to take more risk so your principal can grow faster over time. When you get extra cash, such as a bonus, you might wish to buy a high-risk investment in the hope of getting high returns. Systematic saving and investing is important for building financial security in the long term.

Long-Term Focus

A saving and investing plan is designed for growth in the long run, not for short-term results. Investors may need to hold investments for 20 or more years to get the returns they want. In any given year, investments may actually lose money. Over time, however, gains exceed losses on sound investments. For example, suppose investments in the stock market have grown at an annual rate of more than 7 percent over any 20-year period of time. This does not mean that, in any given year, stocks earned 7 percent. In fact, in some years, the return may have been very low. In other years, the return may have been more than 20 percent. Investors must plan to hold investments for the long term to achieve substantial growth over time. As a young person, you should set investing and savings goals that focus on the future.

You can track prices of stocks and other investments using Internet sites. Stock prices are also shown in many newspapers. You might want to track a stock that interests you for several weeks to see how much the price changes. The chart in Figure 10-3.1 shows changes in the price of a stock over a period of 12 years.

© Getty Images/PhotoDisc

Achieving financial goals requires training and discipline, just as preparing for a marathon does.

Dollar-Cost Averaging

One strategy for buying stocks or other investments is dollar-cost averaging. With **dollar-cost averaging**, a person invests the same amount of money on a regular basis, such as monthly. The amount is invested regardless of whether prices are high or low. Sometimes the investor pays more and gets fewer shares. Sometimes the price is low and more shares are purchased. Overall, the dollar cost per share may be less than the average price. Using this strategy, investors do not have to study the stock market and try to determine the best time to buy stocks.

FIGURE 10-3.1

Stock prices may go up or down over the long term.

DIVERSIFICATION

Diversifying is a very important saving and investing principle. **Diversification** is holding a variety of investments for the purpose of reducing risk. When one type of investment goes down in value, there may be others that go up. Thus the losses of one area are offset by the gains in others. It is important for investors to choose more than one type of investment. This is to avoid "having all your eggs in one basket." If a company fails, the investor could lose everything if he or she has only that one investment.

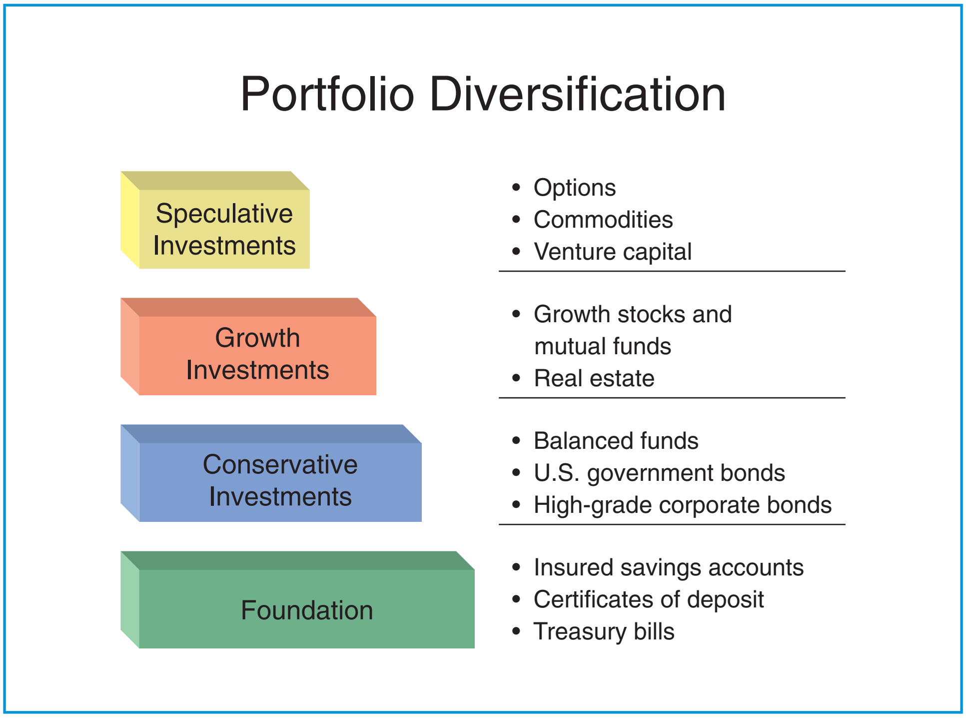
All of a person's savings and investments make up that person's investment portfolio. An **investment portfolio** is a collection of assets, such as certificates of deposit, stocks, bonds, real estate, and other holdings. In order to lower risk over time, the portfolio should be diversified. A portfolio should have a strong foundation of safe investments. For example, insured savings accounts and certificates of deposit are safe investments. The portfolio should have some relatively safe, low-risk investments. These might include U.S. bonds and conservative mutual funds. A mutual fund is operated by a professional investment firm. The firm sells shares in the mutual fund and invests the money in a variety of stocks, bonds, and other investments. Mutual funds have specific objectives, such as growth (high earnings) or balance (good earnings with acceptable risk). Mutual funds allow investors to have diversified holdings within one investment.

A portfolio could include some higher-risk choices that have the potential for high returns. Growth stocks and real estate are examples. Some people also include speculative investments. These options have high earnings potential. However, they are also high-risk. For this reason, some people include only a few or no speculative investments in their portfolios.

Over time, the portfolio should gain in value at a rate greater than the rate of inflation. Each investor must decide how much of each type of investment to include. A sample portfolio is shown in Figure 10-3.2.

FIGURE 10-3.2

An investment portfolio may contain several types of investments.



Investment choices will vary based on the person's age, income, family situation, goals, and attitude toward risk. You will learn more about various types of investments in Chapter 11.

UNDERSTANDING THE MARKET

Having a basic understanding of the market will help you make better investing decisions. The **market** refers to any place where investments are bought and sold. There are stock markets and bond markets. There are real estate markets and markets for precious metals such as gold and silver. For most things that an investor may want to buy or sell, a market exists. The term *market* is also used to refer to price levels or other market conditions. For example, the statement "The market was off today" may mean that prices in the stock market were low compared to prices on other recent days.

Bull Market

A **bull market** exists when stock prices are steadily increasing. A bull market may last a few months to a few years. During a bull market, price advances are often followed by profit-taking. Profit-taking occurs when people who own stocks that have increased in price sell those stocks. This selling activity may cause prices to drop for a while. The bull market does not end, however, because a few stocks drop in price. As long as the general trend is toward increasing stock prices, it is still considered a bull market.

When prices are rising, this may be a good time to sell certain stocks. Suppose a company in which you have stock has been performing poorly in recent months. This could be a sign that the company is poorly managed. It could mean that the demand for products that this company makes is falling. There could be some other problem that you do not know about. If stock prices in the market overall are rising, the price of this one stock may also go up. This could be a good time to sell a stock that you expect to do poorly in the future.

Bear Market

A **bear market** exists in the stock market when prices are steadily decreasing. Bear markets may last from a few months to a year or more. This is a good time to buy stocks that are sound investments because prices are lower. At times in a bear market, there is a lot of buying activity. This can cause a temporary rise in stock prices. The bear market does not end, however. As long as the general trend is toward declining stock prices, it is still considered a bear market.

Economic Conditions

Investors should consider economic conditions when forming an investment strategy. There will always be the rising and falling of the economy that causes prices to rise and fall. It is a normal part of the market and how it works.

Focus on . . .

Market Timing

In investing, the old saying goes, "Buy low, and sell high." The question is, How do you know when prices have reached their lowest point (so you can buy)? How do you know when prices have reached their highest point (so you can sell)? The answer is simple. You do not know; you can only make an educated guess.

To be good at investing, you have to choose timing principles that you follow. For example, you may own a certain stock or another investment and check it every day or week to see what its price is. When you see a downward trend in price, it might be the time to sell. Some experts say, however, that when prices are falling, that is the time to buy stocks that you think are a sound investment. You can get more shares of stock for less money when you "buy low."

When prices for stocks that you own are rising, this may be the time to sell. If you have owned the stocks for a long time and they have gained in value, you can take some of the profits by "selling high."

When to buy and when to sell is up to each investor. Some people leave those decisions to the experts. They buy shares in a mutual fund rather than buying individual stocks or other investments. Experts at the investment firm decide when to buy and sell the individual investments that make up the fund.

When the economy is in a period of general growth, the market for many investments is growing. Economic growth is often defined as a period of time when people are working (low unemployment rate), profits are good, wages are rising, and people are optimistic. When a company's profits are rising, its stock prices often rise as well. When this happens with many companies, overall prices in the market rise. Investors who think that the market will continue in a growth trend may choose this time to buy stocks. They think the stocks will grow in value. Investors who think the growth trend is about to end may choose this time to sell stocks. They want to sell at the current high prices before the market begins a downward trend.

When the economy is in a period of general slowdown, the market for investments is declining. Prices may be falling. Economic decline can be a good time to buy stocks that you think are sound investments. You can buy while prices are low. This increases your chance of making profits when you sell at some future date. Some investors think it is important not to spend (or invest) everything during an economic growth period. Instead, they wait for a period of decline and buy then, taking advantage of lower prices.

Ethics

Price Gouging

Economic conditions can change quickly in times of emergency. For example, when a natural disaster occurs, there are inevitable shortages. If a flood occurs, people may desperately need clean water to drink. They may need gasoline, food, and other necessities. Businesses that have these essential goods have two choices—they can keep their prices the same, or they can raise their prices. If they raise prices to what is considered an unfair amount, this is known as price gouging.

Some people think it is good business to raise prices when demand is high. They view this process as simply supply and demand forces at work. Others think that price gouging is unethical. They believe businesses are taking advantage of people who are unable to buy elsewhere or do without the product. Some states have laws against price gouging in times of declared civil emergencies.

What can you do to avoid being a victim of price gouging? The best strategy is to plan ahead. Prepare for emergencies by having essential items on hand. Keep a supply of clean drinking water and food packaged to prevent spoilage to feed your family for several days. Gather blankets, flashlights, a portable radio, and batteries ready for use. Have a corded phone on hand. A cordless phone may not work if electrical power is out. Buying essential items ahead of time will allow you to avoid paying higher prices during an emergency.

© Joe Skipper/Reuters/Landov

Buy essential items ahead of time to avoid paying high prices during an emergency.

10-3 Activity 1 Can You Recall?

Answer these questions to help you recall what you have read. If you cannot answer a question, read the related section again.

1. Explain how to save and invest using a systematic strategy.
2. Why is having a long-term saving and investment strategy important?
3. What is dollar-cost averaging? What is the advantage to using this investment strategy?
4. How does diversification lower investment risks?
5. What is an investment portfolio?
6. What types of investments should be the foundation of an investment portfolio?
7. What are some factors that will affect the types of investments a person may need in an investment portfolio?
8. How is a bull market different from a bear market?
9. When the economy is growing and stock prices are rising, why might an investor sell stocks?
10. When the economy is slowing down and stock prices are falling, why might an investor buy stocks?

10-3 Activity 2 Systematic Saving and Investing

Allison is 24 years old. She works part-time while going to school. She is able to save $50.00 a month. She now has $600.00 in savings. She would like to buy some type of investment that will give her more return than the 1.5 percent she is able to earn on a savings account. Allison is able to save systematically. She can set aside this money for 10 years or more and can continue to set aside $50.00 per month.

1. How should Allison plan to invest (in terms of risk and liquidity) at this point in her life?
2. Open the *Excel* file *CH10 Future Value* from the data files.
3. Look at the example problem provided in the worksheet. This investor is making an initial investment of $500.00. An additional $100.00 per month will be invested for 30 years (360 payments). The interest rate is 7 percent. The value of the investment after 30 years will be $126,055.35.

4. Use the Calculator section of the worksheet to enter data for Allison's investment. Enter **0.08** for an 8 percent annual interest rate.
5. Allison wants to leave her investment in place for 10 years. Multiply 10 years times 12 months per year to find the total number of payments. Enter this number in the worksheet.
6. Enter **50.00** as the amount of the monthly payments.
7. The present value of the investment is $600.00, the initial amount she will invest. Enter the present value amount **600.00** in the worksheet.
8. The maturity value will be calculated automatically. What will be the value of Allison's investment after 10 years?

Marketing, Sales & Service

EXPLORING CAREERS IN MARKETING, SALES, AND SERVICE

Do you like to work with people? Are you good at persuading others to take action? If the answer is yes, a career in marketing, sales, and service might be right for you. Jobs in this career area are varied. Some jobs involve advertising and promoting products. Others involve buying, merchandising, or direct selling. Storing and shipping products and customer support provide many jobs in this area. E-marketing, or selling and promoting products on the Internet, is also part of this career area.

Jobs in marketing and sales are found in businesses and government. This job area also includes entrepreneurs such as small business owners. The need for jobs in marketing, sales, and service is expected to grow over the next few years. The outlook varies somewhat by job.

Skills Needed

Some of the skills and traits needed for a career in marketing, sales, and service include the following:

- Knowledge of products
- Communications skills
- Computer/technology skills
- Leadership skills
- Ability to work with others showing patience and tact
- Decision-making skills
- Problem-solving skills

Job Titles

Many jobs are available in marketing, sales, and service. Some job titles for this career area include the following:

- Customer service representative
- Graphic designer
- Information systems manager
- Marketing manager
- Market researcher
- Merchandise buyer
- Retail salesperson
- Sales manager
- Shipping/receiving clerk

Explore a Job

1. Choose a job in marketing, sales, and service to explore further. Select a job from the list above, or choose another job in this career area.
2. Access the *Occupational Outlook Handbook* online. A link to the site is provided on the Web site for this textbook.
3. Search for more information about the job you selected to answer these questions:
   - What is the nature of the work this job involves?
   - What is the job outlook for this job?
   - What training or qualifications are needed for this job?
   - What are the median annual earnings for this job?

Review

CHAPTER 10

Summary

- The purpose of saving is to accumulate money for future use with an emphasis on safety of the money. The purpose of investing is to use money to make more money. The emphasis is on growth with acceptable risk.
- Saving and investing begin with meeting short-term needs, such as emergencies, vacations, and current goals.
- Liquidity is the ability to turn an asset into cash quickly and without penalty.
- To meet long-term needs, such as building financial security, you must plan carefully for saving and investing.
- The principal amount of an investment can grow when you add more money to your investment. It can also grow through compounding interest.
- Return on investment (ROI) is a measurement of return given as a percentage. Looking at ROI allows you to compare investment choices.
- Risk and return are related: the more risk you are willing to accept, the higher the return you may be able to earn.
- All investors take risks such as investment risk, inflation risk, industry risk, stock risk, and political risk.
- Saving and investing can provide tax advantages when gains are tax-free or tax-deferred (taxed later).
- Systematic saving is a strategy that involves regularly setting aside cash that can be used to achieve goals according to a planned investment schedule.
- A saving and investing plan is designed for growth in the long run, not for short-term results.
- Using a dollar-cost averaging strategy, a person invests the same amount of money on a regular basis regardless of market conditions or prices.
- Diversification means owning a variety of investment choices to lower risks. A portfolio is a collection of these choices.
- The market refers to any place where investments are bought and sold.
- In a bull market, prices are steadily increasing over time. In a bear market, prices are steadily decreasing over time.
- Economic growth often leads to rising prices and increased buying. Economic decline often leads to falling prices and decreased buying. Both conditions can present good opportunities for investors.
- Price gouging is charging unreasonably high prices for essential goods, such as food and fuel, at certain times when demand is high, such as in times of emergency.

Key Terms

bear market
bond
bull market
contingencies
diversification
dollar-cost averaging
emergency fund
financial security
industry risk
inflation risk
investment portfolio
investment risk
liquidity
market
political risk
stock risk
stocks
tax-deferred

ACTIVITY 1
Review Key Terms

Use the key terms from Chapter 10 to complete the following sentences:

1. Shares of ownership in a corporation are called ______________.
2. A measure of the ability to turn an investment into cash quickly is called ______________.
3. Unplanned events, such as emergencies, are called ______________.
4. When taxes are not levied against gains until the money is taken from the account, the investment is said to be ______________.
5. The chance that factors that affect an industry as a whole will change the value of an investment is called ______________.
6. A(n) ______________ is a collection of investments, such as stocks, bonds, and real estate.
7. Saving and investing the same amount of money each month regardless of market conditions is using the ______________ strategy.
8. A(n) ______________ is a debt instrument issued by a corporation or government that requires the issuer to pay the bondholder the loan principal plus interest at maturity.
9. When stock prices are steadily decreasing over time, this type of market is called a(n) ______________.
10. The potential for change in the value of an investment is called ______________.
11. Holding a variety of investments in order to reduce risk is called ______________.
12. The chance that an event in politics will affect the value of an investment is called ______________.
13. ______________ is the ability to prepare for future needs and meet current expenses to live comfortably.
14. The chance that activities or events that affect a company will change the value of an investment in that company is called ______________.
15. When stock prices are steadily increasing over time, this type of market is called a(n) ______________.
16. An amount of money set aside to handle expenses related to unplanned events is called a(n) ______________.

17. The chance that the rate of inflation will be higher than the rate of return on an investment is called ______________.
18. Any place where investments or assets are bought and sold is called a(n) ______________.

ACTIVITY 2
Math Minute

Round your answers to the nearest percent.

1. Jerry bought stock for $350.00. A year later, he sold it for $385.00. What is his return in dollars? What is his return on investment?
2. Brandy sold her collection of model cars for $600.00. She had purchased them for $520.00 a year earlier. What is her return in dollars? What is her return on investment?
3. Pablo bought 25 shares of a stock for $150.00 a share. He received dividends of $3.00 per share each year for 5 years. After 5 years, Pablo sold the stock for $155.00 a share. What is his return in dollars? What is his return on investment?
4. Keiko bought 46 shares of stock for $22.12 each. She sold the stock for $17.00 per share a year later. What is her return in dollars? What is her return on investment?

ACTIVITY 3
Investment Strategies

TEAMWORK

Work with a classmate to complete this activity.

1. Read each of the following scenarios.
2. Describe the saving and investing strategy you would advise for each scenario. Give reasons why you selected this strategy.

Scenario A
Ben Fong has saved $1,000. Currently, the money is earning 0.5 percent interest in a checking account. Ben works part-time and goes to high school. He plans to start college in 4 or 5 years. Ben does not have any other savings or investments.

Scenario B
Bill and Barbara Wilson are a married couple. Both of them are working, and they pay taxes at a high rate (35 percent). They have saved $5,000 and wish to invest it for the future. They have other savings and retirement plans, including both low-risk and high-risk investments.

Scenario C
Gloria Vega just inherited $1,500 from her uncle. She is single, 25 years old, and living with her parents. Gloria works full-time while attending college part-time. She has some savings ($2,500) and no investments.

ACTIVITY 4
Portfolio Diversification

Critical Thinking

An investment portfolio is a group of assets, such as certificates of deposit, stocks, and bonds. The portfolio should be diversified to lower risk. Investment choices will vary based on the person's age, income, family situation, goals, and attitude toward risk. They will also vary depending on the amount of money to be invested. In this activity, you will think about how to select types of investments for a diversified portfolio.

Assume that you are 28 years old. You have completed college and have a job that pays $40,000 a year. You have no debt. You have no dependents that you help support. You have savings of $30,000. You have decided to create a diversified investment portfolio.

Answer the following questions to help you think about how to structure your portfolio. Refer to Figure 10-3.2 on page 302 for examples of each part of a portfolio. However, you should select amounts for each category based on your own ideas about investing and how comfortable you are with taking risks.

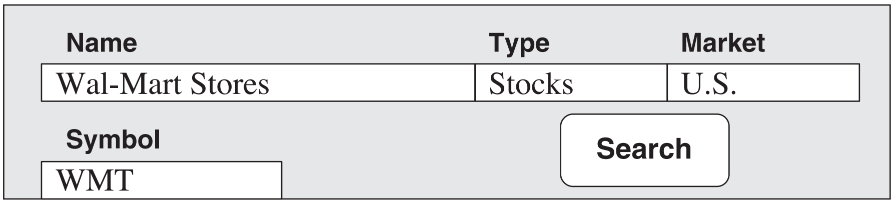
1. What percentage of your savings will you place in the foundation portion of the portfolio? What will this amount be in dollars? What types of investments will be in this part of the portfolio?
2. What percentage of your savings will you place in the conservative investments portion of the portfolio? What will this amount be in dollars? What types of investments will be in this part of the portfolio?
3. What percentage of your savings will you place in the growth investments portion of the portfolio? What will this amount be in dollars? What types of investments will be in this part of the portfolio?
4. What percentage of your savings, if any, will you place in the speculative investments portion of the portfolio? What will this amount be in dollars?
5. What amount of money will you plan to invest each coming month or year to help build your portfolio?
6. What long-term goals will you keep in mind as you choose your investments?

ACTIVITY 5
Track Stock Prices

INTERNET www.thomsonedu.com/school/pfl

Tracking a stock's price for several weeks or months before buying the stock is a common investment strategy. If the stock price rises and falls often, you may be able to buy when the price is low. Stock prices are available online and in many newspapers. Typically, the user must enter or find a symbol (a series of letters) that represents the company. For example, the symbol for Wal-Mart Stores is WMT. If you do not know the symbol for a company, you can find it online. In the following sample symbol search screen, the user enters the name of the company; selects a type of investment, such as Stocks; and chooses a market. When the search is complete, the symbol appears.

Sample Symbol Search Screen



Depending on the Internet site or newspaper, various information is provided about the stock. The opening price of the stock, the closing price (also called Last Trade), and any change in the stock price are usually shown, as in the following example:

Wal-Mart Stores, Inc. (WMT)	
Date	7-21-06
Close (Last Trade)	43.72
Change	⇩ 0.57
Previous Close	44.29
Open	44.51

1. Select a large corporation with which you are familiar.
2. Access the Internet and find a site that gives stock quotes. Links to several such sites can be found on the Web site for this textbook. You can find other sites by entering **stock quotes** in a search engine.
3. Search to find the market symbol for this company if you do not know it.
4. Find the Close (Last Trade) price for the stock for the current date. Record the date and the price.
5. Continue to find and record the Close (Last Trade) price of the stock every 1 to 3 days for the following 2 or 3 weeks as your teacher directs.
6. Create a line chart to show the changes in the stock price. Use Figure 10-3.1 on page 301 as an example for your chart. Use **Days** or **Weeks** instead of Years for your chart.