FIFO Test V Review — SAVING & INVESTING

The following are the main ideas that we learned about within each of these lessons. Hopefully all of this looks vaguely familiar! You should be comfortable with each of these concepts for the test.

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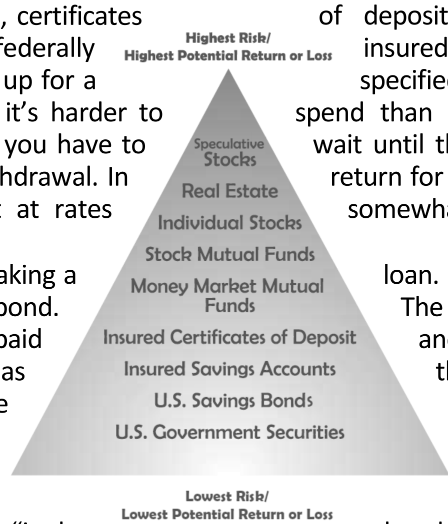
❶ Spending & Saving Tradeoffs

- As with any economic decision, there is no free lunch in deciding about investments. Here are some of the risks you take when you invest your money:
  1. Financial Risk – you might lose all or part of your money
  2. Market Price Risk – the price of your investment may go down
  3. Liquidity Risk – You may not be able to get your money out quickly
  4. Inflation Risk – prices in the economy may rise faster than the value of your investments
  5. Fraud Risk – some investments are scams … be careful!

- Savings Accounts. These accounts 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. The money in a savings account 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. Also, 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. Finally, 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. You share in the profits of the business and you have a vote in the decision-making authority. 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. A company could have great success, making its shareholders rich. Or it could go down the tubes, making its shareholders lose whatever they invested.

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❷ Financial Institutions (Mainstream vs. Non-Mainstream)

MAINSTREAM FINANCIAL INSTITUTIONS
- Banks, Credit Unions, Brokerage Firms, Insurance Companies
- Financial Services at Mainstream Institutions: Checking account, Savings account, Money market accounts, Electronic transfers of funds, Certificates of deposit, Loans, Mortgages, Home equity loans, Brokerage services, Safe deposit box, Credit cards, Debit cards
- Regulation of Financial Institutions: Federal regulators, State regulators, Licensing of people who provide services

- Benefits of Using Mainstream Institutions: Lower cost, Credit history, Security, Encourages saving, Record keeping

NON-MAINSTREAM FINANCIAL SERVICES

- Check-cashing outlets are fast and do not require much identification. They offer other services including money transfers.
- Short-term lenders offer small loans for $150 to $300. Payday loans are the most common sort of loan. Usually customers write a postdated check and leave the check with the loan provider for an agreed-upon amount of time — often two weeks or until the next payday. Then the loan provider cashes the check unless the customer reclaims the check and repays the loan.
- Rent-to-own stores rent and sell many products including appliances, furniture, television sets and CD systems. Ordinarily a customer agrees to rent a product for a period of time, perhaps one week or one month. If the customer rents the product for a specified period of time — commonly 18 months — he or she will become the owner of the product.

Being unbanked means having no relationship with mainstream financial institutions.

- ADVANTAGES OF BEING UNBANKED: Many financial services are provided (Loans, Check cashing, Wire transfers); Services are nearby; Services are quick; Services are provided with a minimum of paperwork and hassle.
- DISADVANTAGES OF BEING UNBANKED: No ability to save; Higher cost; Less secure: cash; Less complete credit history; No relationship with a bank or other mainstream provider

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❸ Strategies for Wealth Building

- Wealth building is good for individuals, families and society because it improves people's quality of life. Whatever goods and services you would like for yourself, your family or nation - better housing, higher quality medical care or anything else - they can be more nearly within reach if you engage effectively in wealth building.
- Many people act as if wealth building were very complex. In fact, an effective approach to wealth building can be summarized in three rules: 1. Start early. 2. Buy and hold. 3. Diversify.

- RULE 1: Rule 1 says "Start early." Money that's saved early so that it can work for a long time has a great deal of importance in overall wealth building. An early start works well because of the magic of compounding. When you save money, you receive a return. In the case of bank accounts, that return is called interest. If you leave the interest in the account, that money also earns interest. In other words, you earn interest on interest. The longer this process goes on, the more it works for you.
- RULE 2: The second rule is "Buy and hold." This means that to build wealth over time, you have to hold on to your long-term savings. You can't be dipping into them frequently, or they won't compound over time in the same way. To buy and hold, you have to have your finances in order. Here are three steps to consider:
- RULE 3: Somebody probably once told you, "Don't put all your eggs in one basket." To diversify is to take on many small risks rather than one large risk. It's far safer to spread risks out. This means holding a variety of financial assets rather than just one.

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❹ Simple Interest, Compound Interest, and the Rule of 72

- Saving is income not spent.
- Interest is the price of using someone else's money. When people place their money in a bank, the bank uses the money to make loans to others. In return, the bank pays the account holder interest. There are various types of interest-bearing accounts depending on the amount of interest and how often the interest is paid.
- Compound interest means that interest is computed on the sum of the original principal and any accrued (accumulated or earned) interest. For example, an account that pays 5 percent interest "compounded semiannually" means that every six months H of 5 percent, i.e., 2.5 percent, interest is paid on the principal and any accrued interest.
- The Rule of 72 is an easy way to estimate how long it will take your money to double at a certain interest rate. In order to determine how long it will take your money to double at a certain interest rate you should divide 72 by the interest rate. For example, 72 ÷ 5 = 14.4. Therefore the principal in a savings account that pays 5 percent interest will double in a little over 14 years. The Rule of 72

assumes people leave their money in an account without taking away from it or adding to it. It isn't an exact number, but it's close enough to serve as an estimate.

- The risk-reward relationship is based on the concept that the higher the risk of loss of principal for an investment, the greater the potential reward of an increase in the principal or higher yield on the principal. And the lower the risk of loss of principal for an investment, the lower the potential reward of increased principal or higher yield on the principal. Therefore, savings accounts are considered very low risk; so, their reward, as compared with other investment options, is a relatively low "yield," or interest rate.
- BE ABLE TO CALCULATE SIMPLE INTEREST AND COMPOUND INTEREST; KNOW HOW TO USE THE RULE OF 72

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❺ The Stock Market

- What is a stock? Why do corporations issue stock?
- When the shares of stock are first *issued*, to whom are they sold? How does the corporation get money from the stocks? Why do investment bankers buy the stock?
- Why do people buy stock? How do people earn money from stocks? (two ways)
- What are dividends? When people buy stock, is there a guarantee that they will receive dividends or that they will be able to sell the stock at a price higher than the price they paid for it? Explain.
- What determines the price of a stock?
- What is the main advantage of owning stock? Disadvantage?
- Why are stockholders willing to assume risk when buying stock in a company? What do you get in return for taking this risk?
- What is the difference between NYSE, AMEX, and NASDAQ stock markets? How can you tell if a stock is traded on each?
- What are stock markets? How do stock markets help sellers and buyers of stock?
- What role do stockbrokers play in buying and selling stocks and bonds? What's the difference between full-service and discount brokers? What kind of investor would benefit most from dealing with a full-service broker?

Stock Strategies

- Peter Lynch … Buy What You Know
- Markets- Current and Future (what is happening in the market and the world?)
- Economic Cycle (what stocks do well in the current economy?)
- Avoid Obvious Risks (front page stories, industry conditions, changes in technology, specific situations)
- Should you invest in what your know or leave it to the experts? Do your homework!

DJIA Research Project

Be able to look at a page from Yahoo Finance and answer some basic questions about the stock.

- What is the current stock price of Procter & Gamble? What is Procter & Gamble's stock ticker symbol? What stock exchange does Procter & Gamble trade on? How has P&G been trading during the past year? Is the stock closer to its annual high or low? Has it been a good investment? Explain?