

# Saving and Investing Strategies

## *Standard 5*

*The student will analyze the costs and benefits of saving and investing.*

## Lesson Objectives

- Examine different types of savings and investment strategies.
- Compare the costs (risk) and benefits (rate of return) of different savings and investment strategies.

## Personal Financial Literacy Vocabulary

Certificates of deposit (CD): A certificate issued by a bank to a person depositing money in an account for a specified period of time (often six months, one year, or two years); a penalty is charged for early withdrawal from CD accounts.

Corporate bonds: A certificate representing the purchaser's agreement to lend money to a business on the promise that the debt will be paid, with interest, at a specific time.

Money Market Mutual Funds (MMMF): A fund restricted by law to investing in the short-term money market. MMMFs provide low risk and low returns, but they maintain their investment value.

Mutual funds: An investment tool that pools the money of many shareholders and invests it in a diversified portfolio of securities, such as stocks, bonds, and money market assets.

Rate of return: The gain or loss on an investment over a specified time period, expressed as a percentage of the investment's cost.

Risk: A measure of the likelihood of loss or profit the uncertainty of an investment's rate of return.

Savings accounts: A financial institution deposit account that pays interest and allows withdrawals.

Savings bonds: A document representing a loan of more than one year to the U.S. government, to be repaid, with interest on a specified date.

Stocks: An investment that represents shares of ownership of the assets and earnings of a corporation.

# Introduction

***Hayley and Hannah are both turning 16 this year and entering their senior year in high school. The girls have been best friends since kindergarten.***

***Hayley's parents started a savings account for her college education right after she was born. Each month, her dad has $50 automatically deposited in the account. Hannah's parents opened a college savings plan on her first birthday. Her account is a mutual fund with a diversified stock portfolio. Her dad also has $50 a month automatically deposited in the account.***

***Which one has the most money in her college account?***

# Lesson

The decision to save and invest is one of the most important choices you can make because it has the potential to impact the rest of your life. It can determine how much money you have today, but more importantly, how much money you will have in the future. Your goals will determine the choices you want to make when planning your savings and investing strategies. Savings is generally used to meet short-term and medium-term goals of seven years or less, while investing is generally used to meet long-term goals, or those over seven years.

Because the timeframe for savings is more limited than the timeframe for investing, most savings strategies have less risk than those associated with investing. One of the safest ways to save your money is by opening an interest-bearing account at your bank or credit union. These accounts usually pay rather low interest rates, but your money is insured by either FDIC or NCUA. FDIC stands for the Federal Deposit Insurance Corporation which insures the money you have in a bank up to $250,000. NCUA stands for the

National Credit Union Association and provides insurance for your money in a credit union, also up to $250,000. Having your money in an insured account means it will always be there when you need it. Also, putting your money in a savings account will allow it to gradually increase as the interest compounds. Savings accounts are great tools for people who want to start small and gradually increase their savings. They are also important strategies for establishing an emergency fund or meeting short-term goals.

In addition to savings accounts, other potential savings strategies include:

- Certificates of Deposit. Certificates of deposit (also called CDs) are offered by most banks and credit unions, and they are also covered by FDIC or NCUA insurance. When you buy a CD, you usually have to wait a certain amount of time until the CD "matures" to get your money. CDs can mature in thirty days or a few years, depending upon which CD you decide to purchase. The longer the term of the CD, the higher the rate of interest you receive. While it may be harder to access your funds with a CD until the term has completed, they do tend to earn more interest than a traditional savings account.

- Government Savings Bonds. Government savings bonds are backed by the United States government, so there is little or no default risk. Default risk is the potential that the bond issuer will not pay the interest or return your money when the bond matures. Savings bonds (EE/E or I bonds) are designed to be held for a minimum number of years before you cash them in to get your money and interest. Because of the length of maturity, government bonds often have a higher rate of return than savings accounts or CDs. Government savings bonds have very low risk, which reduces the potential earnings, but yet they are a good savings strategy for someone who is just starting to save.

- Money Market Mutual Funds. Money market mutual funds are designed to provide higher rates of return than savings accounts, CDs or savings bonds because your money is put into very short-term investments with a low risk. MMMFs are available at most banks and credit unions, as well as other financial service providers. Money market accounts at a bank or credit union are insured, like any other savings account while those offered by other providers are generally not insured. Therefore, those accounts at other service providers tend to have higher interest rates to offset the potential increase in risk.

### *Investing Strategies*

When investing your money, you are really hoping for a higher rate of return than when you save. Investment options tend to have higher risk than savings strategies, but that is because they tend to have greater potential rates of return. As a young person, you may have many reasons for investing your money. Most adults, however, tend to focus their investments on retirement benefits. Regardless of how young or old you are, it is never too early to consider your investment strategies for long-term goals.

Following are several investment tools you may want to consider:

- Mutual Funds. Mutual funds provide an opportunity for investors to pool their money together to buy shares of a fund that invests in many different financial products, such as stocks, bonds, and other securities. They are a great way for people with limited money and limited knowledge about investing to get started. Mutual fund accounts have a professional money manager who monitors the account closely to ensure it is earning the maximum amount possible. At the same time, mutual funds may go through periods of time where they do not earn a high rate of return, and in fact, may even lose money. Their rate of return is based on a variety of economic factors, which fluctuate from time to time. However, if you are investing for a long-term goal, you generally have time to recover from any losses. Most financial experts highly recommend mutual funds for anyone interested in investing because the potential benefits of gain are greater than the potential costs of loss.

- Stocks. Buying stocks allows you to own part of a company. For example, if you buy a share of stock in Merger, Inc., you are a shareholder in that company. Purchasing stock in a single company can be exciting if you are interested in what the company does, but it does provide more risk than investing in a mutual fund. You might liken it to the old saying of "putting all your eggs in one basket." If you drop the basket, there go your eggs! And, if the company fails, there goes your investment.

REMINDER

*High potential rewards or rate of return have potential risk of loss. Lower potential rewards or rate of return have lower potential risk of loss.*

When buying stocks, it is generally advisable to buy a variety of stocks and diversify your portfolio. Diversifying you portfolio means you would own stocks in more than one company, spreading your risk. Or, putting your eggs in multiple baskets! To diversify a portfolio, an individual investor should own at least ten different single stocks in different industries. Buying and selling stocks can be exciting and profitable; however, it is more risky and more expensive than owning a mutual fund. All things considered, owning stock has one of the best rates of return of any investment; however, you must be willing to "ride the market" because it can be somewhat volatile.

- Corporate Bonds. When you buy a corporate bond, you have basically made a loan to the company. You allow them to use your money, and they pay you interest on your money. The interest you receive increases the value of your initial investment. Buying bonds for a single company is much like owning stocks in a single company; if something happens to that company, you can lose most, or all, of your investment. Buying into bond mutual funds is an alternative because it allows you to spread your risk. While bond mutual funds can lose money when interest rates increase, they tend to offer greater protection from losses than a single bond. In general, investing in bonds is a lower risk option with lower rates of returns than stocks.

## *Rate of Return*

Because risk levels are different for the various saving and investing options, the rates of return also vary. The rate of return is the amount of money you can earn or lose when saving or investing, and it is a percentage of the amount you invested. As a general rule, increased levels of risk have greater potential for higher rates of return. The key word, of course, is potential.

Below is a chart showing different types of investments and their average rate of returns. As you can see, different kinds of investments have historically provided different rates of return. Average rates of return do not guarantee what you will earn; they only show what has happened in the past with that type of investment.

| Asset Class | Rate of Return* |
|---|---|
| Common stocks | 10%-13% |
| Stocks of smaller companies | 14%-16% |
| Long term corporate bonds | 6.5%-8% |
| Long term US government bonds | 5%-7.5% |
| Short term US Treasury bills | 3.5%-5% |

***Average rate of return since 1926, Ibbotson and Associates**

# Conclusion

Choosing the best savings or investment product will help you meet your personal and financial goals. Your choices will also depend upon when you need to use the money. Short-term goals are best for savings and long-term goals are best for investing. Building a diverse portfolio will help you better manage your saving and investing risk, adding to your overall rate of return. After all, the goal of saving and investing is to EARN money — not lose it!

FINAL NOTE: So, who has the most money for college: Hayley or Hannah? If you said Hannah, you are correct! Her parents made the best choice for reaching their long-term goal. Hayley's savings account earned an average of 3% interest for the past 16 years while Hannah's mutual fund earned an average of 12% for the past 15 years. All things being equal, Hannah would have the most money in her account.

This lesson was written and created by Oklahoma educators in partnership with Oklahoma Council on Economic Education

Name:______________________________ Class Period: ______________________________

# Saving and Investing Strategies Review 5.3

Answer the following questions and give the completed lesson to your teacher to review.

1. List one short-term goal and explain a savings or investing strategy to help you reach that goal.

2. List one long-term goal and explain a savings or investing strategy to help you reach that goal.

3. Explain the difference in risk to saving versus investing. Does savings or investing have a higher potential rate of return?

4. Write a short paragraph about this statement: Even though you have long-term goals, it is still important to have short-term savings.

Name:________________________________Class Period: ______________________________

# Saving and Investing Strategies Activity 5.3

Complete the following assignment and give it to your teacher for review.

Part A. Place the following terms in the correct category in the table below.

Certificates of deposit

Corporate bonds

Money market mutual funds

Mutual funds

Savings accounts

Savings bonds

Stocks

| Savings | Investing |
|---|---|
| | |
| | |
| | |
| | |

Part B. Each of the above strategies has both costs and benefits. In this section, write the definition or a description of the strategy, and identify one cost and one benefit associated with that strategy.

1. Certificate of Deposit

   Description: ________________________________________________________________

   Benefits: __________________________________________________________________

   Costs: ____________________________________________________________________

2. Corporate Bonds

   Description: ________________________________________________________________

   Benefits: __________________________________________________________________

Costs: ________________________________________________________________

3. Money Market Mutual Funds

Description: ____________________________________________________________

Benefits: ______________________________________________________________

Costs: ________________________________________________________________

4. Mutual Funds

Description: ____________________________________________________________

Benefits: ______________________________________________________________

Costs: ________________________________________________________________

5. Savings Account

Description: ____________________________________________________________

Benefits: ______________________________________________________________

Costs: ________________________________________________________________

6. Savings Bonds

Description: ____________________________________________________________

Benefits: ______________________________________________________________

Costs: ________________________________________________________________

7. Stocks

Description: ____________________________________________________________

Benefits: ______________________________________________________________

Costs: ________________________________________________________________