Lesson 13

Intro to Investing

Economics & Personal Finance

Key Terms

- Back End Load
- Dividends
- Expense Ratios
- FDIC Insured
- Front End Load
- Inflation
- Savings Account
- Year to Date Return (YTD)
- Yield

To Save Money:

1. Set a **Financial Goal**
   - Goals should be SMART
     - Specific
     - Measurable
     - Action-oriented
     - Realistic
     - Time-bound
2. Figure out your **Available Income**
   - How much can you save per month?
3. Determine the **Time Horizon**
   - How long will it take to reach your goal?
4. Avoid **Spending Traps**
   - Stick to goal by not spending money on items that are quickly gone

Savings/Investment Basics

- Savings/investments grow through **interest**
  - Money you earn on your investment
- Savings/investments grow more rapidly using the principle of **compound interest**
  - Interest earned on interest
  - If interest is reinvested (kept) in the savings or investment, interest will be earned on that larger amount
  - Investment will grow more rapidly the longer it is kept and reinvested
  - Requires **time** to work

- Some interest-earning investments have **guaranteed** rates of return (yield)
  - Savings accounts
  - Bonds
  - You will know your annual yield on these types of investments
- Other investment have no guaranteed **rate of return**
  - Stocks
  - Mutual Funds
  - Yield is calculated periodically (annually, etc.) based on current value and original value

FDIC-Insured or Not

- Insurance on **deposits** in financial institutions
  - Federal Deposit Insurance Corporation (FDIC)
    - Insures deposits up to $250,000 in **banks**
  - National Credit Union Association (NCUA)
    - Insures deposits up to $250,000 in **credit unions**
    - Called the National Credit Union Share Insurance Fund (NCUSIF)
- Banks pay for this **insurance**
  - Protects you against loss of your money
  - Your deposits are guaranteed up to the set limit
- No insurance available for stocks or mutual funds

Inflation & Your Rate of Return

- **Inflation**
  - The general rise in the cost of goods
  - Makes your money worth less over time
    - Can't buy as much with a given amount of money as you could before the inflation
- Inflation reduces your effective **return on an investment**
  - Money earned can now buy less (less buying power) than an identical amount could have bought earlier

How To Calculate Impact of Inflation on Rate of Return

- Subtract inflation rate from yield
- Result will be less than **original yield**
  - If inflation is higher than yield, your effective yield is negative (a loss)
- Example:

Investment Yield	5%
minus	
Inflation Rate	3%
Effective Yield	2%

Is My Money Growing?

- Normally get monthly statement
  - Bank statement from savings account
  - Report from brokerage house on stocks/mutual funds
- Monthly statement will normally report:
  - **Monthly** growth/loss
  - **Year-to-Date** growth/loss

Calculating Your Rate of Return

$$\text{Annual Rate of Return} = \frac{(\text{Sales Price} + \text{Dividends}) - \text{Purchase Price}}{\text{Purchase Price}} \times 100\%$$

Example:

- Purchase Price: $50
- Sale Price: $60
- Dividend paid: $1

$$\text{Annual Rate of Return} = \frac{(\$60 + \$1) - \$50}{\$50} \times 100\%$$

$$\text{Annual Rate of Return} = \frac{\$11}{\$50} \times 100\%$$

$$\text{Annual Rate of Return} = \textit{22\%}$$

How Do Commissions Affect Rate of Return?

- **Commission**
  - Amount paid to broker who handles the actual buying and/or selling of **stock**
  - Pay commission when you:
    - Buy stock ($$ fee per transaction)
    - Sell stock ($$ fee per transaction)
- Commission reduces your **profit** from the sale of a stock
  - Increases actual purchase price
  - Decreases actual sale price

What Is a Money Market Account?

- **Savings** account with **high** minimum balance
  - Pays higher interest rate than regular savings account
- Bank will take your money and loan it out at a **higher** interest rate than they are paying you
  - **Minimum** balance guarantees that they will have at least that amount that they won't have to give you back at a moment's notice
    - If balance drops below minimum, you no longer earn any interest
- Great way to earn **interest** on large amounts of money you may need ready access to

What is a Mutual Fund?

- A pool of **stocks**, **bonds**, money market accounts, a family of funds, and other types of investments managed by an **investmen**t company
  - Individuals can buy shares of the **fund** and profit from its investment **gains**.
  - The mutual fund company **pools** investors' money and buy a broad range of investments to create a strong portfolio.
    - Generally a more broad range of investments than you can own **individually**
- Can reduce the **risk** involved with investing in the stock & bond markets because you own a **diverse** portfolio of investments.
- **Must** be purchased through a broker; cannot be purchased directly by you.

What Are Fund Expenses & Why Are They Important?

- Mutual fund companies make money through **charging fees**
- **Front end** load
  - Fee charged up front when the purchase of shares of the fund is made
    - May need to hold on to the fund for along time to recuperate these costs.
  - Might be good idea if you will **hold on** to fund for a long time
    - Better to pay fee on smaller amount than in the future when fund may be worth more

- **Back end** load
  - Fee charged when **sale** of shares occurs
  - Can be more than front end load if shares have gone up significantly
    - Good idea if you think you can make more by including what would be a front end load than you anticipate paying out in a back end load
- **Annual fees**
  - **Percentage** of fund value paid to managers as an expense (pay for employees, other expenses)
    - Called ***expense ratio***
  - Higher expense ratio makes fund more costly and less profitable than identical fund with lower expense ratio
  - Fees cover the cost of the researchers who manage the funds.

Can I Avoid Mutual Fund Fees?

- "100% no-load" or "**true no-load**" funds
  - Don't charge front-end load, back-end load fees
  - May charge annual fee
    - Managers of fund have to get paid somehow

Scams to Avoid

- You are informed you won a lottery you never entered.
- You are instructed to “wire”, “send”, or “ship money as soon as possible to some large city or another country (like Nigeria).
- You are asked to receive pay or commission for letting money transfers come through your account.
- You are asked to confirm, update, or provide your account information.