Preparing to Invest

1. Introduction: Saving and Investing

People save and invest to have enough money at some point in the future to pay for the things they want or need. While you might hear the two terms used interchangeably, saving and investing are overlapping yet distinct concepts that involve different processes. Stated most simply, saving is the act of putting aside for another day some of the money you earn or receive as gifts, while investing is the act of choosing products and strategies to make that money grow.

If you have specific financial goals that will cost money—such as purchasing a car or a home, paying for college, or building a secure retirement—accumulating assets and building wealth through saving and investing is the key to achieving those goals.

Saving for the Future

There are various ways to save. One way is to open one or more deposit accounts, such as a checking or savings account, in a bank or credit union—or what you'll sometimes hear described as a savings institution. Deposit accounts give you ready access to your money, and your account balances are typically insured by the federal government up to a set limit.

Insurance for bank accounts is provided by the Federal Deposit Insurance Corporation (FDIC), while insurance for the credit union accounts is provided by National Credit Union Share Insurance Fund. The insurance protects individual, joint, business, and trust accounts up to $100,000 for each depositor in a participating bank or credit union. As a result, when you put money into an insured bank or credit union account, you don't risk losing any of your money—neither the amount you put in, which is your principal, nor the amount you earn in interest. Retirement accounts in those same institutions are insured up to $250,000 for each depositor, provided all the money is in bank accounts.

Another way to save is to purchase U.S. savings bonds either through an online account with Treasury Direct (www.treasurydirect.gov), at a bank, or sometimes though a program where you work. Savings bonds are backed by the federal government, so your money is safe. They pay interest until they reach maturity—which is generally 30 years from the date of issue. Series EE savings bonds pay a fixed rate of interest, while Series I savings bonds pay interest linked to the rate of inflation.

You can't cash a savings bond for a year after you purchase it, and you'll lose three months interest if you cash it in within the first five years. After that, you can cash it any time without penalty and collect the interest that has accrued.

Earning Interest

Every savings institution tells you the interest rate it is paying, expressed as both a nominal, or named, rate and an annual percentage yield (APY). If the APY is larger than the nominal rate, even by a little bit, that means the interest is paid more frequently than once a year and that the interest earnings are added to the principal, or amount on deposit, each time they are paid. This process, called compounding, creates a bigger base on which future earnings can accumulate.

Banks and other financial institutions use a complex formula to calculate how interest compounds over the years. But you don't have to be a math wizard to see how your money can grow. The Rule of 72 is a shorthand way to figure out how many years it will take for compounding to double your money at a particular interest rate. What you do is divide the interest rate you're earning into 72.

For example, let's say you have $1,000 and you want to know how long it will take to double your money. If you earn 6% interest each year on your account, you divide 72 by 6:

72 ÷ 6 (representing 6% interest) = 12 (years to double your money)

At the end of 12 years, you will have just over $2,000 in your account.

Remember, this illustration only focuses on the impact of compounding on your initial deposit of $1,000—and does not take into account any additional deposits you might make over time. If you were to deposit $100 each year to your account, it would take only 6 years for you to have $2,000.

The true magic of compound interest is that you earn interest not only on your principal, but also on the interest you accumulate each year.

Learning About Bank Products

Savings institutions offer different types of accounts, sometimes described as bank products, which pay different interest rates. In general, the higher the rate paid on an account, the more limitations there are on access to your money. These are the most common types of accounts:

- **Basic savings accounts** usually pay interest at a lower rate than other bank offerings, though some institutions may pay higher than average

rates especially when they are competing for customers. You can withdraw or make additional deposits any time you like.

- **Money market accounts** usually pay a somewhat higher rate than basic accounts, but typically limit the number of withdrawals or transfers you can make each month. These accounts may impose fees or stop paying interest, or both, if your balance falls below a certain minimum.

- **Certificates of deposit** (CDs) pay the highest rates but require you to leave your money in the account for a specific term, or period of time, to earn interest. If you take your money out before the CD matures, or reaches full term, you may forfeit some or all of the interest you expected to earn. Generally, the longer a CD's term, the higher the rate of interest it pays.

Seeking Growth through Investing

If you are willing to take a certain amount of risk with the money you have saved, you can use it to make investments that you expect to be worth more in the future or will pay you regular income over time at a rate higher than you usually can earn on a bank account—or both.

Two of the key ways in which investments differ from savings accounts are: (1) investments are not insured by the federal government and can lose value, and (2) investment earnings are not guaranteed. If you choose your investments carefully and if the financial markets perform in your favor, your return—or what you get back on the amount you invest—can be higher, sometimes much higher, than you could earn on an insured savings account.

Higher expected returns are accompanied by risk. By investing, you take the risk that the investments you choose may not live up to your expectations, or that troubles in the marketplace may depress investment prices. You can have a loss if you sell your investment for less than you paid for it. In a worst-case scenario, your investment might lose all its value. You can limit your risk, however, by not putting all your eggs in one basket and by choosing a well-diversified mix of investments.

While there are many things of value that you might choose to buy because you expect them to provide a profit, the term *investment* is usually used to describe products that are traded in an organized and regulated marketplace. The best known investments include:

- **Stocks**, or equities, which give you ownership shares in a corporation

- **Bonds**, or fixed income, which promise (but usually don't guarantee) repayment of the money you invest plus interest for the use of that money
- **Mutual funds** and exchange traded funds, which are pooled investment vehicles that invest in stocks, bonds, or other financial instruments
- **Cash equivalents**, which include U.S. Treasury bills and other short-term interest-paying investments, such as money market mutual funds (as opposed to money market deposit accounts at a bank)

Other types of investments include listed options, which are contracts to purchase or sell a stock at a set price in the future, and real estate investment trusts (REITS), which invest in properties or, less often, in mortgages on properties. Purchasing shares in a REIT is very different from the direct purchase of real estate. The latter can be considered an investment in the sense that a house or property can increase in value and may provide income if you rent it out to a person or company. An important difference, though, is that real estate is not traded on an organized market where there is almost always a buyer when you want to sell. In fact, while real estate may sell quickly in some periods, it may sell very slowly in others.

The Perspective of Time

Although the term saving is used generically to mean putting money away for the future—as in the expressions "retirement savings" or "saving for a rainy day"—a particular characteristic of saving is that it's especially appropriate for short-term goals, which you hope to accomplish in a year or two. In this case, you don't want to risk losing what you have accumulated.

In contrast, investing is usually more appropriate for mid-term and long-term goals because you need the potential for stronger growth that investments can provide in order to afford the more costly things you want to be able to pay for. Time helps you to withstand the risks that accompany higher expected returns from investing in stocks, bonds, or mutual funds. Most importantly, time allows you to recover from the potential short-term losses.

2. Create a Budget—and Pay Yourself

The first step to responsible saving and investing is getting a handle on your expenses. Unexciting as it sounds, the best way to do so is to write down what you and others in your family earn, and what your monthly expenses are. It's not a bad idea to keep a running log of all income and expenses, even the little ones, for a couple of months. By identifying and eliminating unnecessary extras, you might find that you have more resources than you previously thought.

Saving and investing are essential to financial security. If you are spending all your income (or worse, spending more than you make by running up debt) and never have money to put away, you'll need to find ways to reduce your expenses or make additional money. This generally requires making some tough choices such as cutting back on dining out or foregoing nice-to-have extras such as a new car or a family vacation—or it may mean taking a second job.

To free up money for saving and investing, it's sometimes helpful to segment current and planned expenses into those that are essential (needs) and those that are non-essential (wants). For example, buying a crib for a new baby is essential, but cable TV is something nice to have that perhaps can be postponed while you are getting your budgetary house in order.

Pay Off Credit Card or Other High Interest Debt

Few money-management strategies pay off as well as, or with less risk than, paying off all high interest debt you may have. You pay the very highest rates if you are borrowing money through so-called "payday lenders." If a payday lender's rate sounds reasonable, that is likely because it is being quoted for a very short period—sometimes just a few days—rather than at the actual annual rate that a bank would have to disclose.

Using credit can have advantages and disadvantages. If you spend within your means and pay off your balance on time and in full each month, credit cards can serve as a safe, convenient substitute for cash—with the added bonus that they can help you establish and maintain a solid credit history. But if you use them to purchase items you couldn't otherwise afford—or max out your cards to cover routine monthly expenses—credit cards can quickly compound your debt.

Many credit cards charge interest rates that ran run as high as 1.5% a month—18% annually—and substantially more if you don't pay off your balance in full each lending cycle, usually one month. If you owe money on your credit cards, the wisest thing you can do is pay off the balance in full as quickly as possible.

Otherwise, money that could be going into an interest-bearing savings account is going to pay interest instead.

Paying only the minimum balance due each month can land you in a perpetual cycle of debt. For example, let's say you have a $3,000 balance on a credit card that charges 18% APR and requires a minimum payment of 2.5% each month. Assuming you charge nothing else, it will take you 263 months—nearly 22 years—to pay off your debt. In addition, the total amount you pay for that $3,000 charge will be $4,115.44.

Once you have paid off your credit cards and any high-interest, short-term loans, you can create a budget that includes money to save and invest. That will allow you to chart a course to financial security. To get started, consider adopting this healthy practice: Pay yourself something each month when you pay your household bills. A desirable number to shoot for is a personal savings rate of 10%—but if that amount isn't realistic for you at the start, don't be discouraged. Any positive savings goal is better than allowing consumer or credit card debt to mount.

3. Set Investment Goals

Most people invest to achieve specific financial goals. Some of these goals are widely shared. For example, many people want to own their own home and send their children or grandchildren to college. And there's an almost universal desire to retire comfortably, with the reasonable expectation that they will have adequate income for as long as they need it.

Other goals may be more important to some people. You may want to travel widely, or accumulate enough money to start your own business (or a business for your child or grandchild). Or you may want the chance to leave your job so you can do volunteer work in a needy area or cultivate an avocation.

The point is, to accomplish your goals you have to be clear on the answers to three key questions: What are your goals and what will they cost? When do you want to achieve each goal? And how much risk can you tolerate?

Identifying Your Goals
You can create a list of your various financial goals on your own. Or you can work with an investment professional who has experience in this area, can help assign each a price tag and a time frame, and can then identify the kinds of savings and investing strategies that may be appropriate for meeting your goals. One advantage of working with a professional is that he or she may provide the encouragement you need to move from thinking about your goals to taking steps to achieve them.

Picking a Date
Part of setting investment goals is determining when you will need the money to pay for them. Most goals fit into one of three categories:

Short term, usually within a year or two. The closer you get to your goal, the less risk you generally want to take with the money you've already accumulated to pay for it. This means you'll be more inclined to put your money into federally insured bank accounts or cash equivalent investments, which aren't likely to lose much value in six months or a year. You may also want to consider alternatives that don't impose potential penalties or fees for accessing your money before a maturity date. For example, a five-year CD might be safe, but the early withdrawal penalty is likely to cut into the money you are counting on for a short-term goal such as a down payment on a home you want to buy next year or a tuition payment that's due next January.

Mid-term, usually within two to ten years. Mid-term goals are typically those for which you need time to accumulate the money. Or they may be things you're

not yet ready for but are looking forward to. The more time you have, or the more flexible the timing, the more risk you can probably afford to take with your money. For example, you might want to invest some of your assets in stocks, either directly or through mutual funds or exchange traded funds, because of the potential for a higher return that would allow you to reach your goals sooner. As the time frame for those goals gets shorter, you can gradually move some of those assets into more price-stable investments.

Long term, usually more than ten years. For many people, the number one long-term goal for most people is a financially secure retirement. But it's also a goal with a long time horizon. When your goal is paying for college, for example, you think in terms of paying costs for four years—or perhaps a few more for a post-graduate or professional degree. But when you think about retirement, you have to think in terms of managing expenses for 15, 20, 30, or maybe even 40 years that you'll be living after retirement.

Since you'll need income for that entire period, it is important to make your money work for you, and this means earning a rate of return that outpaces inflation and allows your principal investment to grow over time. That generally means allocating a larger percentage of your portfolio to stocks and mutual funds that invest in stocks in the early stages of your investment horizon. Over time, you can gradually shift a greater percentage of your accumulated account value into income-producing investments such as bonds.

Considering Risk and Return

Because virtually every investment carries some degree of risk, it is critical that you assess your tolerance for risk. If you are the sort of person who will lie awake at night worrying about your investments if you put most of your money in the stock market, then you might want to consider balancing your portfolio with lower-risk investments, such as Treasury bills, highly rated bonds, or other lower risk investments.

Should you decide to adopt a low-risk investing strategy, be aware than cash, cash equivalents, and traditionally low-risk investments tend to have low rates of return. As a result, while you might be able to protect your principal from loss, you run the risk that your investment returns will not keep pace with inflation.

Historically, stocks have provided the best returns over the long-term, but their year-to-year fluctuations make them riskier than long- and short-term bonds or cash and cash equivalents. According to data maintained by Ibbotson Associates from 1926-2006, common stocks recorded a 10.4% annualized return during the 80-year period, while long-term government bonds returned an average of 5.4% and 30-day Treasuries averaged 3.7%.

If you are investing for the long term—for example, you are investing for retirement and have no plans to retire for many years—you stand a good chance of riding out the market's short-term fluctuations and reaping the higher returns that stocks and stock mutual funds can offer. On the other hand, if you are very close to retirement age, you cannot afford to have your entire retirement portfolio take a tumble. In that case, it may be better to hold a portfolio consisting of less risky investments.

4. Establish an Emergency Fund

Emergencies happen. A roof needs replacing. People are injured in accidents. Employers lay off workers. If something unexpected happens to you, will you have the money you need to pay the repair bills or see you through weeks or even months of being out of work?

Insurance is one way to protect yourself against certain situations—such as a fire in your home or the unexpected death of a breadwinner—that can substantially impact your financial situation. Health insurance is essential because there is always the risk you'll be injured or become ill, and disability insurance can fill the gap if you're injured or ill and can't work. But even the best insurance doesn't protect you against every financial problem you may encounter.

If you have access to credit, through a credit card or line of credit, you may be able to tap that resource in a pinch, even though you will probably owe a substantial amount of interest on the money you borrow. Sooner or later, you'll also have to repay the principal.

To keep yourself financially grounded, especially in the face of unexpected events, you need to have an emergency fund. That's an account that holds at least three to six months of your income—or more if you are the sole support for yourself or you have dependents.

Setting Up Your Emergency Fund
If you don't already have money in a savings account that you could use in an emergency, opening one should be your first investment decision. Using six-months of salary as a guideline for how much you'll need to save, estimate how long it will take you to build up a fund to that level if you put 10% of your earnings away every time you're paid. If you can't afford 10%, you can make it 5% and add any unexpected money you receive, such as a gift, until you reach your goal. Then leave that money untouched unless you actually face a financial emergency.

Some people choose a CD for their emergency fund, or a series of CDs of approximately equal value, with one maturing every six months or every year. This approach is called laddering. You can roll over the CDs as they mature, to keep your ladder intact. The loss of interest you face for taking money out early may motivate you to keep your fund intact. But in a real emergency, the interest you may lose is a small price to pay for having the money you need. And if you have to spend any of the money, you should plan to replace it.

You might also consider buying U.S. Treasury bills with some of your emergency fund money. They, too, can be timed to mature on a regular schedule and, like CDs, they tend to pay more interest that a simple savings account. And while they aren't bank products, they are backed by the federal government. That means there is no risk of losing principal if you hold them to maturity. And because they have very short terms, 4 weeks, 13 weeks, or 26 weeks, they usually don't expose you to either inflation risk or interest rate risk.

Other options for an emergency fund include money market mutual funds. A money market mutual fund is a mutual fund that must, by law, invest in low-risk securities, such as government securities and certificates of deposits. Compared with other types of mutual funds, money market funds are highly liquid, low-risk securities. Unlike money market deposit accounts, money market funds are not federally insured. While they are intended to pay dividends that are comparable to prevailing short-term interest rates, they can lose value.

5. Choose Investments Wisely

Once you've identified your goals, estimated their cost, and determined when you'll need the money, it's time to decide which combination of savings accounts and investments is appropriate for you. Part of this challenge is that most people plan and invest for a variety of goals—some short term, some mid term, and some long term—all at the same time. One possible solution to this dilemma is to consider establishing a separate account for each goal to make it easier to select and manage your investments. That way, you can treat the money you're saving for a down payment on a home differently from the contributions you make to an individual retirement account (IRA) or a Coverdell education savings account (ESA).

If you work with an investment professional to set your goals and take steps to reach them, he or she should be able to help you identify the types of investments that are most appropriate for different time frames. An experienced investment professional ought to know the spectrum of alternatives that are available to you, how different investment choices work, and the risks and returns you should be prepared for if you choose a particular investment. But ultimately you will need to know what you own and why. You cannot make an informed choice about an investment without asking probing questions about its features, risks, and costs—and you should not invest in something you don't understand, no matter who recommends it to you.

If you take the lead yourself, you should be prepared to spend time learning about various investments and the markets in which you buy and sell them. You should think about whether the investments you're considering are or are not appropriate at this point in your life. The more you know about your investment choices, the more likely it is you'll make decisions that are right for you.

Regardless of whether you select investments on your own or seek professional advice, you should be aware that you pay fees and expenses with virtually all financial products and services. Those costs, which reduce your investments' returns, are generally documented — for example, in a required disclosure document, such as a mutual fund prospectus, or in a brokerage firm's schedule of fees and commissions. It's important to find out what those costs are and compare the total expense with the expected returns, as well as the costs of other, similar investments.

Keeping an Eye on the Big Picture
Setting investment goals and making investment choices is just the beginning. You'll also want to learn as much as you can about how to evaluate potential investments and keep track of the progress you're making toward accumulating

the money you need to reach your objectives. That doesn’t necessarily require checking your account every day, but it does mean that you should keep an eye on whether the value of your portfolio is increasing from month to month and year to year. It often pays to take a long-term perspective on investing and not be too hasty to switch investments based on short-term results. .

But if your investments aren’t delivering the results you had anticipated over a period of time, especially if the financial markets as a whole are doing well, you should be prepared to seek alternatives.

You’ll also want to keep in mind the passage of time. What you initially considered to be long-term goals can become mid-term and short-term goals very quickly. That requires rethinking how your money is invested and whether you should begin to make some changes.

In addition, while some goals are flexible and can be postponed, others have specific dates. For example, many students begin college at 17 or 18, and need money for tuition at that point, not several years in the future. Other goals are more flexible. You can often wait to buy a home or postpone retiring from your job if that extra time will make it more affordable.

But you also have to be prepared for surprises. For example, many people retire earlier than they had planned because their employer downsizes or a company closes its doors.

6. Practice Good Habits

Good habits pay off in many areas of life, and practicing good savings and investing habits is no exception. Sometimes, a single action can create a continuing habit. For example, if you contribute as much as possible to an employer sponsored retirement plan where you work or if have money transferred directly each month from your checking account to one or more savings and investment accounts, you've established the habit of paying yourself automatically. Not only does that eliminate the risk that you will forget to save or invest regularly, but you also might find that you never the miss that money because it comes out of your paycheck before you can spend it. In fact, you might ultimately decide it makes sense to do the bulk of your saving and investing this way.

Remember, too, that if you spend the money in a tax-deferred retirement account—such as an individual retirement account (IRA) or employer-sponsored 401(k) or similar plan—before you reach age 59 ½, you will owe taxes and probably penalties. That's an added incentive not to touch the money even when you might be able to withdraw it.

You should also consider:

1. Reinvesting all the interest, dividends, or distributions you earn on your existing investments, which happens automatically with tax-deferred accounts

2. Earmarking a percentage of all gifts, bonuses, and unexpected income to your investment accounts

3. Paying your credit card bills in full each month and investing the money you had been spending on finance charges

4. Budgeting a specific percentage of your income for investing

5. Making sure that the amount your employer withholds for taxes is neither too much nor too little—the average refund is more than $2,000—and put the difference in your investment account throughout the year.

It's often wise to open a special account to hold the money you are accumulating specifically to buy investments. That might be a money market mutual fund or other cash account with your brokerage firm so that you can easily transfer the money needed to pay for the purchase of a stock, bond, mutual fund, or other investment. Similarly, proceeds from investments you sell and any dividends or

interest from investments you've already made can be rolled into that account, where they will be available to cover new purchases.

If you invest directly with a mutual fund company, you can set up a similar arrangement. You might use the fund company's money market fund to hold your cash, and then transfer it into a stock, bond, or other mutual fund when you have enough cash to meet any investment minimum. Once you've purchased a money market fund with the mutual fund company, you can then arrange for a regular direct deposit from your paycheck—or an automatic transfer from a bank account—to your account. The amount required for additional deposits is almost always less than the minimum to purchase a fund.

Whether you open an account at a brokerage firm or with a mutual fund company or both, be sure to ask about any account maintenance and transaction fees that may apply.

Finally, it is important to check your account statements—from every bank, brokerage firm, mutual fund company, or other financial institution you do business with—to confirm sure that all of your transactions are accurately reflected. If you detect an error, be sure to contact your financial institution right away. And, for your investments, be sure to monitor your portfolio performance on a regular basis to make sure that you maximize your returns over time.