LESSON SEVEN: INVESTING

WHAT IS FINANCIAL PLANNING?

Lesson 7: Investing

WHAT IS FINANCIAL PLANNING?

- Students will learn what investing means
- We'll explain basic 401ks and IRAs and how to use them

Financial Planning – Investing In Your Future

What is investing? It's actually pretty simple: investing means putting your money to work for you. There are many ways you can go about making an investment. This includes putting money into stocks, bonds, or mutual funds. The goal is always to put your money to work so it earns you an additional profit. Almost without exception, the responsibility of planning for retirement is shifting away from the state and towards the individual. By planning ahead, you can ensure financial stability during your retirement.

Different Types of Investments:

Bonds: When you purchase a bond, you are lending out your money to a company or government. In return, they agree to give you interest on your money and eventually pay you back the amount you lent out. Bonds are relatively safe, and because there is little risk, the rate of return is lower than other investments.

Stocks: When you purchase stocks you become a part owner of the business. his entitles you to vote at the shareholders' meeting and allows you to receive any profits that the company allocates to its owners. These profits are referred to as dividends. Stocks fluctuate in value on a daily basis. When you buy a stock, you aren't guaranteed anything. In most cases, the only way that you can make money is if the stock increases in value - which might not happen. However, compared to bonds, stocks provide relatively high potential returns. Of course, you must assume the risk of losing some, or all, of your investment.

Mutual Funds: A mutual fund is a collection of stocks and bonds. When you buy a mutual fund, you are pooling your money with several other investors, which enables you (as part of a group) to pay a professional manager to select specific securities for you. Mutual funds are all set up with a specific strategy in mind. The primary advantage of a mutual fund is that you can invest your money without the time or the experience that are often needed to choose a sound investment. Theoretically, you should get a better return by giving your money to a professional than you would if you were to choose investments yourself.

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Investing using a 401K or IRA

How does a 401k or IRA work?
Using a third-party service, the money you contribute to your plan is invested in mutual funds, bonds, and stocks. You determine the level of risk you want to take, and determine the mix of investments that make the most sense for your financial situation. Your return on investment is all dependent on the risk and type of investment that you choose.

What's the difference between a 401k and an IRA?
A 401k is sponsored by your employer. That means that the company you work for is providing the opportunity for you. You make pre-tax contributions from your paycheck, and pay taxes later when you take the money out. Many employers will match whatever you put into your 401k up to a certain percentage. If they do that, you should consider contributing the maximum amount to take advantage of the benefit, if you don't, you are leaving money on the table. A 401K also has loan privileges that lets you borrow money, and repay it.

On the other hand, Individual Retirement Accounts or IRAs, are accounts you open, fund, and oversee the investments. You can choose a traditional IRA that you fund with pre-tax dollars, like a 401K, and pay the taxes on withdrawal. Or you can choose a ROTH IRA and fund it with after-tax dollars and pay nothing when you withdraw the funds.

Who has control? With a 401k, your employer is in control - they initiate the plan, they determine what investments you have access to, and they maintain all the records involved. With an IRA, you are in the driver's seat with control of everything.

Can you have both? Of course you can. Many people in the position to do so, will max out their 401k plan and also have their own IRA. There is a limit to what you can contribute, so it's best to consult with a tax advisor on what's best for you. Typically, the contribution amount for a 401K is higher than what you can contribute to an IRA.

Compound Interest vs. Simple Interest
Different types of interest, and interest rates can affect your return on investment. An investment with simple interest means that you will only accrue interest on the initial investment amount. If you invest $100 at a simple interest rate of 6% per year, that means each year you will make $6 on your investment, ending with a total balance of $136.

How to Calculate Simple Interest:

Principal x Interest Rate x Time

Simple Interest/Rate of Return Example:

Imagine you have $100 and plan to put it in the bank for 6 years with a 6% interest rate, calculated as .06%. Here's what the calculation would look like:

$100 x .06 x 6 = $36. The amount will grow by $36 over 6 years using simple interest.

Year 1: $100 + $6 = $106

Year 2: $112

Year 3: $118

Year 4: $124

Year 5: $130

Year 6: $136

How to Calculate Compound Interest:

Principal x (1 + Interest Rate)$^{(Time)}$

Compound Interest/Rate of Return Example:

Imagine the same scenario ($100, interest rate calculated as .06% for 6 years), but this time interest will be compounded annually. Here's how your money grows:

Year 1: $100 x .06 = $6 ($100 + $6) = $106

Year 2: $106 x .06 = $6.36 ($106 + $6.36) = $112.36

Year 3: $119.10

Year 4: $126.25

Year 5: $133.82

Year 6: $141.85

- To determine the compound interest quickly, try 100 x (1+.06)^6. Your answer is still $141.85!

Formula: Principal x Interest x Time

Compound interest means that you will earn interest on the accrued interest, plus the initial investment. That same $100 at a compound interest rate of 6% will result in a total balance of $141.85.

Formula: Principal x (1 + Interest Rate)(Time)

INVESTMENT ACTIVITY

Consider each of the following scenarios

1. Paul receives $2,000 as a graduation gift from his grandparents. Rather than spend it, he decides to invest it in a two-year bond that earns 5% simple interest. John doesn't need access to the money right away because he wants to save it for a $3,000 down payment on a house in 5 years.

    - Is the bond a wise investment for Paul? Why or why not?

    - What would be a better option for Paul?

2. If you had the choice between investing $1,000 in a stock that earns 7.5% compound interest or investing $1,500 in a bond that earns simple interest at 7.5% - both over the course of 5 years. Which would you prefer and why?

3. If you had $20,000 to invest, and had a choice of the three options below, which one would make you the most money from the choices below:

    a. Bond with a simple interest rate of 5% over 10 years

    b. Mutual fund with a compound interest rate of 4% over 10 years

    c. Stocks – $10,000 with a simple interest rate of 10% over 2 years, and $10,000 with a compound interest rate of 5% over 8 years