



Getting Started: Saving and Investing

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Most, if not all, individuals and families have some financial goals. However, setting aside enough money for savings and investments to accomplish these goals, as well as choosing the appropriate financial products, can be difficult. Making a firm commitment to saving and investing is probably the most important step in achieving these goals.

Saving vs. Investing

You may think of saving as a form of investing—and with deregulation of financial markets, there has been some “blurring” of the lines between financial products traditionally considered for investment purposes and those more feasible for savings. However, there are differences between saving and investing.

Savings provide funds for emergencies and for making specific purchases in the relatively near future (generally within two years). The primary goal is to store funds and keep them safe. This is why savings are generally placed in interest-bearing accounts that are safe (such as those insured or guaranteed by the

federal government) and liquid (those in the form of cash or easily changed into cash on short notice with minimal or no loss). However, these generally have low yields. Because of the opportunities for earning a higher return with a relatively small pool of funds, some financial experts suggest savers consider slightly higher-risk (but liquid) alternatives for at least part of their savings.

The goal of investing is generally to increase net worth and work toward long-term goals. Investing involves risk. For example, earnings generally are not guaranteed and you could lose some of your original investment (principal).

Before you invest, consider getting your general financial situation under control first, such as by having:

- An emergency fund
- Some savings for short-term goals
- Adequate insurance
- Control over credit use
- A retirement plan
- And possibly, equity in a home

An Emergency Fund

Financial experts tend to agree that everyone needs an emergency fund equal to three- to six-months

Where to Get Funds to Save and Invest

Here are some ideas for setting aside funds to save and invest. Some may involve relatively small amounts of money, but in combination with other techniques, the total can be substantial.

- **Pay yourself first.** Make savings and investments a regular, fixed expense (like your rent or mortgage payments).
- **Make savings and investments automatically happen.** Use payroll deductions, automatic bill payment systems, and other ways to have funds transferred directly from your paycheck or checking account. Have distributed capital gains, dividends, and interest automatically reinvested.
- **Save windfall income.** Put bonuses, cash gifts, tax refunds, and overtime pay into savings and investments.
- **Pay installments to yourself.** Once you have paid off an installment loan, continue to budget for the payment but put it into savings and investments.

- **Be frugal.** Substitute the local library, public parks, and other free or low-cost services for higher-cost services. Cut back or cut out something (such as eating out). Sometimes it is easier to cut back in increments—reducing your spending by 5 percent; then by another 5 percent—rather than all at once. Or, every month or two, try doing without all but the essentials for one week. Save or invest the amount by which you have reduced your spending.
- **Don't spend your next raise.** Save or invest at least 50 percent of it. The remainder can be used to offset higher costs of living.
- **Break a habit.** Put aside the amount you would have spent.
- **Check your wallet.** At the end of each day, empty your wallet or pocket of loose coins and place them in a container. Or, take \$1 out of your wallet each day and place in the container. Periodically, put the funds into savings and investment vehicles.

of living expenses. The exact amount needed depends on such factors as the stability of your income; family size; the amount of your basic expenses; whether you are covered by unemployment compensation or other income loss plans; disability and other insurance benefits available to you in an emergency; other savings and investments that could be accessed; and the employment or earning skills of other family members.

Why do you need an emergency fund before you start to invest? Households that fail to maintain an adequate emergency fund are financially vulnerable to unexpected occurrences.

An emergency fund can help meet these unexpected financial needs and, at the same time, prevent having to sell or liquidate investments to cover the emergency. Further, it may not be the best time to liquidate these investments or you may have to pay a penalty to get your funds.

Savings for Short-Term Goals

Funds often need to be set aside for irregular expenses (those that do not occur every month, such as real estate and personal property taxes, insurance premiums, and back-to-school clothing) and to meet other specific short-term goals (such as for a new refrigerator or a vacation). These expenses and goals usually do not extend beyond one or two years, so, like an emergency fund, safety and liquidity are of primary concern.

Unlike short-term goals, intermediate- and long-term goals, involve a longer period of time, ranging from a few years to many years. Because of this, you can commit your funds for a longer time and consider a range of investment alternatives. While you may risk not having your money available immediately, you gain the opportunity for greater earnings and protection from inflation.

Adequate Insurance

Having adequate insurance for your family is also important. This generally includes health insurance (with major medical and catastrophic coverage), life insurance as protection for dependents, disability income insurance for major income earners, and property and liability insurance (homeowner's or renter's insurance, automobile insurance, and business insurance where appropriate).

Control Over Credit

A rule of thumb for most families is not to commit more than 16 to 20 percent of spendable income to consumer credit obligations (excluding mortgage payments). Families with high percentages of debt should consider increasing credit payments to reduce debt, especially if consumer credit interest rates are high and returns on most investments are low.

A Retirement Plan

Providing for a secure retirement (either through an employer plan, or on your own, or both) requires careful planning and regular contributions. Before

investing, it is important to have at least begun planning how to fund your retirement and making contributions toward that plan. Adequate retirement funds—such as replacing at least 65 to 75 percent of preretirement income—will probably be one of your investment goals, also.

Equity in a Home

This prerequisite depends upon your values. If homeownership is important, some equity in a home is a good idea before starting to invest. If homeownership is not important, or if a down payment on a home is a goal you plan to work toward simultaneously, meeting this requirement may not be necessary before starting an investment plan.

Investment Consideration

There are many things to consider when beginning an investment plan. Some are personal, requiring you to carefully evaluate yourself (knowledge, attitudes, skills, goals, and personality) and your financial situation. Others involve using selection criteria to evaluate specific investments (and specific types of investments).

The interplay of these two sets of considerations is crucial to wise investment decision-making. It is also important to note that, while the remainder of this publication addresses investment considerations, similar considerations need to be taken into account when choosing where to put savings dollars.

Personal Considerations

When beginning an investment plan, carefully consider:

- Your investment goals
- Time available for working with investments
- Knowledge of investments
- Available funds for investing
- Ability to handle a loss
- Present financial situation
- Risk tolerance

Investment goals. What do you and your family hope to achieve through investments? Do you want a secure and comfortable retirement, a fund for your children's college education, or to build an estate? How much money will you need to reach your goals? How long do you have to reach these goals? Because these goals are long-term, it is important that you make them specific, realistic, measurable, and in writing. This may involve working with a variety of financial advisers. You also need to prioritize these goals, since working toward one goal can sometimes hinder progress toward another goal.

Gathering a large sum of money may be overwhelming when you think of the amount as a lump sum. However, when you look at the amounts month by month and year by year, they can be both possible and manageable. The chart on the following page may help you determine a monthly target amount to invest to reach a goal.

Time available for working with investments.

Different investments take different amounts of time to study, evaluate, and manage. How much time are you willing to devote to researching, studying, and monitoring your investments?

Knowledge of investment alternatives. This consideration is tied to the “time available” you have to devote to investments. Investment advisers recommend investing in what you know about or are willing to learn about. If you don’t have that knowledge already, are you willing to invest the time to learn about and evaluate investment alternatives? Even if you work with an investment adviser, you will need a certain amount of knowledge about investments to ask the right questions and, perhaps even more important, understand the answers and the consequences of the decisions.

Amount to invest. Realistically, how much money do you have to invest? Is money available from a one-time occurrence (such as an inheritance), or do you expect to have a certain continuing amount from current cash flow? Do you have (or can you acquire) the ability to consistently and regularly contribute to an investment plan?

Recommendations for regular contributions to savings and investments vary from 5 to 20 percent or more of your take-home income, depending on your financial situation, your family size, and the number of years until you retire.

Amount to lose. What amount, if any, can you afford to lose? Be realistic. The amount of loss you can accept will influence the types of and specific investments you choose. For example, if that figure is nothing or next to nothing, you probably should not even consider investing, but rather stick to savings. Because of relatively low yields on savings products, however, inflation will create some loss of purchasing power.

Present financial situation. What is your present financial situation? What is your income? What do you own (assets)? What do you owe (liabilities)? Do your assets match your investment goals?

There are some financial factors also relating to risk. In general, the larger your investment portfolio, the more financially secure you are, the farther off your retirement, and the more optimistic about the economy you are, the more risk you may comfortably assume. But your situation may involve conflicting risk factors. For example, as you near retirement, you probably have a larger investment portfolio (i.e., can assume more risk), but you have fewer years of future earnings coupled with fewer years before retirement income is needed (i.e., can assume less risk).

Risk tolerance. How comfortable are you with risk? We all have different temperaments and tolerance levels when it comes to risk. If an investment causes you to lose sleep or not eat, it is a good indication that the investment has a higher risk level than your personal “risk-comfort zone.”

If you are married, what is your spouse’s risk tolerance? If it is not similar to yours, some very important discussions and decisions need to occur

Monthly amount needed to reach a goal

Total dollars needed	Years to achieve goal				
	3	5	10	15	20
6 percent rate of return (after taxes)					
\$5,000	\$126	\$71	\$30	\$17	\$11
10,000	253	143	61	34	22
15,000	379	214	91	51	32
20,000	506	285	121	68	43
30,000	759	428	182	103	65
9 percent rate of return (after taxes)					
\$5,000	\$121	\$66	\$26	\$13	\$7
10,000	241	132	51	26	15
15,000	362	197	77	39	22
20,000	482	263	103	52	30
30,000	724	395	154	79	45

before investing, such as how to allocate investment funds among alternatives. It may even be necessary to split investment dollars into “his” and “hers,” with each spouse investing according to their individual “risk-comfort zone.”

Another element involved with risk tolerance is the emotional attachment you feel for a particular investment. Financial experts generally caution people not to become emotionally involved with investments—to keep them on a business basis. Emotional attachment may prevent you from being objective. For this reason, your home is probably better seen as “housing,” rather than a true investment.

Investment Section Criteria

Commonly accepted criteria for evaluating types of investments, as well as specific investments, include:

- Risk
- Return
- Liquidity and marketability
- Cost
- Diversification
- Taxes
- Effort and expertise

Risk. Risk refers to the uncertainty that the actual rate of return on an investment will differ from what is expected. There are many sources of risk to the investor. They can act together or separately and can impact your investments’ principal, growth, and income. (See the discussion on “Sources of Risk” on page 6)

Some risks are associated with the securities market and the economy as a whole. Generally, these risks cannot be reduced by individual investor decisions.

Other risks are related to characteristics of specific investments, companies, or industries. Individual investor decisions (such as diversifying investments) may help reduce this type of risk.

Analyze your “risk-comfort zone”

These questions may help you analyze your “risk-comfort zone.”

- Do you prefer to work by yourself, make your own decisions, and be your own boss?
- If you received an unexpected “windfall,” would you prefer to invest in a somewhat speculative investment (where the potential return could be great, but the potential loss could also be great)?
- When you lose something, do you spend little time searching for it?
- When you make decisions, is knowing immediately what the outcome will be not that important to you?
- Do you feel other people do a worse job of handling their finances than you do?
- Does the thought of traveling to a foreign country by yourself exhilarate you?
- Do you believe in yourself, have confidence in your decisions, and feel good about who you are most of the time?

The more “yes” answers, the more of a risk taker you probably are. However, only you can decide your tolerance for risk.

Return. The gain or profit you receive from investing is referred to as the return. This may include the receipt of income (interest, dividends, or rent) or capital gains (where the investment has increased or appreciated in value). The combination of income and capital gains is the total return from an investment.

Obviously, if the value of the investment has fallen, a negative rate of return may result (depending upon whether income received from the investment exceeds the loss in value). However, if an investor does not actually sell or liquidate the investment (but rather holds it), the loss may only be a “paper” one.

Most investors measure return on a yield or rate of return basis—that is, as a percentage of the amount invested on an annualized basis—rather than in dollars. That way, you can compare the yields on different investments and find out how much you earned per dollar invested. Remember, the rate of inflation and your tax bracket reduce your actual rate of return on any investment. A formula for calculating rate of return is given on the next page.

Liquidity and marketability. Liquidity is the ability to turn an investment into cash without significant loss when you need it. Savings accounts and money market accounts are among the most liquid places to keep funds. Real estate and collectibles (such as coins, antiques, and art) are among the least liquid because of the likelihood of taking a loss should they

have to be sold to obtain quick cash.

Liquidity is important when there is an emergency and money is needed right away. Liquidity allows you to change your strategy as the investment climate changes. For example, when interest rates were at historic highs, some investors were not able to move long-term investments into those earning the higher rates of return.

Marketability, on the other hand, is the ability to find a buyer when you want to sell, regardless of the potential gain or loss involved. For example, homeowners may discover their homes do not sell as quickly as they would like (i.e., are less marketable than desired).

Cost. Costs include the particular security, as well as any fees for purchasing or selling the investment, administrative fees, or other services. Further, there may be a minimum required to invest in a particular security.

Diversification. Diversification is a technique for managing risk. In the simplest terms, it means that not all of your funds are placed in any one type of investment. When purchasing stocks, diversification may mean you own stock in several companies within an industry or stock in companies that represent several different industries. Similarly, when buying bonds, it may mean you have bonds from different companies within an industry or bonds from companies that represent different industries. Bonds or certificates of deposit (CDs) may also have staggered maturities. As a result, if one investment fails to meet your expectations (or if interest rates, the economy, or other investment conditions change), the impact of overall returns may be less severe. It might be easier for you to remember diversification in terms of a simple rule: Do not put all your eggs in one basket!

Taxes. Your personal tax status is related to your marginal tax bracket. When your marginal tax rate is high, you send more tax dollars to the government. This lowers the amount you have to save, spend, or invest, as well as the amount you earn from savings and investments. Of course, there are some investments where contributions are tax-deductible. This is when interest earned is tax-free, or where taxes on earnings or capital gains can be deferred until some point in the future.

Effort and expertise. This is a factor that cannot be overlooked. Certain types of investments require little or no time commitment or special knowledge. Others may require constant management and a great deal of specialized expertise. Consider the amount of effort and expertise necessary for a particular investment, in light of the personal considerations mentioned earlier. Further, the amount of effort and expertise necessary may determine whether, and to what extent, you rely on an investment adviser.

For example, if you have the time, energy, ability, and interest in studying, researching, and monitoring investments, you may want to consider stocks and bonds. If you lack this time, energy, ability, and interest, you may want to consider investments such as mutual funds.

Minimum rate of return (RR)

You can estimate the minimum rate of return (RR) you need to break even with inflation and federal taxes.

Divide the inflation rate by 100 minus your marginal tax bracket (the tax rate you would pay on the next dollar of income earned). For example, imagine that the inflation rate is 4 percent and you are in the 15 percent marginal tax bracket.

$$RR = \frac{4}{100-15} = .047 \text{ or } 4.7\%$$

The minimum rate of return needed to break even is 4.7 percent. In the 28 percent bracket, the rate needed with a 4 percent inflation rate is 5.6 percent.

Where to Put Savings and Investment Dollars

This publication is designed to familiarize you with the differences between saving and investing and to introduce you to investment consideration—both personal considerations and investment criteria.

In summary, to develop your savings and investment plan, you need to:

- Set savings and investment goals.
- Determine how much you need to save to reach your goals.
- Become familiar with the savings and investment alternatives.

This publication is not intended to provide a complete and in-depth discussion on savings and investments. Rather, it is designed to provide an introduction to common savings and investment planning and to help the beginning investor start to design and implement a savings plan.

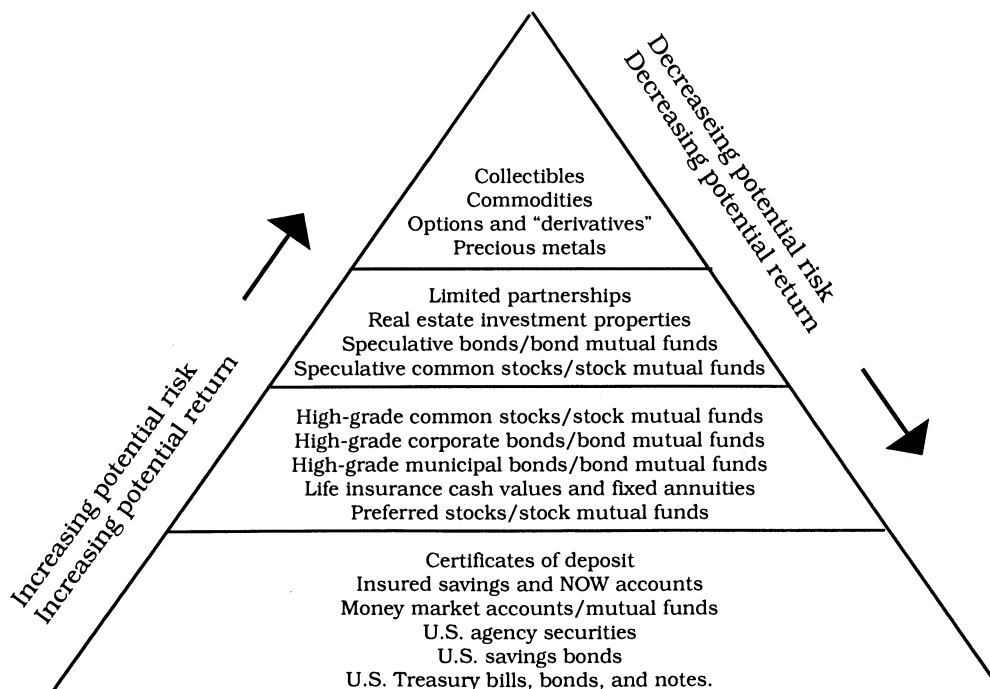
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Trade-off Between Risk and Return

There is a trade-off between risk and return. The risk of an investment is related to its expected return. In general, if you want higher returns, you must be willing to accept greater risk. This relationship may not hold exactly true over short periods of time, but over a long investment period, increased return means increased risk.

While there are no hard and fast distinctions (since a particular investment may be more or less risky than others of a similar type, depending upon the specific characteristics of the individual investment), the graph below may provide an overall guide to types of savings and investments and their relative risk and return.

Note that within each group, the savings and investments are listed alphabetically.



Sources of Risk

Sources of risk for the investor include market risk, interest rate risk, reinvestment risk, purchasing power risk, exchange rate risk, business risk, default risk, and financial risk.

- *Market risk* is the uncertainty that results from outside factors that can impact on the securities market. For example, political, social, and economic events and investor reactions may affect the entire securities market.
- *Interest rate risk* is the uncertainty associated with changes in interest rates. When interest rates go up, prices of fixed-income investment (such as bonds) generally go down.

That is, if interest rates go up, investors can receive high returns from purchasing newly issued securities rather than buying previously issued securities from investors that earn a lower interest rate. For an investor to sell a security earning the lower interest rate, the price of security would need to fall in order to attract purchasers.

This inverse relationship also holds true when interest rates go down. That is, when interest rates do down, prices of fixed-income investments generally go up.

- *Reinvestment risk* is associated with interest rate risk. If interest rates go down, investors who receive interest payments (or those who sell or liquidate an investment) may have to reinvest those funds at lower interest rates.

- *Purchasing power risk*, sometimes call inflation risk, results from the loss of purchasing power that occurs when general price levels go up. Under these conditions, money invested (or received from an investment) today will purchase fewer goods and services in the future.
- *Exchange rate risk* is associated with foreign currency fluctuations. When investors buy and sell foreign securities that must be converted into U.S. dollars, the return on the investment is affected by what has happened in the exchange rate for that currency related to U.S. dollars.
- *Business risk* is associated with a company's profitability and its ability to pay dividends and interest to its investors. Such factors as management competence, changing costs, type of business or industry and general economic conditions can influence the degree of business risk.
- *Default risk* is closely tied to a company's financial condition. This risk involves the possibility that the return received on an investment will be less than promised because the bond issuer cannot pay its financial obligations (i.e., make interest payments or return the principal at maturity).
- *Financial risk* is related to the financing of a company. The solvency of a company is related to its earning power and debt structure. A company with healthy earnings can expand and pay off its bondholders. On the other hand, a company with little to no earnings may go out of business.

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