AMERICAN FINANCIAL SOLUTIONS

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INTRODUCTION TO INVESTING

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INTRODUCTION TO INVESTING

In this workbook, we will discuss ways in which you can increase your wealth by creating a step by step investment plan.

Why do People Invest Money?

- **To save for a major purchase—house, college, automobile**
- **For retirement**
- **To put idle money to work**
- **For enjoyment—now and later**

Let's start with a basic question—why do people invest money? There are many reasons, but here are a few common ones. If you are planning to make a major investment in a few years—a new home, an automobile or college for you or your child, you might consider an investment that will generate income for that purchase.

You may also invest to save for retirement. And even if you are nowhere near retirement age, starting a retirement plan early pays off—even if you invest modestly.

Some people have extra cash—from a pay raise, an inheritance, or the sale of a home—that can be invested profitably. Judgment is required, however. You must have the confidence to know how much money is necessary to live on, and what portion of your income can be safely tucked away with minimum risk. While putting aside money in a savings account is something everyone can do to invest in their future, it is important for people to thoroughly understand other investment opportunities and the basics of money management. Be sure to review the other workbooks in our series, if necessary, on the basics of budgeting and saving money.

If you are at the point where you are able to save some of your paycheck each month, you will find the world of investing to be personally satisfying—both now, while you are doing it, and later when you can reap the benefits.

SHOULD YOU INVEST MONEY?

- **Consider Your Overall Financial Position**
- **Do you have Extra Cash?**
- **How Do You Feel About Risk?**

How do you know if you should invest money? One clue is to look at how you are managing your overall financial position. If you are having trouble meeting your expenses, you should defer investing money until you have your finances in order.

On the other hand, if you are generating extra cash each month, and you find that your checking account continues to grow, then it's time to move some of that money to an investment that will generate a return.

Before you do so, you should do some soul searching about risk. Examine the three investment possibilities on this slide. How would you characterize each one?

Investment A is very conservative—a low rate of return is earned each year, but the risk is low, based on the consistency of the earnings. This investment won't set the world on fire, but the person who owns it should be able to sleep at night.

Investment B shows some variation in earnings—in fact sometimes it loses money, but in a narrow range.

Investment C appears to be the most risky—the variation in earnings is dramatic—would you be comfortable with this investment performance?

Investment	Year 1	Year 2	Year 3	Year 4
A	+4%	+4%	+4%	+4%
B	+5%	-3%	-3%	+7%
C	+14%	-22%	+39%	-15%

THE NATURE OF RISK

- **Your Time Horizon**
- **Your Stage of Life**
- **The Need for Diversification**
- **Risk versus Return**
- **“Get Rich Slowly”**

Lesson one in investing is that it involves taking risks. Even NOT investing involves some risk. For example, if you have $1,000 under your pillow, you are taking a risk that it will still purchase $1,000 of goods at a later date. If the US experiences an inflationary period, your thousand dollars may lose value.

For example: You have $1.00 saved in a drawer. Right now, you could take that money to the store and purchase a candy bar. However, over the course of a year, inflation causes the price of the candy bar to rise to $1.03. Your $1.00 in the drawer is no longer enough to buy the candy. Your $1.00 has lost its value.

Before investing you should think about your age and stage in life. If you are young and single, you have many working years ahead of you, and you can probably take a little more risk in your investments than a 50-year old would feel comfortable taking. If you are supporting a family, you may have your hands full just staying within a budget. As people age, they typically begin to look for more and more conservative investments. They look for investments that have a consistent return, rather than many ups and downs.

You must also diversify your investments. You know the old saying not to “put all your eggs in one basket”—that saying was probably uttered by a frustrated investor who invested heavily in the housing market and lost it all.

A truth in the investment world is that investments that offer the most return are usually the most risky. As you start investing, you should keep your risk level relatively low until you gain experience. For most people the term “get rich slowly” is the best bet.

BUILDING WEALTH—THE MAGIC OF COMPOUNDING

Suppose you invest $1,000 at 6% interest per year—how much will it grow to in 1 year? 2 years? 5 years? 10 years?

$1,000 for 1 year at 6% grows to $1,060.
$1,000 for 2 years at 6% grows to $1,123
$1,000 for 5 years at 6% grows to $1,338
$1,000 for 10 years at 6% grows to $1,790

Most successful investors use a strategy of investing regularly and letting the money grow. Even at a modest interest rate, your investment can achieve dramatic results—if you wait long enough.

Suppose you invest $1,000 at 6% interest and leave it alone for one year. Your investment will earn 6% for the year. Six percent of $1,000 is $60. Your investment will GROW TO $1,060.

What if you leave the investment in the account for two years? Your investment will earn 6% of $1,000 in the first year, and will then earn 6% of $1,060 in the second year. Notice that in the second year, you earn interest on the principal ($1,000) and you also earn interest on the $60 interest you earned in the first year. This idea of earning "interest on the interest" is an important key to successful investing.

The longer you leave this 6% investment alone, the more it grows. In fact if you leave the money in for 12 years, it will approximately double.

Imagine the results if you continued to add to the investment throughout the year! Please review the table on How Compound Interest Works on the next page.

HOW COMPOUND INTEREST WORKS

Earned interest 4%

Type of Savings	**Non-interest bearing** (piggy bank style)	**Annually** Compounded Interest 4%	**Monthly** Compounded Interest 4%
Amount of deposit	One time lump sum of $500	One time lump sum of $500	One time lump sum of $500 PLUS annual addition of $100
Length of Deposit year 1	$500	$520.00	$520.37
Length of Deposit 5 years	$500	$608.33	$1,162.99
Length of Deposit 10 years	$500	$740.12	$1,972.50
Length of Deposit 30 years	$500	$1,621.70	$7,440.49

THE RULE OF 72

You can calculate the approximate time it takes for your money to double.

Divide 72 by the interest rate of your investment
Example: 72 divided by 6 percent = 12 years

Here's a short-hand rule for measuring the growth of an investment, called the Rule of 72. Divide the number 72 by the interest rate of your investment. The result will tell you the approximate number of years it takes for your investment to double.

In our previous example of $1,000 at 6%, divide 72 by 6. The result is 12. Your $1,000 will double in about 12 years. The higher the interest rate, the shorter time it will take to double.

You can also use the rule of 72 to calculate what interest rate you will **need to earn** in order to double your money in a specific time.

For example if you have 8 years to invest, divide 72 by 8 and you will see that an interest rate of 9% is required to double your money.

This rule only works if the interest rate stays constant—and if you leave the money in the investment for the required period. The point is that you should think LONG TERM for your investments to give them the time required to compound.

TWO BASIC TYPES OF INVESTMENTS

- **Investments in interest-bearing instruments**
  - **Fixed rate of interest**
  - **May be insured by the FDIC, or may not**
- **Investments in the stock market**
  - **No guarantee of return**
  - **May generate dividends**
  - **May result in capital gain or capital loss**

Investments fall into two basic categories—those that are interest bearing, and those that are investments in the stock market. You may already be familiar with a bank savings account—if so, you know that the money you deposit earns interest, which is then paid to you by your bank. In the case of a savings account, your bank insures your deposits up to the maximum allowable limit—which reduces your risk to about zero.

Other types of interest bearing investments include certificates of deposit, treasury securities, and bond investments. We will look at each of these items. The other basic type of investment is in the stock market. When a corporation needs to raise money to operate its business, it issues shares of stock. An Investor pays for these shares and becomes a part owner of the company. For example, if Bob purchases 100 shares of stock in the Boeing Company, and pays $60 per share, Bob becomes an owner of that company.

A stockholder can make money in two ways by owning a stock—dividends and through the sale of shares.

For example, it the stock pays a dividend of 10 cents per share, Bob will receive a check for $10 from Boeing as his share of the earnings. Additionally, if Bob holds the stock for a while, he might find that the market price of the stock has increased to $70 per share. He could then sell the shares and make a profit of $10 per share or $1,000.

INVESTMENT IN A SAVINGS ACCOUNT

- **Always a safe investment**
- **Insured by Federal Deposit Insurance Corporation (FDIC) or National Credit Union Association (NCUA)**
- **Use for emergency cash, rainy day fund, holding tank for future purchases**
- **No penalty for withdrawal**
- **Low risk, low interest rate**

Let's start with an investment you are probably already familiar with—the bank savings account.

Savings accounts have always been a safe place to deposit money, mainly because they are insured up to the maximum allowable amount. In every investment portfolio, some amount of cash should be left in one or more savings accounts—for emergency situations, a rainy day fund in case of illness or job loss, or as a place to accumulate funds for a future purchase such as a car or house.

You should have at least 6 months income available in a savings account as a safety measure—PRIOR TO thinking about an investment program.

A savings account is a very low risk proposition—which is why it carries a low interest rate. Your intent with a savings account is SAFETY, rather than return on investment.

One other thing—you can withdraw your money from a savings account at any time, without a penalty for doing so.

CERTIFICATES OF DEPOSIT

- **You choose the maturity**
- **FDIC Insurance up to the maximum allowable amount**
- **Penalty for early withdrawal**
- **Low risk, higher return than a savings account**
- **Read all contractual materials**

In addition to savings accounts, many banks also offer certificates of deposit, or CDs. A CD is similar to a savings account as you deposit your money, and receive interest. But it is a little more formal. For example, the bank may offer a 3-month, 6-month, 9-month or one year CD, and the interest rate may differ slightly, depending on the maturity. Some CD’s may go even longer than one year—to 3, 4 or 5 years for example.

The catch is that there is a penalty for withdrawing your money prior to the maturity date of the CD.

You must choose your maturity carefully, and only invest an amount that you don’t need until maturity. There may be a minimum deposit required, such as $10,000, although you can find CD’s available for $1,000 or less. The interest rate offered may vary with the amount you are willing to invest.

CD’s are usually insured by the FDIC, up to the maximum allowable amount—but always verify this with your bank.

Be sure to read all materials carefully to make sure you understand all aspects of the investment.

U.S. TREASURY SECURITIES

- **The United States Government issues various types of securities through its Treasury Direct website:**
  - **Treasury Bills (maturity up to 26 weeks)**
  - **Treasury Notes (maturity 2-10 years)**
  - **Treasury Bonds (30 year maturity)**
  - **TIPS—Inflation protected securities (5-20 yrs)**
  - **See: http://www.treasurydirect.gov**

Another type of low-risk investment is through the United States government website called Treasury Direct. Through this website, a variety of conservative investments can be made in federal government securities.

The maturities vary among the products offered at Treasury Direct, from less than a half-year for treasury bills to 30 years for treasury bonds.

Additionally, for those investors looking for a way to protect their investment from inflation, Treasury Direct offers TIPS—a product that compensates the investor if inflation occurs.

If you own a computer with an Internet connection, you can arrange to have your bank account debited at the moment you wish to make your investment. At maturity, your principal and interest are automatically re-deposited in your bank account.

Although these investments are very conservative, the Internet makes them convenient, and the wide range of interest bearing products can be used advantageously.

BOND INVESTMENTS

- **Bonds are issued by corporations, governments and other entities**
- **A bond carries a fixed interest rate**
- **Usually issued in $1,000 denominations**
- **Risks due to market interest rate changes, possibility of default**
- **Become informed before investing**

You should know a little about bonds, as they can provide a good return—but you must be aware of their risks.

A bond is a piece of paper issued by a corporation or government. On that piece of paper, there is a face value (usually $1,000), and an interest rate. If you purchase a $1,000 6% bond, you will receive, at maturity, $1,000.

Additionally, each year you own the bond, you will receive $60 of interest. A bond can have a very long maturity, so you might own a bond 10-20 years before it matures. However, if you wish to sell the bond before maturity, an organized market exists for that purpose.

One of the risks that you take in purchasing a bond is that the issuing company or government might go bankrupt or fail to pay off the bond. Though infrequent, this does happen sometimes.

A more likely risk is that a change in interest rates may make the value of your bond fall. For example, if you purchase a 6% bond and interest rates in the market increase to 7%, your bond may be "discounted" because its rate is less than bonds that have entered the market.

Because of these risks, bonds should only be purchased by those who are experienced investors who have researched and learned about this product.

INVESTMENTS IN CORPORATE STOCK

- **Stock is offered on stock exchanges**
- **Purchase stock through a broker**
- **The broker's commission is paid at purchase AND at sale of the stock**
- **You make money two ways—dividends (if declared) and capital gains**
- **There is no guarantee you will make money!**

Now let us talk about another type of investment—corporate stock. As mentioned earlier, corporations issue stock to raise money for business purposes. Investors purchase shares of stock hoping that the company they now own a piece of will make a profit.

Stock investors make money in two ways. If the corporation declares a dividend, each share of stock will get a share of the dividend. Additionally, if you purchase a stock and the market price of the stock increases, you may have a capital gain when you sell the stock.

Stock is usually purchased through a stock broker. You pay the broker to establish an account, and then indicate how many shares of stock you want. You must pay a brokerage fee to acquire the shares. Later, when you sell those shares, you will have to pay the broker again. As you might guess, it is a waste of money buying and selling shares of stock frequently, without a good reason to do so—the brokerage fees can wipe out any profit you make.

Take the time to research the market, and choose stocks that have a long term probability of success. Even with due care, you may find that making money in the stock market is not an easy task.

INVESTING IN MUTUAL FUNDS

- **A mutual fund purchases shares on your behalf**
- **The mutual fund is managed by a skilled expert**
- **Terms of the mutual fund dictate the types of investments that will be made—risk is controlled somewhat through diversification**
- **Many established & trusted fund families**

If you are interested in buying stocks and bonds, but are a bit intimidated by the prospect of making good choices, you might consider investing in a mutual fund. A mutual fund allows you to invest your money and allow an investment expert to manage it for you. The fund will invest according to a certain set of terms that are detailed in a descriptive pamphlet called a prospectus.

You can order a prospectus from several mutual funds, and get an idea of how they invest, as well as their degree of success over the previous 5-10 years. Mutual funds are an excellent way to become familiar with stock and bond investments, and can provide very good returns.

A distinct advantage of a mutual fund is that the investment manager will purchase many different stocks, providing diversification. If one stock underperforms, its losses may be matched by another stock that did well. The level of diversification is far greater than a single investor can achieve.

There are many excellent mutual fund families that provide good service. Some famous ones include Fidelity Investments, American Funds, and American Century Investments. You can visit all of these fund families on the Internet.

TYPES OF MUTUAL FUNDS

- **Money Market Funds**
- **Growth Funds**
- **Income Funds**
- **International Funds**
- **Emerging Markets Funds**
- **Small Company Stock Funds**
- **Intermediate Term Bond Funds**

Above is a list of some typical names of mutual funds. Each family may have its own name for a particular type of fund. From reading the names, we might guess what each of these funds invests in.

A money market fund is usually a very conservative place to put your money, not unlike a savings account.

A growth fund tries to make money by investing in stocks that will experience capital gains—that is, the focus is on a positive change in the stock price.

An income fund might be looking for stocks that are paying dividends.

International funds are invested around the world, as the fund manager sees fit.

A small company stock fund is usually a somewhat risky (but sometimes very profitable) type of fund that looks for companies that are new and mobile. You will also find mutual bond funds that provide returns based on interest and trading of bonds.

You should do a little research before you choose a fund. There are many publications that provide timely information about mutual funds—for example: Money Magazine, Kiplinger's Personal Finance Magazine, and Business Week. Additionally, there is Morningstar, which provides in-depth analysis and commentary on stocks and mutual funds.

LOAD VS. NO-LOAD FUNDS

- **Load Funds: Purchase through a broker; pay a small percentage fee**
- **No-Load Funds: Purchase on your own; no load**
- **Read the prospectus before investing!**

There is one other thing that needs to be mentioned about mutual funds. Some funds are sold through stock brokerages, who will charge a fee. For example, if you purchase a fund through a broker, you might invest $1,000 and an additional fee of $50, which is 5% of the amount invested. This extra fee is called a "load" and exists to cover the advice that the broker may give you.

On the other hand, a no-load fund does not charge an up-front fee—your entire investment goes into the market. However, a no-load fund may still charge for its service. Read the prospectus carefully to determine how charges are made—all fees must be clearly stated.

As with all investments, read the terms carefully. Carefully research funds you are interested in on the Internet and in investment magazines.

RETIREMENT ACCOUNTS

- **The Individual Retirement Account (IRA)**
- **An Investment You Should Consider**
- **Dividends earned are tax free and will compound tax free**
- **May reduce your taxes now**

One investment that you should definitely consider is an Individual Retirement Account, or IRA. The IRA is a way to save money for when you retire, and will supplement your social security income.

Depending on the type of IRA you choose, you may get a tax deduction for making the IRA deposit.

The major advantage of an IRA is that all income you earn is simply added to the account—and is not taxed at the time it is earned. At the time you retire, you withdraw the IRA funds and you are taxed at that time—when, presumably, you are in a lower tax bracket.

You should consider an IRA every tax year—and particularly in those years in which you may be getting a tax refund. You can use that refund to finance your IRA.

Any of the mutual fund families discussed earlier can provide IRA accounts for their funds; banks and brokerages have IRA accounts as well.

A new type of IRA is the Roth IRA. You are taxed on the income before investing but the investment grows tax free and you do not pay tax when you withdraw it. You can withdraw money from a Roth IRA for a down payment on a house or to pay for education with no penalty for early withdrawal.

YOUR 401(K) OR 403(B) PLAN

- **Very similar to IRA investments**
- **You contribute from your earnings; your employer may match a % of your contribution**
- **You choose the Mutual Fund or other investment vehicle**
- **Your earnings grow tax free**

If you have a good job, your employer may provide a retirement arrangement called a 401(k) program. In this type of program, you contribute a portion of your earnings each pay period to the company 401(k) plan and your employer may match a percentage of your contribution. The entire amount is then deposited with a mutual fund or insurance company—and you get to decide how the funds are invested.

403(b) plans are very similar to 401(k) plans; however they are used for employees of public schools and some tax exempt non-profit companies.

You will be able to invest the combined deposit into stock investments, bonds, money-market funds, social choice funds, or whatever you choose. As you would expect, mutual fund families are often used as the funding partners, because they have such a wide range of investment products available.

Similar to IRA investments, your deposits, as well as the earned dividends or interest, will compound tax free.

If you stay with an employer for many years, and choose your investments wisely, your 401(k) may end up with hundreds of thousands of dollars to supplement your social security payments from Uncle Sam.

ADDITIONAL INVESTMENT OPTIONS

- **Your Home as an Investment**
- **Provides shelter**
- **May increase in value over time**
- **Provides tax savings due to mortgage interest deduction**
- **May be able to defer capital gain at time of sale**
- **Can provide nest egg at retirement**

Let us not forget an important part of anyone's investment portfolio—the family home. While not all real estate investments are sound, the family home provides many financial benefits—beyond just a roof over your head.

Your home may increase in value over time, providing you with a profit at the time of sale. Under the correct circumstances, you may even be able to defer the capital gain.

Each year, the interest you pay on your mortgage can be deducted on your tax return, and may even turn a tax payment into a tax refund.

If you hold on to the family home until you retire, you may be able to make enough profit at sale for a retirement nest egg.

All of these benefits are subject to tax rules, which change frequently. You may wish to read the tax law yourself or talk to a well-informed associate or advisor, prior to taking action.

AN INVESTMENT PORTFOLIO

- **Portfolio will change over time**
- **Think about life stages**
- **Stocks versus bonds**
- **Risk and return**
- **Traditional Thinking—the strength of the American stock market**

If the information you have seen so far seems a little overwhelming, that is understandable. The subject of investing is one that is learned over time. It may be too soon to talk about an investment portfolio, but it is worth your time to become more knowledgeable about investing.

As we indicated earlier, you will need to become the master of your finances simply to have the "little extra" money available to even begin an investment program. Also, life events can get in the way—you will need cash as you seek a home, have children, take care of parents, and so on. It is a good idea to have savings deducted from your pay so that you never see the money.

Paying yourself first is the most effective way to save and invest. You may be fortunate enough to begin taking advantage of an IRA each year, or you may take a job that offers a 401-K program.

The point is that you need to be aware of the possibilities of investing, BEFORE the opportunities arise. Time is your best ally in building your investment portfolio. The earlier in life you are able to begin putting money aside, the longer a time it has to compound. This is particularly true with investments in the American stock market—you may invest in a stock early in life that does not make money for several years—a young person can afford to wait.

A traditional investment "rule of thumb" is that the proportion of your portfolio devoted to stocks is 100 minus your age. This would suggest that a 20 year old might invest 80% of their portfolio in stocks and the rest in bonds or cash. An 80-year old should be primarily invested in interest-generating investments.

A MIX OF POSSIBILITIES

- **What is the optimal mix?**
- **Cash and savings accounts, treasury securities**
- **Certificates of Deposit**
- **Individual Retirement Accounts—Stock/ Bond Funds**
- **401(k) or 403(b) program at work—Stock/Bond Funds**
- **Some Individual Stocks**
- **Your Home**

The bullets above summarize the possibilities for your future investment portfolio. Begin with cash and near-cash investments that will tide you over in case of illness or a job loss.

Move some money to certificates of deposit when you can afford to park your money for the required maturity period. Fund your IRA every year, if possible; if you have many years before you retire, invest the IRAs in stock funds.

Similarly, if you have many years before retirement, invest in your company's 401-K program, primarily in stock funds. As you become confident, you might choose some individual stocks. Read investment magazines to get a feel for what the experts are saying—but ultimately, make your own decisions. Consider the purchase of a home, both as a place to live, and as a good investment.

What is the optimal mix of these investments? That will depend on your assessment of risk, your experience, and possibly a little luck. If you begin your investing early in life, you will have the time to make a few mistakes, and still come out all right.

REVIEW OF THIS WORKBOOK

- Investment Goals
- Nature of Risk
- Compounding of Earnings
- Stocks and Bonds
- CDs and Treasury Securities
- IRAs and 401-K
- Real Estate

We have covered many topics in this workbook. You may wish to review this material from time to time as you become more experienced in investing.

We started by talking about investment goals, and the nature of risk. We also looked at the mathematics of how an investment compounds over time. We looked at the basic ideas of stocks and bonds.

We then discussed Certificates of Deposit and treasury securities.

For longer term investments, we discussed the advantages of establishing IRAs to reduce taxes and increase wealth. We also addressed the possibility of using a 401-K retirement program as a vehicle for investing, with contributions from both you and your employer.

Finally we discussed the purchase of a home as both a good place to live, and as an investment.

QUIZ

On the next page, you fill find a quiz on the information presented in this workbook. Please complete the quiz, and send it, along with the Participant Form near the back of the workbook, to American Financial Solutions and we will send you a certificate for completing the course.

QUIZ—INTRODUCTION TO INVESTING

1. When investing money, a young person should:

a. Save half of their income
b. Make investments that are at a slightly higher risk
c. Make very conservative investments
d. Put all of their savings in a CD.

2. The Rule of 72 calculates:

a. The age you should start investing
b. The interest you will earn on your investment
c. The amount of time it takes your money to double
d. How to diversify your investments

3. The investment with the lowest risk is:

a. A savings account at a bank or credit union
b. Investment in bonds
c. Investment in the stock market
d. A certificate of deposit

4. Investing in a certificate of deposit is a good idea as long as:

a. You have a good relationship with your bank
b. The interest does not change
c. You don't withdraw the money early
d. You are not investing a lot of money

5. Which of the following is an example of a low risk investment?

a. A CD
b. A US Treasury Bond.
c. A Savings Account
d. All of the above

6. When investing in stock in the Stock Market:

a. You pay the broker when you buy the stock
b. You pay the broker when you sell the stock
c. Both a and b
d. Neither a nor b

7. One of the benefits of investing in a Mutual Fund is:

a. Your money is guaranteed to grow
b. It carries a fixed interest rate
c. You cannot lose money
d. It is managed by an expert investment manager

8. A major benefit of investing in an IRA is:

a. The income you invest is not taxed at the time you invest it
b. The IRS will not audit you
c. The interest you earn compounds tax free
d. Both a and c

9. Diversifying your investments is a good idea because:

a. It is less complicated
b. It decreases risk
c. It increases your rate of success
d. Both b and c

10. Which of the following are good opportunities for investing your money?

a. Real Estate
b. IRA
c. Mutual Fund
d. All of the above

PARTICIPANT CONTACT INFORMATION

If you would like to receive a certificate for completing this course, please:

- Complete the quiz on the preceding pages
- Complete the form below
- Mail both items to:
  American Financial Solutions
  Attn: Education
  263 4th Street
  Bremerton, WA 98337
- Or fax to: (888-282-5811)

Introduction to Investing

Please print your name (as it will appear on your certificate):

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Address ______________________________
City ______________________________
State ____________________ Zip ____________________

WORKBOOK REVIEW:

- Investment Goals
- Compounding of Earnings
- Stocks and Bonds
- CDs and Treasury Securities
- IRAs and 401-K
- Real Estate Investment

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