



# CHOOSING TO SAVE

## “TAKE CHARGE OF YOUR FINANCES” ADVANCED LEVEL

### SAVING

**Savings** is the portion of current income not spent on consumption. Savings tools are liquid assets. **Assets** include everything an individual or household owns with monetary value. Examples of assets include cash, automobiles, houses, and furniture. **Liquidity** is how quickly and easily an asset can be converted into cash. If an individual were to have an emergency, cash needs to be available in a savings tool that is easily accessible. Savings are often used to provide for emergency expenses, but are also used to save for the purchase of expensive items without having to use credit. Paying for a vacation or purchasing an automobile are large financial events that may be accomplished by using savings.

### INVESTING

**Investing** is the purchase of assets with the goal of increasing future income. A major difference between savings and investing is the degree of liquidity. Investments are not typically as liquid as savings tools; however, the degree of liquidity depends on the type of investment tool. In order to get money from certain investment tools without losing the amount put in, an individual may have to wait a long time. Therefore, an individual shouldn't rely on investments to provide money in case of an emergency. Investments are usually used to pay for long-term expenses such as paying for a house down payment in ten years, retirement income in thirty years, or paying for a child's college education.

## WHY ARE SAVING AND INVESTING IMPORTANT?

Saving provides the foundation for financial security while investing enhances wealth. Saving is essential to financial security, because without savings, an individual or household might not be able to pay for an unanticipated expense, no matter how large their income is. **Wealth** is defined as a measurement of how much a person or household owns once all debts have been paid. By investing, an individual or household is working towards wealth accumulation. By becoming financially secure and building wealth, saving and investing help an individual or household pay for a particular level of living in the present and then aspire to a standard of living in the future. **Level of living** is defined as the amount of money needed to pay for the necessities and comforts currently enjoyed. **Standard of living** is the minimum necessities, comforts, or luxuries thought to be essential. Standard of living is a higher level of living that an individual or household wishes to reach through income increases and wealth accumulation. Investments may help an individual or household reach their desired standard of living.

Wealth is measured with a net worth statement. A **net worth statement** describes an individual's financial condition on a specified date. Saving and investing help increase assets and decrease liabilities, which results in a larger net worth and therefore, increased wealth.

Assets



Liabilities



Net Worth  
(wealth)

**Assets** – Everything an individual or household owns with monetary value

**Liabilities** – Debts (what is owed to others)

**Net worth** – Amount of money left when liabilities are subtracted from assets





SAVING	INVESTING
Portion of income not spent on consumption	Purchase of assets with the goal of increasing future income
Pay for emergencies and large purchases	Pay for long-term goals such as retirement and higher education
More liquid	Less liquid
Provides the foundation for financial security	Helps build wealth

## HOW MUCH MONEY SHOULD BE SAVED AND INVESTED?

It is recommended that a person save at least six months worth of expenses in liquid assets. For example, a household with \$2,000 per month of expenses should have at least \$12,000 in savings ( $\$2,000 \times 6 \text{ months} = \$12,000$ ). However, the specific amount of savings every person or household needs depends on many factors, such as income, number of dependents, job security, etc. To reach this amount of savings, it is recommended that a person save 10-20% of net income every month. **Net income** is the amount of an individual's take-home pay after taxes and other deductions have been taken out. Once an appropriate amount of savings is available in liquid assets, a person could redirect their goals from saving to investing and continue to invest 10-20% of net income every month.

How much money do you believe you should have in savings?

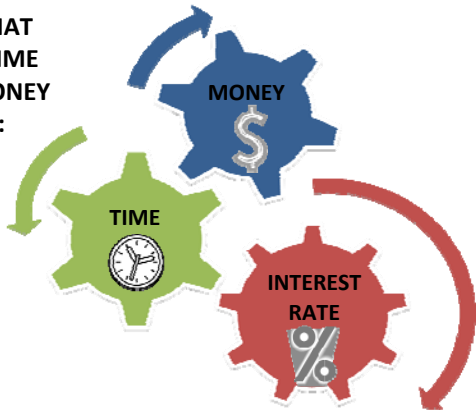
## TIME VALUE OF MONEY

The **time value of money** is one of the most powerful and important ideas in both savings and investing. The time value of money concept means money paid out or received in the future is not equivalent to money paid out or received today. Essentially, the power of time helps a person to earn more money.

**INTEREST RATE**

**Interest** is the price of money. **Interest rate** is the percentage rate paid on the money invested or saved. **Compounding interest** is defined as earning interest on interest. The higher the interest rate, the higher the return will be. A **return** is the profit or income generated by savings and investing. Table 1 is an illustration of how interest rates affect \$1,000.00 invested for 5 years.

**FACTORS THAT MAKE THE TIME VALUE OF MONEY POSSIBLE:**



Interest Rate (compounding)	Amount Investment is Worth
1%	\$1,051.01
3%	\$1,159.27
5%	\$1,276.28
7%	\$1,402.55
9%	\$1,538.62





**TIME**



The longer an individual saves or invests, the more time money has to increase in value. For example, at 10% interest rate Sally Saver started investing \$3,000 per year at age 22 and invested a total of \$30,000.00. Ed Uninformed began investing \$3,000 per year earning a 10% interest rate at age 28 and invested a total of \$111,000.00. At age 65, when Ed and Sally would like to retire Sally has earned \$1,205,063.00 from her \$30,000 investment. Ed has earned \$1,079,856.00 from his \$111,000.00 investment.

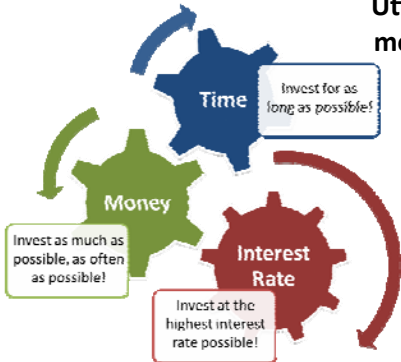
**AMOUNT OF MONEY**



The amount of money that an individual saves or invests also has a big impact on the time value of money. The larger the amount of money invested, the larger the return on investment will be. **Principal** is the original amount of money saved or invested. However, a person can continue to invest money and have the investment grow even more. Table 3 illustrates the difference in returns for different amounts of money invested at 7% interest compounded annually for 5 years.

Table 3: 7% interest compounded annually for 5 years	
Amount of Principal Investment	Return on Investment
\$100.00	\$40.26
\$1,000.00	\$402.55
\$10,000.00	\$4,025.52

**Maximize Your Return!**  
Utilize the time value of money to your greatest advantage!



Are you taking advantage of the time value of money?  
If not, how can you begin?

**HOW DO I BEGIN TO SAVE MONEY?**

In order to successfully save money, a person needs to consider their future. Goal setting helps a person think about their future-self. A **goal** is the end result of something a person intends to acquire, achieve, do, reach, or accomplish. Goals are usually the most successful when a person considers the consequences of that goal and formally writes the goal down. In order to set successfully set and reach savings goals, follow the process outlined in the diagram below:



**EVALUATE THE CONSEQUENCES OF GOALS:**

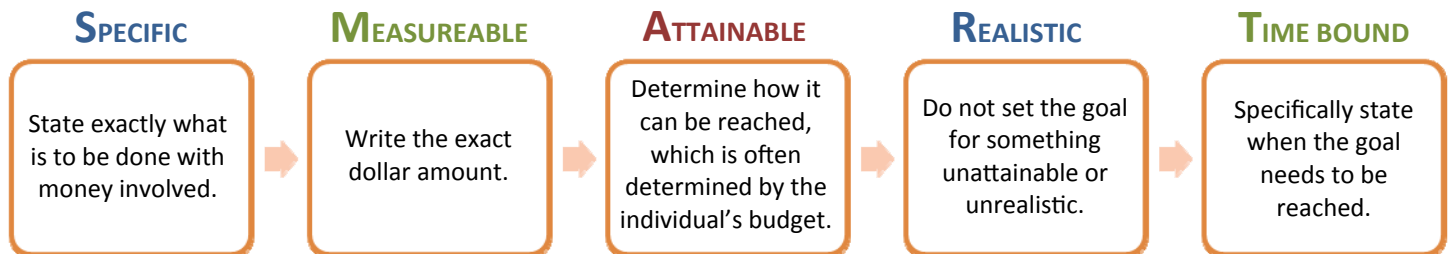
It is important to understand the concepts of trade-offs and opportunity cost when setting goals. A **trade-off** is giving up one thing for another. Every decision inevitably involves a trade-off. Earning more money in the future by saving and investing is a trade-off to spending money in the present. **Opportunity cost** of a decision is the value of the next best alternative that must be forgone. Opportunity cost allows you to analyze the consequences of choices to decide which trade-offs to make. The opportunity cost of saving and investing for the future is the value of spending money in the present.





A person's spending will most likely be affected by the decision to save money. The exact changes to spending will depend on the trade-offs made. It is important to adjust spending plans to help reach savings goals. A **spending plan** is a paper or electronic document used to record both planned and actual income through expenditures over a period of time. Income could be increased, or expenses could be adjusted. Each time a purchase is made, an individual should evaluate the opportunity cost to determine if that purchase is more important than putting the money towards reaching their goals. Earning more money in the future is a trade-off to spending money in the present. If adjusting or cutting other expenses is necessary to assist with reaching savings goals, then flexible expenses should first be examined. If flexible expense cuts don't allow for enough extra money, then fixed expenses should be examined. Fixed expenses are more difficult to cut from a spending plan, because they are often contractual, meaning that an individual may be locked into that expense for a certain period of time, such as cell phone plans or a lease to rent an apartment. Cutting fixed expenses may require drastic actions, such as moving, giving up internet service, or selling a car.

### WRITE A SMART GOAL! SMART GOALS SHOULD CONTAIN THE FOLLOWING ELEMENTS:



An example of a SMART savings goal is: I will \$100 from every monthly paycheck for the next year in order to develop an emergency savings fund worth \$1200. I will give up various expenses indicated in my spending plan in order to reach this goal.

### MAKE SAVING AUTOMATIC!

**Pay yourself first** is a popular and very effective saving strategy. Paying yourself first means to set aside a predetermined portion of money (10-20% of net income is recommended) for saving each time a person is paid before using any of the money for spending. Creating a saving before spending habit means savings should not be viewed as what is remaining at the end of the month after current wants and needs have been satisfied. Paying yourself first is most effective when it is automatic. Two methods of making savings and investing automatic are automatic transfers and payroll deduction.

#### Automatic Transfers

Most depository institutions and employers offer ways for people to make savings and investing automatic. A **depository institution** is a business that offers banking and finance services, such as savings and investing tools. Most depository institutions will allow their customers to set up automatic transfers between accounts. Once the initial setup is complete, the customer doesn't have to do anything else and a designated amount of money will be automatically moved into a designated account every month.

#### Payroll Deduction

Most employers offer payroll deduction to their employees. With payroll deduction, employees can designate a certain percentage or specific amount of their paycheck to be deposited into an account of their choice.

