Standard & Poor's Extension Activities

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Introduction

The following Standard & Poor's articles have been carefully selected to provide practical insights for students on the topics of business and personal finance. Each article expands on material that was presented in the chapter.

You may want to use the following steps in helping your students analyze each article:

- Have your students read the article carefully, paying close attention to details. Encourage students to underline facts and ideas they consider to be important. Key terms and definitions are provided in the Vocabulary List.
- After they have read the article, have the students complete the Fact and Idea Review and the Critical Thinking Questions.
- Use the Extension Activity to generate a classroom discussion on the given topic from the article.

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Student **Class** **Instructor**

Date Assigned **Date Completed**

ACTIVITY 1 Personal Financial Planning

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

How to Work With a Financial Advisor

A **financial advisor** can provide valuable assistance in helping you build a sound financial foundation. Think of your financial advisor as a kind of doctor for your financial health. At a minimum, your financial advisor will assess your **risk tolerance**, analyze your resources, take into account your **tax liability,** and make investment recommendations in the form of a written financial plan that will help you achieve your goals. The plan will try to ensure that your current and future assets are used to their best advantage given your current financial situation and your financial goals.

The experience and qualifications of financial advisors vary. There are no minimum licensing or education requirements that must be met in order to be a financial advisor, so you'll want to inquire about experience and training before selecting an advisor. Financial advisors (also called financial planners or financial consultants) can earn designations by completing accredited courses of study. Two of the most common designations are Certified Financial Planner (CFP), which is awarded by the Institute of Certified Financial Planners in Denver, Colorado, and the Chartered Financial Consultant (ChFC), which is awarded by the American College of Bryn Mawr in Pennsylvania. There is also the Registered Financial Planner, which is a designation awarded by the International Association of Registered Financial Planners, located in Tampa, Florida.

Financial advisors are often trained as accountants, lawyers, insurance agents, or stockbrokers—all professions that have a relationship to different aspects of your financial well being. Because of this association with another profession, a financial advisor frequently will specialize in a specific type of financial planning, such as retirement planning or estate and trust planning.

Financial advisors are usually compensated in one of three ways. They may:

- charge a fee for their time and service, but sell nothing;
- give free advice, but charge a commission on transactions involving investment products such as mutual funds, stocks, bonds, and insurance products; or
- charge both a fee and commission on transactions.

Knowing what to expect from your financial advisor will help establish a good relationship. At your first meeting, you and your advisor will identify your financial needs and investment goals. To prepare for your first meeting, call your advisor and ask what specific documents and information you should bring. These may include essential documents such as wills, copies of insurance policies, pension information, and investment account statements. In addition, you should be prepared to discuss questions about your goals, income, expenses, and savings.

After you and your financial advisor have established your investment goals and objectives, your advisor will create a plan for you and review this with you. The plan may include making sure you have sufficient insurance, that you have cash reserves to meet unexpected financial needs, and that specific short- and long-term goals are provided for. The plan will also include investment recommendations for current and future assets, and estimates of how much you will need to save to achieve your financial goals.

After your first meeting, you'll want to schedule annual financial reviews with your advisor to make sure the plan works to your satisfaction and that none of your goals have changed over time. If you have major changes or events in your life, keep your financial advisor informed of these. Such examples would include a change in marital status, the birth of a child, a change in income, or an inheritance.

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Student **Class** **Instructor**

Vocabulary

financial advisor a specialist who offers specific financial help and advice.

risk tolerance a person's level of willingness to take a chance on a financial loss when making investment decisions.

tax liability the total amount of taxes a person owes.

Fact and Idea Review

1. What can a financial advisor do for you?

2. What professional designations might a financial advisor hold?

3. How are financial advisors compensated for their services?

4. What questions should you be prepared to answer at your first meeting with your advisor?

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5. How often should you meet with your financial advisor?

Critical Thinking

1. At what stage in your life do you think it would make the most sense to develop a relationship with a financial advisor?

2. Why is it important to establish a good relationship with your financial advisor?

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Extension Activity

Most people never seek the advice of a professional financial advisor to help them manage their finances. Where do you usually seek assistance with money questions? Compile a list of your top choices. As a class, discuss how you would feel about speaking with someone you don't know very well about money issues.

Student Class Instructor

Date Assigned Date Completed

ACTIVITY 2 Finances and Career Planning

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Federal and State College Financial Aid Programs

The cost of financing a college education can be daunting. Although most colleges agree that the family should be the primary support vehicle, financial assistance does exist.

Federal Programs

The federal government administers six major financial assistance programs.

Pell Grants

The Pell Grant is based solely on financial need. The amount of the award is based on student need (within certain limits) and on how much money Congress appropriates to the program each year.

Stafford Student Loans

The Stafford Student Loan is a federally subsidized loan program that allows the student to borrow from private lenders and the government at low interest rates. Families with high incomes are eligible for the program if certain needs tests are satisfied. The loan is insured either by the federal government or a state agency.

Repayment of principal and interest is **deferred** until six months after a student graduates or leaves school, and standard repayment is made over a 5- to 10-year period depending upon the amount owed.

An undergraduate may borrow up to certain limits each school year under the program. The government pays the interest for all undergraduate and graduate school years and for six months after the last class.

PLUS Loans

Parent Loans for Undergraduate Students (PLUS loans) are available to parents of **dependent** undergraduate students.

PLUS loans through participating lenders are handled like guaranteed student loans. Repayment of a PLUS loan begins 60 days after parents receive the money, and each lender establishes a repayment period of up to 10 years. Repayment of principal on a PLUS loan to a full-time student is deferred until the student graduates or leaves school. Unlike guaranteed student loans, the student receiving a PLUS loan must begin interest payments within 60-days of receiving the full loan.

Supplemental Education Opportunity Grant

A Supplemental Education Opportunity Grant (SEOG) is a grant to a student with demonstrated financial need. The money is sent, however, by the federal government directly to the colleges, which determine the award amount and dispense the money to the students.

Once distributed, there are no additional sums. Applications are made through the academic institution's office of financial aid. Early application is strongly recommended.

College Work-Study Program

The College Work-Study Program is a program administered by each college to provide employment for students who demonstrate financial need. The federal government grants funds to colleges for this purpose. Students normally obtain employment under this program as part of an overall financial aid package. They generally work 12 to 15-hours per week during school sessions and up to 40-hours a week during vacation periods.

The Perkins Loan

Perkins Loans are administered by colleges that also act as lenders. Eligibility is based on the student's calculated need. A student will pay no interest while still in school. There is a nine-month **grace period** after leaving college. Repayment is stretched out over 10 years.

State Programs

State governments also offer a variety of assistance programs. But most state assistance is available only to state residents attending schools within that state. Some states do make exceptions and permit state residents to attend out-of-state schools. A few states allow nonresidents to receive assistance while attending a school within the state or have **reciprocity arrangements** with other states. Application procedures vary from state to state.

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Vocabulary

deferred for loans, payment of principal (and sometimes interest) that is postponed to a later-date.

dependent a person whom you support financially according to certain IRS requirements.

grace period a period of time during which no payments are due.

reciprocity arrangement a mutual recognition between states of certain privileges granted to individuals.

Fact and Idea Review

1. Name the six federal government financial assistance programs.

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2. When must interest and principal payments on a Stafford Student Loan begin?

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3. In the College Work-Study Program, how many hours does a student generally work during school sessions? During vacation periods?

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4. What is the maximum repayment period for a Perkins loan?

5. What are the requirements of most state assistance programs?

Critical Thinking

1. What are some reasons a prospective student with limited funds may choose not to borrow money to pay for college? In what circumstances might taking out a student loan be a good idea?

2. In evaluating a loan package, do you think it would be better to choose a shorter repayment period or a longer repayment period? Why?

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Extension Activity

Salaries are often tied to the amount of education required in order to perform a particular job. Choose an occupation that you might be interested in and research what training is required to do that job. How much would that training cost? What would be the average starting salary for that particular job versus the average salary for high-school graduates? Does the difference in salary reflect the cost of training? Share your findings in class discussion.

Student	Class	Instructor
Date Assigned	Date Completed	

ACTIVITY 3 *Money Management Strategy*

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Stop Singing Those Holiday Spending Blues

The holidays can be a magical time of year, filled with the warmth of family and friends and the joy of giving—or receiving—the perfect gift. But if you're not careful, the holidays can also be a financial drain—leaving bills that linger long after the winter snow has melted.

The key to managing holiday spending is to treat it as you would any other financial goal: plan, **budget**, and save. Financially happy holidays are a year-long endeavor.

Start with Savings

Not having enough money during the holidays can make you reach for your **credit card**, adding **interest** payments to your holiday expenses if you can't pay the bills off in January. Remember, even a low interest rate adds to the cost of every purchase you make and could negate any bargains you found.

To avoid credit card use, begin setting aside a little money from each paycheck in January in a special account reserved for holiday expenses. If you never see the money, you're less likely to miss it.

Build a Budget

With a savings plan underway, your next step is to start planning for holiday expenses. The Holiday Budget worksheet to the right can help you figure out where the money goes and target a savings goal. Don't forget those other expenses besides gifts, such as meals out and decorations. If you still have receipts from last December, you can use them to help plan the coming year's expenses.

Your goal should be to bring your holiday budget in line with what you will be able to save before the holidays. If you find a sizable gap between savings and expenses, try to find ways to reduce costs or save more.

Cutting Back on Spending

Last-minute shopping is the easiest way to wind up in debt during the holidays. You can begin to reduce holiday expenses by starting your shopping for next year as soon as the holiday season winds down. Post-holiday sales offer deep discounts on wrapping paper, cards, and decorations. The same strategy can be used for gifts.

Gift-Giving Alternatives

One of the easiest ways to reduce gift costs is to give the gift of time. Homemade coupons for a home-cooked meal, an afternoon at the beach, or a pledge to mow the lawn, paint or clean the house, or baby-sit can be just as valuable as store-bought items.

Planning, budgeting, and creativity can help keep holiday bills in check—and keep you from reaching for credit cards. If you must use credit to balance the holiday budget, use the card with the lowest interest rate and work to pay down the balance as soon as possible after the holidays. The holiday season is more joyous when you're not still paying for it when summer arrives.

HOLIDAY BUDGET

Use this worksheet to estimate your savings and spending goals for the holidays.

Amount You Expect to Save	$__________	(A)
Gift Budget		
Recipient	**Expected Gift Cost**	
__________	$__________	
__________	$__________	
__________	$__________	
__________	$__________	
__________	$__________	
__________	$__________	
__________	$__________	
__________	$__________	
Total gift spending:	$__________	(B)
Miscellaneous Budget	**Expected Cost**	
Wrapping paper	$__________	
Greeting cards	$__________	
Decorations	$__________	
Food and Beverage (include meals out)	$__________	
Baby sitter	$__________	
Other		
__________	$__________	
__________	$__________	
__________	$__________	
__________	$__________	
Total miscellaneous spending:	$__________	(C)
Total spending (add lines B and C):	$__________	(D)
Total extra or shortfall (subtract line D from line A; a negative means you saved more than you budgeted):	$__________	

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Student **Class** **Instructor**

Vocabulary

budget to create a plan for using one's money in a way that best meets one's wants and needs.

credit card a method of payment which allows the user to buy now and pay later. This convenience comes with a price: interest.

interest periodic charge in exchange for the use of credit.

Fact and Idea Review

1. What is the key to managing holiday spending?

2. What items should you list when you create a gift budget?

3. What should be your goal in building a holiday budget?

4. Name two ways to reduce gift expenses.

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5. If you must use credit, how can you minimize your interest expense?

Critical Thinking

1. What problems are likely to arise if you wait until the last minute to shop for gifts?

2. What are some ways to increase the chances that the gifts you give will be appreciated?

Extension Activity

Make a list of some of the gifts that you have received and valued most. In small groups of three to five, discuss with each other why those gifts were important. Next, discuss in your group some of the gifts that you have given to others. Were they appreciated or valued? Why?

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Student Class Instructor

Date Assigned Date Completed

ACTIVITY 4 Consumer Purchasing and Protection

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Buying a New or Used Car

Thinking of buying a car? You'll save money, avoid headaches, and get the car you want if you pay attention to buying advice from auto-industry insiders and consumer-credit experts.

First decide what kind of vehicle you need. Consider whether a late-model used car, costing thousands of dollars less than a new vehicle, would meet your needs. The biggest cost in owning a new car is **depreciation**, with some new cars dropping in value by as much as 20% in the first year on the-road.

Vehicle Value

Determine how much money your car of choice—with the options you want—is fetching on the local market. When you get to the auto showroom, you'll probably find good deals and, perhaps, **rebates** on slow sellers. But expect high prices and little bargaining room on fast-sellers like pickups and sport utility vehicles. That means you have to know the real value of the car or truck if you want to get the best deal.

Making the Deal

The first step to getting a good deal on a new car is to be informed. New car cost guides are available in bookstores, libraries and on the Web. These will help you find the **factory invoice price** and the cost of various options.

When you are negotiating price with the dealer, remember the invoice price does not represent the actual cost of the car. The dealer receives a-rebate from the manufacturer for each car he or she sells, usually 2% to 3% of the **sticker price**. Depending on the time of year and the demand for the car, that rebate may be enough profit for the dealer to sell the car **"at invoice."**

At other times, the dealer may add additional profit to the price of the car. With some domestic cars, you can expect to pay $200 to $600 over invoice. For more popular models you may pay two to three times that much.

The Deal, No-Haggle and Otherwise

There are one-price car dealers who won't haggle over price because they have already put a realistic sticker on their vehicles. This is an attractive way to buy if you are not comfortable negotiating a price or if you find haggling with a salesperson not to your taste. But keep in mind that some 90% of the dealers are ready, if pressed, to give a little to get your business. By knowing the real value of the vehicle, you're at a decided advantage.

You'll want to visit a few dealers—once to look and another, separate time to negotiate. A convenient location should be a consideration. The cost of many adjustments to your car must be absorbed by the dealer who sells you the car, so find one nearby. In those first months of your warranty, another dealer can legally refuse to do the special-adjustment service.

Financing

Most people use financing to pay for a new car. If you are thinking about financing your new car, you may do so through an auto loan.

Be sure to get the shortest payback time you can comfortably handle. A shorter-term loan with larger payment amounts will save money in the long run. A $15,000 loan at 8% for five years, for example, will cost $3,240 in interest. By paying an extra $62 a month for the same loan over four years, your interest cost would drop to $2,568.

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Student Class Instructor

Vocabulary

"at invoice" the factory invoice price.

depreciation the loss in a vehicle's value due to time and use.

factory invoice price the vehicle price charged to the dealer by the manufacturer.

rebate a partial refund of the price of a product.

sticker price the suggested retail price; charged to the customer by the dealer.

Fact and Idea Review

1. How much does a new vehicle typically drop in value in the first year on the road?

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2. What types of vehicles usually have rebates to the customer?

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3. What is meant by selling "at invoice"?

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4. Why should you purchase a vehicle close to where you live?

5. What is the advantage of financing a car purchase with a shorter-term loan?

Critical Thinking

1. Do you think it is fair for dealers to charge you more for a car than they pay the manufacturer? Why?

2. What are some advantages and disadvantages of shopping at a one-price car dealer?

Extension Activity

Many people today lease cars rather than purchase because the monthly lease payments are lower than the monthly payments required to purchase the car. However, with a leased vehicle, additional charges may result if the vehicle is driven more than 15,000 miles during the lease term. Moreover, at the end of the lease, the car must be returned. In groups of two or three, study newspaper dealer ads for terms on leased vehicles versus a purchase. As a class, discuss the pros and cons of leasing versus buying a car.

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ACTIVITY 5 Banking

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Money Market Investments Add Stability and Liquidity

When you begin to build a **portfolio** of investments, you need to consider your short-term goals as well as your long-term goals. For example, do you plan to take a vacation or buy a car during the next year? You must also think about what portion of your portfolio will need to be **liquid**, or easily accessible, in case of emergencies. In addition, consider how much stability your portfolio will need to allow you to feel comfortable as you pursue your longer-term goals.

Offering higher rates of return than traditional bank deposit accounts, money market accounts can serve short-term and emergency cash needs, as well as provide an element of stability to help diversify your portfolio. However, while savings accounts are generally insured by the **Federal Deposit Insurance Corporation** (FDIC) up to $250,000 per depositor, money market accounts are not guaranteed.

Money market accounts invest in short-term debt instruments that will repay **principal** within one year. For example, when the U.S. government needs money quickly, it borrows by issuing Treasury bills (T-bills) that institutions and individuals will purchase. The T-bills represent the government's promise to pay back the loan. These investments mature, or come due, in short periods of time, when the government repays the loan.

Similarly, banks will offer short-term debt instruments called **certificates of deposit** (CDs), and corporations will offer **commercial paper**. Other money market securities include repurchase agreements, banker's acceptances, and government-agency obligations.

Money market investments generally have a high credit quality, which means that there is little risk that their issuers will not be able to repay their debt. Because of this high quality, they are considered low-risk investments. Money market accounts pool these securities in one investment vehicle that brings low-risk opportunities to the everyday investor.

The short maturities of money market instruments result in a low sensitivity to interest rates. As long as the investment manager who buys and sells securities for the money market account can hold the securities to maturity, the account value will not drop due to changes in interest rates.

Because of their low-risk holdings and their low susceptibility to changes in interest rates, money market accounts offer investors little risk of loss to their principal. In addition to providing stability and low risk, money market accounts offer the following benefits:

- **Liquidity**—Money market accounts do not require you to invest your money for set amounts of time. You can withdraw your money whenever you need it, without penalty. Other short-term, stable investments are not as liquid. For example, CDs charge penalties for early withdrawals.
- **Daily valuation**—Dividends are credited to your account daily, which ensures that your earnings are always up to date and available.
- **Low minimum investments**—Money market accounts generally offer lower initial investment minimums than other types of investments.
- **Check writing**—Many money market accounts allow you to write checks against the balance, although there can be limits on this privilege.
- **Competitive interest rates**—During a high-interest-rate environment, money market accounts can offer competitive yields providing solid returns that are higher than bank savings accounts.

Within an investor's portfolio, money market accounts can serve two main purposes: short-term cash needs and diversification. Funds in your money market account are available for cash needs, which may include larger-ticket expenses you will have over the next year, such as that new car or vacation. Also, retirees often find money market accounts to be appropriate vehicles for managing current income and cash needs, and for cash needs one to three years distant.

Money market investments can help diversify a portfolio, adding some stability to a portfolio heavily weighted in the riskier stock and bond investments.

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They can also serve as a convenient place to park substantial amounts of cash while you decide where you want to invest it.

While money market accounts are useful for meeting short-term needs and diversification strategies, investors should remember that they are conservative investments. Investing your portfolio too heavily in money market instruments can hurt its potential for long-term growth. Investors who are primarily seeking high long-term returns may be best served by investing the majority of their money in bond and stock investments. Because money market returns tend to just keep pace with inflation before taking taxes into account, money set aside in money market accounts can actually lose purchasing power after inflation and income taxes on annual returns are factored in.

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Vocabulary

certificate of deposit (CD) a savings alternative in which money is left on deposit for a stated time period (ranging from a month to five or more years) to earn a specific rate of return.

commercial paper a short-term note issued by companies. The length of the issue is usually from 30 to 270 days. Money market funds are often composed largely of treasury bills and commercial paper.

Federal Deposit Insurance Corporation (FDIC) the federal governmental insurance organization for banks and depositors. The FDIC will cover deposits (basically up to $250,000 per account) at any bank it insures if the bank fails or runs into financial difficulty.

liquid any asset that can be quickly converted to cash. A checking account is a liquid asset because it can be used in the same basic way as cash.

portfolio all the securities held by an investor.

principal when referring to a loan, the amount borrowed.

Fact and Idea Review

1. What is the main advantage of money market accounts versus traditional bank deposit accounts?

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Student Class Instructor

2. What does the U.S. government do when it needs money quickly?

3. Why are money market investments considered low risk?

4. List and explain five benefits of money market instruments.

5. Why are money market accounts considered a conservative investment for the long term?

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Critical Thinking

1. What factors might influence the returns you earn on money market investments?

Student **Class** **Instructor**

2. If you were a senior in high school who recently inherited $25,000, would you invest any of it in a money market account? Why or why not?

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Extension Activity

Many different types of financial institutions offer money market accounts. Using the public library, the local branches of these institutions, or the Internet, collect information on the various types of money market accounts offered in your community. How do their fees differ? How competitive are the rates paid on these accounts?

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ACTIVITY 6 Consumer Credit

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Managing Debt and Credit

Credit is defined by Dun & Bradstreet's motto as "Man's Confidence in Man." However, the definition of credit today is more like "Man's Confidence in Himself." Using credit today means you have confidence in your future ability to pay that debt. Forty years ago, your grandparents may have paid cash for their homes and their cars, a largely unheard-of (and most likely impossible) event today. If they borrowed money at all, chances are it was from a relative or a friend, and not a financial institution.

Today debt and instant credit are part of our everyday lives. The convenience of instant credit, however, has taken its toll. Many individuals use credit cards to spend more than they earn, and a few of these people actually build themselves a debt prison from which some never emerge. On the other hand, those who never use credit can be denied a loan or credit when they have a justifiable need or use for it. Using credit establishes a history of financial responsibility; until you establish a **credit history**, your chances of qualifying for an important loan such as a **mortgage** are greatly reduced.

Installment debt and **revolving credit** are two ways of borrowing. Installment debt allows you to purchase items at a competitive interest rate: for example, 6 to 7 percent for a 30-year home mortgage and about 9 percent for a car loan. The loan is paid back on an **amortizing** schedule: monthly payments of a fixed amount that remain constant over the life of the loan. At first, most of the monthly payment consists of interest. In later years, principal begins to be paid down. Installment debt is easily budgeted and the debt is eliminated on a pre-determined date.

A revolving line of credit, also called "open-ended credit," is made available to you for use at any time. Credit cards—such as Visa, MasterCard, and department store cards—are examples of revolving credit. When you apply for one of these cards, you receive a credit limit based on your credit payment history and income. When you use the credit line, you must make monthly minimum payments based on the total balance outstanding that month. Some lines of credit will also have an annual account fee.

While revolving credit is a convenient way to borrow, it can also become an endless pit of minimum payments that barely cover the interest due. As you pay off your debt, the minimum payment is also reduced, thus extending your payoff period and consequently the interest you pay. Paying just the minimum due on a $2,000 credit card loan could mean making monthly interest payments for 10 or more years! Many cards charge rates of interest as high as 18 percent annually. If you have a good credit history, you may qualify for a lower rate; however, a few late payments will push your interest rate higher. Also, carrying a balance on a credit card can make it harder for you to obtain less expensive types of financing.

Revolving credit, in addition to being convenient, eliminates the need to carry a lot of cash, and helps bridge small timing differences between income and expenses. The itemized monthly statements also can help you track your expenses. Some people can easily yield to the temptation that the convenience of credit cards offers. Impulse buying, failing to compare costs, and purchasing large items you can't afford are all downfalls brought on by always-available purchasing power.

Installment Debt vs. Revolving Debt

Beginning Balance	$2,500	$2,500
Interest Rate	10%	18.5%
Years to Repay	4	30*
Interest Cost	$544	$6,500

*Paying 2 percent minimum monthly payment.

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Student **Class** **Instructor**

Vocabulary

amortizing reducing the balance of a loan, such as a mortgage, every time a payment is made.

credit history a record of someone's use of credit—amount borrowed, payment record, and current amount owed.

installment debt money you borrow that is repaid at regular intervals of time until the total amount that is owed has been paid.

mortgage a long-term loan extended to someone who buys property.

revolving credit often called "open-ended credit." Credit cards are examples of revolving credit, allowing the user to buy now and pay later.

Fact and Idea Review

1. Why is it important to establish a good credit history?

2. What are three advantages of installment debt?

3. What factors determine your credit limit on a revolving credit card?

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4. How does making minimum monthly payments affect the interest you pay on credit card purchases?

5. List three advantages of using revolving credit.

Critical Thinking

1. Why do some credit cards charge annual rates of interest that amount to nearly 18 cents on every dollar borrowed?

2. Give three reasons why it is a good idea to establish a discipline of never carrying a balance on a credit card.

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Extension Activity

Credit cards are a convenient and in some cases essential financial tool. For example, people who travel frequently use credit cards to reserve airline tickets, rent cars, and book hotels. As a class, brainstorm ways to make sure you will never spend more than you can afford by using a credit card. Consider asking a trusted friend or family member to hold the card for you or declining any offer to increase credit line.

Student **Class** **Instructor**

Date Assigned **Date Completed**

ACTIVITY 7 The Finances of Housing

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Don't Give Up on That Refinancing

Signing a loan document isn't the end of the mortgage decision. As interest rates change, you'll need to decide through the years whether you should **refinance** your mortgage. If interest rates have dropped, you may be able to secure an attractive rate and come out in the black in just a few years, even if you have to pay up to 4 percent of the amount you're borrowing in **points** and fees.

Let's say you owe $100,000 on your home, and you refinance from 8.5 percent to 7.6 percent for 30 years, paying one point—or $1,000—and $1,000 in other fees. Your monthly payments will drop from $769 to $706, and it will take you about 32 months to recover your costs. That's not a bad deal if you have several years left on your original mortgage. (One tax **caveat**: When you refinance, you have to **amortize** the points you paid over the life of the loan; with a new loan, you deduct the points in the year you take a mortgage.)

To see if a new fixed-rate loan makes sense, try one of the refinancing calculators available on the Internet. Plug in the details of your loan and the expected rate, and you'll see in an instant what your savings could be. Then shop around for the best rates and terms available. Mortgage companies, banks, and credit unions all offer mortgage loans, and the terms and rates can vary substantially. No-fee and no-point loans are available from some lenders, usually at a slightly higher interest rate.

If you think that in the coming months interest rates are going to drop lower still, you could try a **hybrid mortgage.** With this type of mortgage you borrow at a fixed rate for a specified number of years. After that, the loan becomes adjustable. Take a 30-year, 5/1 hybrid, which is fixed for five years, then adjusted once a year after that. The initial fixed rate on this type of mortgage may be significantly lower than the rate on a conventional 30-year loan. An adjustable-rate mortgage will offer the lowest rates, but with the potential that you could have to make higher payments down the road if interest rates rise.

Excerpted with permission from Standard & Poor's *Personal Wealth.*

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Vocabulary

amortize when referring to income taxes, the process of deducting points on annual tax returns over the term of the mortgage loan.

caveat a warning or an explanation given to prevent misinterpretation.

hybrid mortgage a mortgage that has two rates of repayment—fixed and adjustable.

points extra interest charges that a home buyer must pay in order to get a lower rate of interest on a mortgage.

refinance to take out a new mortgage at a lower interest rate.

Student Class Instructor

Fact and Idea Review

1. When is a good time to consider refinancing a mortgage loan?

2. Are points paid for refinancing tax-deductible? If yes, over what period of time?

3. What types of companies offer mortgage loans?

4. What is a hybrid mortgage?

5. Which type of mortgage typically carries the lowest rate?

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Student Class Instructor

Critical Thinking

1. If you have 20 years left to pay on a mortgage and interest rates have declined, would it be better to refinance with a 30-year mortgage, or a 20-year mortgage?

2. What are some of the risks of an adjustable-rate mortgage compared to a fixed-rate mortgage?

Extension Activity

A borrower's credit rating is an important factor in a lender's willingness to provide a mortgage at the lowest rates available. A poor credit history can mean a much higher mortgage rate. Research the various types of credit scoring systems used by lenders. What factors lead to a poor credit score and can result in a higher mortgage rate?

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Student Class Instructor

Date Assigned Date Completed

ACTIVITY 8 Saving and Investing

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Manage Risk in Your Portfolio

To most people, "risk" evokes negative images—driving faster than the speed limit, placing bets on "a long shot," or traveling alone to unfamiliar places. Mention risk in terms of investing, and people might think about losing their life's savings. But in reality, investment risk comes in many forms, and each can affect how you pursue your financial goals. The key to dealing with investment risk is learning how to manage it.

Step One: Understand Risk

Barron's *Finance and Investment Handbook* defines risk as the "measurable possibility of losing or not gaining value." Fear of losing some money is probably one reason why people may choose conservative investments, even for long-term savings.

While investment risk does refer to the general risk of loss, it can be broken down into more specific classifications. Familiarizing yourself with the different kinds of risk is the first step in learning how to manage it within your portfolio. Risk comes in many forms, including:

Market risk

Also known as systematic risk, market risk is the likelihood that the value of a security will move in tandem with its overall market. For example, if the stock market is experiencing a decline, the stock mutual funds in your portfolio may decline as well. Or if bond prices are rising, the value of your bonds will likely go up.

Interest rate risk

Most often associated with fixed-income investments, this is the risk that the price of a bond or the price of a bond fund will fall with rising interest rates.

Inflation risk

This is the risk that the value of your portfolio will be eroded by a decline in the purchasing power of your savings, as a result of inflation. Inflation risk needs to be considered when evaluating conservative investments, such as bonds, bond funds, and **money market funds*** as long-term investments. While your investment may post gains over time, it may actually be losing value if it does not at least keep pace with the rate of inflation.

Credit risk

This type of risk comes into play with bonds and bond funds. It refers to a bond issuer's ability to repay its debt as promised when the bond matures. Bonds and bond funds are given credit ratings by such agencies as Moody's and Standard & Poor's. In general, the higher the rating, the lower the credit risk. Junk bonds, which generally have the lowest ratings, are among the riskiest in terms of credit. People who invest in them typically seek higher yields of compensation for their higher credit risk.

International investments also involve additional risks, including the possibility of fluctuating **currency** values (currency risk) and the risk that political and economic upheavals may affect a country's markets.

Step Two: Diversify

The old cliché, "Don't put all your eggs in one basket," is very applicable to the realm of investing. The process of **diversification**, spreading your money among several different investments and investment classes, is used specifically to help minimize market risk in a portfolio. Because they invest in many different securities, mutual funds are ideal ways to diversify. Selecting more than one mutual fund for your portfolio can further reduce risk. Also consider the potential benefits of selecting investments from more than one asset class: When stocks are particularly hard hit due to changing conditions, bonds may not be affected as dramatically.

Step Three: Match Investments to Goals

Before you can decide what types of investments are appropriate from a risk perspective, you need to evaluate your savings goals. Is your goal preservation of principal, generating income for current expenses, or building the value of your principal over and above inflation? How you answer this will enable you to find an appropriate balance between the return you hope to achieve and the risk you are willing to assume.

Examine your time horizon for meeting your goals, and consider how comfortable you may be riding out short-term losses in the value of your

(continued on next page)

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investments. Remember, the longer your time horizon, the more **volatility** you can tolerate in your portfolio. At the same time, long-term investors need to be concerned about inflation. If you are investing your retirement funds you may also be concerned about building **capital** over the long term.

The Risk of Not Investing Appropriately

When thinking about how to balance risk and return in your portfolio, don't forget that the risk of loss is not the only kind of risk. Give some thought to the risk of investing too conservatively and not reaping a high enough return to provide for your financial future. Also be aware of investing in instruments that may be too risky for your shorter-term goals. A financial advisor can help you select vehicles that are suitable for your goals.

Using Risk to Its Full Potential

In life, almost every attempt at success involves some risk—and your investment strategy is no different. By devoting time to examining your goals, conducting some research, and working with a financial advisor, you can learn how to manage risk in your portfolio by choosing appropriate investments.

*An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund.

Excerpted with permission from Standard and Poor's *Your Financial Future*.

Vocabulary

capital an individual's net worth (the difference between the amount that a person owns and the debts that he or she owes).

currency a country's medium of exchange; money.

diversification the process of spreading one's assets among several types of investments to lessen risk.

money market funds mutual funds that invest in certificates of deposit, government securities, and other safe investments.

volatility the potential for rapid or unexpected change.

Fact Idea and Review

1. How does Barron's *Finance and Investment Handbook* define risk?

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2. What are the steps of managing risk?

3. What type of investment would lose its value most quickly during a period of high inflation?

4. Describe one type of risk not discussed in this article.

5. Why is investing in a mutual fund a good way to manage risk?

Critical Thinking

1. Identify a potential investment. Discuss how different kinds of risk affect this investment.

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2. How would you react if you invested in stocks and then saw the value of your holdings drop by 37 percent during the next two years?

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Extension Activity

Write down two long-term financial goals you might have. Would you prefer to choose a conservative, a moderate, or an aggressive investment mix to pursue these goals? In groups of three to five students, discuss with each other your reasons for choosing a specific investment mix. Conduct a survey of all responses to profile the investment goals of the class.

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Student | Class | Instructor

Date Assigned | Date Completed

ACTIVITY 9 Stocks

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Focus on Time in the Market, Not Market Timing

Sports commentators often predict the big winners at the start of a season, only to see their forecast fade away as their chosen teams lose. Similarly, market timers often try to predict big wins in the investment markets, only to be disappointed by the reality of unexpected turns in performance.

What Is Market Timing?

Market timing is an investing strategy in which the investor tries to identify the best times to be in the market and when to get out. Relying heavily on forecasts and market analysis, market timing is often utilized by **brokers**, financial analysts, and mutual fund **portfolio** managers to attempt to reap the greatest rewards for their clients.

Market Timing Has Its Risks

Although professionals may be able to use market timing to reap rewards, one of the biggest risks of this strategy is potentially "missing" the market's best-performing cycles. This means that an investor, believing the market would go down, removes his investment dollars and places them in more conservative investments. While the money is out of stocks, the market instead enjoys its best-performing month(s). The investor has, therefore, incorrectly timed the market and "missed" those top months. Perhaps the best move for most individual investors—especially those striving toward long-term goals—might be to purchase shares and hold onto them throughout market cycles. This is commonly known as a "buy-and-hold" investment strategy.

As seen in the accompanying table, purchasing investments and then withstanding the market's ups and downs can work to your advantage.

If you're not a professional money manager, your best bet is probably to buy and hold. Through a buy-and-hold strategy, you take advantage of the power of compounding, or the ability of your invested money to make money. Compounding can also help lower risk over time: as your investment grows, the chance of losing the original principal declines.

Regular Evaluations Are Necessary

Buy and hold, however, doesn't mean ignoring your investment. Remember to give your portfolio regular checkups, as your investment needs will change over time. Most experts say annual reviews are enough to ensure that the investments you select will keep you on track to meeting your goals.

Normally a young investor will probably begin investing for longer-term goals such as marriage, buying a house, and even retirement. The majority of the portfolio will likely be in stocks and stock funds, as history shows they have offered the best potential for growth over time, even though they have also experienced the widest short-term fluctuations. As the investor ages and gets closer to each goal, he or she will want to rebalance portfolio assets as financial needs warrant.

The Risk of Missing Out

		A 1973–2002	B 1983–2002	C 1993–2002
[1]	Untouched	$20,968	$10,937	$2,443
[2]	Miss 10 Top-Performing Months	6,656	4,328	1,157
[3]	Miss 20 Top-Performing Months	2,977	2,100	651

Perhaps the most significant risk of market timing is missing out on the market's best-performing cycles. Columns A, B, and C represent the growth of a $1,000 investment beginning in 1973, 1983, and 1993, and ending December 31, 2002.

Row 1 shows the investment if left untouched for the entire period shown above; Row 2 shows the investment if it was pulled out during the 10 top-performing months; and Row 3 shows the investment if it was pulled out during the 20 top-performing months.

Source: Standard & Poor's. Stocks are represented by **Standard & Poor's Composite Index of 500 Stocks**, an unmanaged index generally considered representative of the U.S. stock market. Individuals cannot invest in indexes. Past performance is no guarantee of future results.

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Student _______________ **Class** _______________ **Instructor** _______________

Vocabulary

brokers see *stockbroker*.

portfolio all the securities held by an investor.

Standard & Poor's Composite Index of 500 Stocks an index that measures the activity of 500 stocks, most of which are listed on the New York Stock Exchange, the American Stock Exchange, and NASDAQ. It provides a broad indicator of the movement of stock price levels and changes.

stockbroker a licensed individual who buys or sells securities for a client.

Fact and Idea Review

1. What is market timing?

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2. Who often uses market timing?

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3. What is the biggest risk of market timing?

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4. What is “buy and hold”?

5. What type of investment offers the best potential for growth over time?

Critical Thinking

1. If you were to use the market timing strategy, what types of information would you seek?

2. Why is it a good idea for a young person to begin investing for retirement?

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Extension Activity

In groups of three to five, research the **Standard & Poor’s Composite Index of 500 Stocks** over the past year. Assume you invested $1,000 one year ago. If you left your investment untouched, what would it be worth today?

Student | Class | Instructor

Date Assigned | Date Completed

ACTIVITY 10 Bonds and Mutual Funds

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Mutual Fund Sales Charges, Fees, and Expenses

In recent years, mutual fund providers have noted customer demand for more variety among product lines and fee structures. As a result, many **investment companies** are offering a wider variety of **mutual funds** categorized by different share classes. The Investment Company Institute (ICI), an industry trade association, has established guidelines for the industry to use in describing these share classes. Each share class is associated with a different fee and cost structure.

All mutual funds have annual fees and expenses, which are used to compensate their professional managers and cover operating expenses. These fees may include a **12b-1 fee,** which is collected to cover marketing and distribution costs and periodically deducted from the fund's earnings each year.

Some mutual funds also charge a sales fee, or **load.** These funds are known as **load funds.** The load compensates the broker who helps you determine which fund is right for you (if you buy the fund from a broker or registered representative). If you are working with a fee-based financial advisor to select your investments, you may want to avoid buying mutual funds that charge a load unless the fund offers exceptional performance potential. When evaluating funds, consider your investment goals and time frame as they relate to how and when the fees are paid.

Load (Class A) funds: With a load fund the fee (also known as a **front-end load**) is deducted from your initial investment, thereby reducing your immediate purchasing power. Investors in these shares are likely to have an extended time frame for their investment goals. These investors expect to remain in the fund for several years. If circumstances change, however, the shares can be redeemed at any time without an additional charge.

One advantage of a load fund is that the fee is based upon the fund's net asset value at the time of purchase and not on any **appreciated value**. In addition, many load funds do not charge an annual 12b-1 fee. Investors should remember, however, that a front-end load could result in slower growth for your money than an investment in a back-end load fund.

Back-end load (Class B) funds: A **back-end load fund** typically charges what is known as a **contingent-deferred sales load** if you sell your shares within five to seven years of purchase. The sales charge may be collected on either the existing net asset value at the time you withdraw the funds or on the net asset value at the time of purchase, depending on the fund. For many funds the sales charge is reduced by 1 percent for every year or two you keep the fund. Usually, after seven years no sales charge is collected. Of course, this declining fee schedule depends on the individual fund.

Back-end load funds may be an appropriate choice for investors who intend to hold the investments for five to seven years. Because these funds tend to charge a 12b-1 fee of about 0.75 percent, a fund with a lower 12b-1 fee may be a better choice for longer-term investors. The advantages of a back-end load are that all of your money goes to work for you immediately, and if you hold the shares long enough, you will not pay a sales charge.

No-load funds: **No-load funds** do not charge sales fees but may incur 12b-1 fees. The average 12b-1 fee charged by no-load funds is 0.25 percent, according to Morningstar, Inc. Because of their lower fees, no-load funds may seem most appealing at first glance. However, before choosing these funds, consider your goals, your level of investment expertise, and how much time you can devote to making investment decisions. If you feel that you need assistance in selecting and investing in mutual funds, then load funds may be the more appropriate choice unless you are working with a fee-based financial planner. Before buying a fund that collects a sales charge, consider its performance record net of sales charges.

No matter what your decision, remember to evaluate your specific goals and personal investment style. With a long-term strategy, you'll be more prepared to select the alternatives that can offer you the best value over time.

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Student Class Instructor

Vocabulary

appreciated value the purchase price plus any increase in value.

back-end load fund a mutual fund that charges a sales fee to the investor when he or she sells shares of the fund; also known as a Class B fund.

contingent-deferred sales load the fee that is charged to a shareholder for selling shares of a Class-B fund.

front-end load a sales fee charged to a mutual fund investor when he or she buys shares of the fund; a front-end load fund is also known as a Class A fund.

investment company a firm that, for a management fee, invests the pooled funds of many investors in various securities.

load a mutual fund sales fee.

load fund a mutual fund in which the investor is charged a sales fee for buying or selling shares of the fund. Class A funds charge the sales fee at the time of purchase; Class B funds charge the fee at the time of the sale.

mutual fund an investment alternative in which investors pool their money to buy stocks, bonds, and other securities based on the selections of professional managers who work for an investment company.

no-load fund a mutual fund in which the investor pays no sales fee.

12b-1 fee a fee that an investment company charges to help pay for marketing and advertising a mutual fund; this fee is separate from the load.

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Fact and Idea Review

1. What trade association has established guidelines for the mutual fund industry to use in describing mutual fund share classes?

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2. What is the purpose of a 12b-1 fee?

3. What are the advantages of a front-end load fund?

4. What are the advantages of a back-end load fund?

5. Why might you buy a fund that charges a load rather than buy a no-load fund?

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Student Class Instructor

Critical Thinking

1. If you were making an investment in a fund that you expected to hold for three years, would you choose a front-end load fund with a fee of 4 percent or a back-end load fund with a 7-percent fee that declines by 1 percent each year? What factors would affect your decision?

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2. No-load funds are typically sold directly to investors through direct mail advertisements or on the Internet. What types of funds would you be comfortable buying directly from the fund company—without the help of a broker or a financial advisor?

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Extension Activity

Fund performance information is reported by several independent companies, including Standard & Poor's, Morningstar, Inc., and Lipper Analytical Services. In addition, many fund companies provide performance information on the Internet. Research and compare the sales fees and expenses associated with Class A shares of an intermediate corporate bond fund, a growth stock fund, a small cap stock fund, and an international stock fund. As a class, compile a-composite profile. Which types of funds carry the highest charges? Which carry the lowest? Discuss why different types of investments may have lower or higher costs.

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Student Class Instructor

Date Assigned Date Completed

ACTIVITY 11 Real Estate and Other Investments

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Benchmarks Gauge Investment Markets

Just as a car salesperson uses the "**blue book**" to gauge the approximate price for a newly acquired vehicle, you can use market **benchmarks** to gauge the approximate performance of your mutual fund investments. Each market index tracks a representative sampling of stocks, bonds, or other securities that may be similar to the holdings in your investment portfolio.

Often tracked in financial Web sites and newspapers, benchmarks can be especially helpful to individual investors by offering a framework where they can evaluate the risk and return history of their own investments. The important consideration to keep in mind is that, when using benchmarks to compare to your investments, you should always compare apples to apples. In order to accurately do this, it helps to be familiar with a variety of benchmarks and the **sectors** and **asset classes** they track.

What Are Benchmarks and How Are They Used?

The dictionary defines a benchmark as "a point of reference for measurement." In investing, benchmarks are measurements used by investors, portfolio managers, and market watchers to track how a particular asset class or sector performs and to compare relevant investments to that measurement.

A Variety of Measures

Some of the more popular and widely used indexes include:

IBC's Money Fund Report Averages™

These benchmarks track the averages of taxable and tax-free money market fund yields on a 7- and 30-day basis.*

10-Year U.S. Treasury Bond

The yield on this long-term U.S. government bond is now looked to as the standard bond yield for long-term bond investment.

Standard & Poor's Composite Index of 500-Stocks (S&P 500)

A broad-based, unmanaged index of the average performance of 500 widely held industrial, transportation, financial, and utility stocks. Many people believe that this, one of the most often-cited indexes, includes the 500 largest stocks on the New York Stock Exchange. Not true: In fact, it includes the stocks of companies that are or have been leaders in their respective industries and that are listed in the New York Stock Exchange, the American Stock Exchange, and the NASDAQ Market System. The industry weightings in the S&P 500 are selected to reflect components of the **Gross Domestic Product (GDP)**.

Dow Jones Industrial Average

Following the returns of 30 well-established American companies, the Dow is among the most renowned of the stock market indexes. However, the S&P 500 can be considered a broader indicator of the stock market. The Dow has usurped much of the focus of the newspapers' investment pages because of its unprecedented string of double-digit gains in the late 1990s.

The NASDAQ Composite Index

This index (about 4,000 issues) was created in 1971 and measures all common stocks that are traded on the NASDAQ market. It contains many new-economy companies and is widely acknowledged as a benchmark for technology stocks.

Morgan Stanley Capital International's Europe, Australasia, Far East (EAFE) Index

The most prominent of the indexes that track international stock markets, the EAFE is composed of companies considered representative of 20 European and Pacific Basin countries.

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Using Benchmarks to Target Expected Return

Benchmarks can be used to assess what types of investments may be most suitable to an investor's goals and investment time frame. By looking at the past performance of a market index, you can gauge the relative return potential of a particular asset class, as well as its risk characteristics. Keep in mind, however, that past performance is not a guarantee of future results. Also, be careful to use the right benchmark. For example, you wouldn't want to invest in corporate bonds maturing in five years based on the benchmark performance of 10-year U.S. Treasury bonds. Your financial advisor can help you assess which benchmarks to use in evaluating the performance and risk of a given market.

Don't Rely Solely on the Blue Book

The short-term, stellar performance of a particular benchmark may spark your interest in a-specific investment class or sector; but remember, you shouldn't buy the car based solely on the blue book price.

In other words, research the investment opportunity, your personal objectives, and risk tolerance before investing. And use the benchmark as just one more resource to keep tabs on your investment performance.

*An investment in a money market fund is not insured or-guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund.

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Vocabulary

asset classes major investment categories such as stocks, bonds, cash, and real estate.

benchmark a point of reference for measurement.

blue book often called the Kelley Blue Book; a resource for information about buying and selling automobiles. It provides a searchable database of trade-in values and prices of new and used cars, trucks, vans, and sport utility vehicles.

Gross Domestic Product (GDP) the total value of goods and services produced within a country's borders.

sector a specific industry or economic activity.

Fact and Idea Review

1. How can benchmarks help an individual investor?

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2. What is meant by comparing “apples to apples”?

3. What benchmark might you use to assess the yields of money market funds?

4. What stocks are included in the S&P 500?

5. When deciding whether to invest in a certain asset class, what other factors should you consider in addition to the benchmark?

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Student Class Instructor

Critical Thinking

1. Benchmarks for alternative investments such as collectibles and jewelry are not widely quoted. How might difficulty in assessing the past performances of these investments affect your investment decisions?

2. Different types of investments will perform differently at different times. How can studying the relative performances of market indexes help you build a diversified portfolio?

Extension Activity

One measure of a portfolio manager's worth is whether the manager can outperform the market index. As a class, make a list of existing market indexes. Divide the class into teams and assign each team a market index to track. Each team should select seven to ten individual securities in the asset class that their index represents. These securities make up the teams' portfolios. Measure the performance of each portfolio compared to the index over a period of several weeks. Prepare a presentation to share the completed results with the class.

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ACTIVITY 12 Planning Your Tax Strategy

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Making a Charitable Choice

The greatest benefit of charitable giving is the knowledge that you've helped make a difference in the lives of others. Charitable giving can also provide tax breaks, if you know how to give and how to keep track of what you've donated.

The first step is to identify the organizations you wish to support. If you want to claim a **tax deduction** for your gift, you'll need to deal with a registered charity to satisfy IRS rules. You can begin by contacting your local charity registration office, which is typically a division of your state attorney general's office. Your local **Better Business Bureau** can also provide information on charities.

Once you've got a short list of registered organizations, contact each one and ask for a copy of its annual report. This report explains the charity's mission, lists its key personnel, and provides a breakdown of how donations are spent. You'll probably want the majority of your money to go to those who need it. Keep in mind, however, that high expenses related to awareness campaigns are designed to educate the public and increase donations, so they might not be cause for concern.

You're free to give as much to charity as you like. However, you'll need to follow IRS rules and keep records of your gifts to claim tax deductions. Monetary contributions are the easiest to report. If you pay by check, make the check payable directly to the charity, not to the person soliciting the contribution or to a donation collection agency. Ask for a receipt and save it along with your canceled check and your bank account statements.

If your contribution exceeds $250 in value, either in cash or other items, you will need to obtain a written description of your gift. This description must contain an acknowledgement from the charity of your contribution, a description of non-cash items donated, a statement of whether the charity provided goods or services in exchange for the donation, and—if goods or services were provided—a good faith estimate of their value. Additional rules apply for contributions worth more than $500.

The fair market value of goods and services received is deducted from any charitable contributions used to offset taxes. For example, if you pay $2 for a candy bar to benefit a local school, and the fair market value of the candy is 75 cents, you can claim a deduction of $1.25.

Two gifts to carefully consider are used items and time. Items such as computers and clothing lose value with use, so you won't be able to declare your full purchase price as a deduction. Time spent volunteering typically isn't deductible; however, expenses associated with volunteering, such as transportation and materials, are deductible.

You can avoid **capital gains taxes** by donating assets that have appreciated in value to charities. Consider selling appreciable assets that you have owned for a year that have lost value, with the proceeds of the sale donated to charity. This allows you to remove the full fair market value of the assets from your taxes while still claiming a **capital loss** on the depreciation.

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Vocabulary

Better Business Bureau an association designed to protect customers and businesses from illegal and questionable practices.

capital gains taxes taxes paid on the profit from the sale of an asset such as stocks, bonds, or real estate.

capital loss the sale of an investment for less than its purchase price.

tax deduction an expense that a person is allowed to subtract from his or her adjusted gross income to arrive at his or her taxable income.

Fact and Idea Review

1. What information would you look for in a charity's annual report?

2. What documentation is needed to report contributions of less than $250?

3. If you purchase goods or services from a charitable organization, what portion of your purchase price is deductible?

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4. When you volunteer your time to a charitable organization, what can you claim as a deductible contribution?

5. Why would a person donate assets that have appreciated (increased) in value?

Critical Thinking

1. Why might it be better to donate used items to a charitable organization than to sell them?

2. The expenses associated with donating time are frequently overlooked at tax time. What charitable events have you participated in that resulted in out-of-pocket expenses? How can you keep track of these expenses so that you can deduct them?

Extension Activity

Many people give to charitable organizations upon request simply because they want to, without thinking too much about the organization's purpose or the tax benefits of their donation. As a class, discuss whether it makes more sense for people to plan ahead or to act spontaneously when it comes to donating to charity. What are the potential benefits of developing a philosophy about charitable giving, taking the time to research the organization to which you donate, and planning a strategy to give?

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Student | Class | Instructor

Date Assigned | Date Completed

ACTIVITY 13 Home and Motor Vehicle Insurance

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Federal Flood Insurance Is a Good Buy

Federal officials say flooding is the leading cause of property loss from **natural disasters** in the United States. According to the Federal Emergency Management Administration, flood costs have risen dramatically in recent years. Yet, even though flood insurance is relatively inexpensive and policyholders can collect for flood damage without an official disaster declaration, many go without coverage.

Special disaster insurance, offered through local insurance agents or directly from the government-run National Flood Insurance Program, is not available everywhere. Flood insurance is available in communities that adopt and enforce what the federal government considers sound floodplain-management practices.

The most **prudent** course of action, of course, is not to live in a flood zone. Some people think that if there's been no flooding for 10 years or 50 years that they're safe. However, in a flood plain, sooner or later the waters will rise. It's wise to **hedge** your bets long before a tropical storm is on the way or a river is set to crest considerably higher—because there's a 30-day waiting period after enrolling, before coverage of property and personal possessions takes effect.

Regular homeowner's insurance may cover certain kinds of water damage affecting only a few homes; wind-driven rain or a broken water pipe that floods the cellar and first floor, for example. However, a real flood—a river over its banks and covering an acre of land or multiple pieces of property—usually won't be covered by homeowner's or property-owner's policies. That's where flood insurance, bought in addition to homeowner's or property-owner's insurance, kicks in.

The cost of flood insurance depends on the location of your property. The federal government's program fixes premiums for the entire country based primarily on a home's location and elevation.

In addition to flood damage coverage, you'll be eligible to apply for secured financing to buy, build, or improve structures in a special flood hazard area. Federally regulated or insured lending institutions require flood insurance coverage before they grant secured financing.

You can find out if your property is in a flood zone by calling the municipal planning or zoning department in your community. If you're in an "A" or "AH" zone, you'll be required by mortgage lenders to get flood insurance.

Flood insurance coverage is available for residential and non-residential buildings, as well as for contents. Homeowners who carry flood insurance are covered for any flood-related damage to the ground level or upper floors of their homes. Flood damage to personal belongings is covered only if the policyholder has bought contents coverage. Coverage for flood damage to basements is limited to structural elements and basic items used to service the building, such as furnaces, water heaters, and utility connections. If you have a home business, a separate policy is necessary to cover structural or contents damage.

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Vocabulary

hedge a protection of some kind.

natural disasters events of nature that take human lives or destroy property. Some examples include avalanches, earthquakes, fire, and floods.

prudent being careful and cautious in the way one acts or behaves; not taking chances.

Student Class Instructor

Fact and Idea Review

1. What is the leading cause of property loss due to natural disasters?

2. Flood insurance is offered through which government program?

3. What types of water damage may be covered by a regular homeowners insurance policy?

4. How is the price of flood insurance determined?

5. What types of losses does federal flood insurance cover?

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Critical Thinking

1. Why do you think property losses from floods are rising?

2. Why do think that many people who live in areas subject to flooding do not buy flood insurance?

Extension Activity

Floods are only one form of natural disaster. Earthquakes are another potential cause of property damage. Research incidences of floods, earthquakes, or other natural disasters in your community and evaluate whether these policies are a good idea for local homeowners.

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Student Class Instructor

Date Assigned Date Completed

ACTIVITY 14 Health, Disability, and Life Insurance

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Buying Life Insurance: Factors to Consider

If there are individuals who depend on you for financial support, or if you work at home providing your family with such services as child care, cooking, and cleaning, you need life insurance. Older couples may also need life insurance to protect a surviving spouse against the possibility of the couple's retirement savings being depleted by unexpected medical expenses.

A popular approach to buying life insurance is based on income replacement. In this approach, a formula of between five and ten times your annual salary is often used to calculate how much coverage you need. Another approach is to purchase insurance based on your individual needs and preferences. The first step is to determine your unique income replacement needs, and add to that your "final" expenses such as funeral services.

You have a choice of several different types of insurance policies. Term insurance is generally the least expensive form of life insurance for people under age 50. A term policy is written for a specific period of time, typically 1 to 10 years, and may be renewable at the end of each term. As you get older, the premiums tend to increase each time you renew. A level term policy locks in the annual premium for periods of up to 20 years. Declining Balance Term insurance is often written to match the amortization of your mortgage principal. While the premium stays constant over the term, the face value steadily declines.

Term insurance has no cash value. Benefits are paid only if you die during the policy's term. Your coverage expires after the term ends unless you choose to renew. When buying term insurance, you might look for a policy that is renewable up to age 70 and convertible to permanent insurance without a medical exam.

Whole Life combines permanent protection with a savings component. As long as you continue to pay the premiums, you are able to lock in coverage at a level premium rate. Part of that premium **accrues** as cash value. As the policy gains value, you may be able to borrow up to 90 percent of your policy's cash value tax-free.

Universal Life is similar to whole life with the added benefit of potentially higher earnings on the savings component. Premiums can be increased, decreased, or **deferred**, and cash values can be withdrawn. Universal life policies typically offer a guaranteed return on cash value, usually at least 4 percent.

Drawbacks to this type of insurance include higher fees and interest rate sensitivity. Universal policies include up-front fees as well as ongoing administrative fees totaling as high as 5 percent to 7 percent of your premiums. You may also find your premiums increasing when interest rates decline.

Variable Life generally offers fixed premiums and the opportunity to invest your cash value in stock, bond, and money market investments. Investment earnings accrue tax deferred as long as the funds remain invested in the insurance contract. Although death benefits usually have a floor, there is no guarantee on cash values. Fees for these policies may be higher than for universal life, and investment options can be volatile.

When you purchase life insurance, you will need to decide whom to designate as the **beneficiary** on the policy in the event of your death. Life insurance beneficiaries will receive the death benefit proceeds tax free. For most married individuals with assets under $1 million, a spouse will be the most logical beneficiary. Be sure to name contingent or secondary beneficiaries. This means that if the primary beneficiary has died, the insurance proceeds will go to an individual or **trust**. Unnamed beneficiaries are assumed to be the "estate of the insured," which means the death benefits end up being distributed according to the instructions of your will. If an individual dies without a valid will, then the order of legal beneficiaries to whom assets are distributed is specified by that state's law.

When naming beneficiaries, it is important to consider the age of the beneficiary. Most policies and plans will not directly transfer assets to minors until a trustee or **guardian** is approved by a court. A guardian, trust, or trustee should be named beneficiary to ensure competent management of the proceeds for the children.

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Vocabulary

accrue to be added over a period of time as an increase, such as adding interest to a savings account.

beneficiary a person named to receive the benefits from an insurance policy. Also, a person named to receive a portion of someone's estate.

deferred postponed until a stated time.

guardian a person who accepts the responsibility of providing children with personal care after their parents' death and managing the parents' estate for the children until they reach a certain age.

trust an arrangement in which a designated person, known as a trustee, manages assets for the benefit of someone else.

Fact and Idea Review

1. Using the income replacement model, how much life insurance do you need?

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2. What type of insurance is generally the least expensive for people under age 50?

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3. Name two advantages of whole life insurance.

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4. How is the cash value of a variable life policy invested?

5. If you do not name a beneficiary, or the beneficiary named on your policy has died, how would the proceeds of your policy be distributed?

Critical Thinking

1. Why might a single adult with no dependents choose to purchase life insurance?

2. If you were planning to purchase life insurance for yourself, would you buy term or whole life? Explain your decision.

Extension Activity

Many people do not purchase enough life insurance to meet their dependents' needs. In small groups of three to four students, calculate the amount of insurance that would be required to replace the income of an individual who earns $50,000 a year, for 10 years. How do factors such as income taxes and investment returns affect the calculation?

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Student	Class	Instructor
Date Assigned	Date Completed	

ACTIVITY 15 Retirement and Estate Planning

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Think You Can't Afford to Contribute to a Retirement Plan? Think-Again.

Even if your retirement is decades away, decisions you make now will affect how comfortable it will be. If your employer offers a retirement savings plan, you can take advantage of that opportunity for **tax-deferred** growth. Here are some reasons why you should plan now to build retirement savings.

- Your contributions to a company retirement plan will reduce your take-home pay. However, because most contributions to retirement savings plans are made with pre-tax dollars, they reduce your taxable income and therefore, the amount of taxes you pay now. In other words, the reduction in your take-home pay that results from your contribution to the plan is offset somewhat by the drop in your income tax.
- You don't pay taxes on the build-up in value until you withdraw money. The money you contribute and earnings that build up over the years from the investments you choose are not taxed until you withdraw them. You'll have to pay taxes eventually, because the earnings are tax-deferred, not **tax-exempt.** If you wait until retirement to withdraw the money, chances are you will be in a lower tax bracket than the one you're in during your earning years.
- Starting early can make a big difference. If you contributed just $38.46 a week for 10 years, your contribution would total $20,000. If this investment earned 8 percent annually, you would have a balance of $67,555 in the plan at the 20th year, $145,846 after 30 years, and $314,870 after 40 years. After 40 years, compound earnings would total $294,870 (equals $314,870 – $20,000). If you wait until you near retirement to start the engine, you won't get the wallop from compounding that results when a sum of money grows in an account year after year.
- A matching contribution from an employer offers an instant return. If your company matches a portion of your contribution, and most do, your retirement savings can grow even faster. Suppose your company matches your contribution at the rate of 25 cents for each $1 you contribute (up to a certain limit). Look at it as an instant 25 percent guaranteed return. Not many investments offer that potential.
- Most pensions pay income at a level that is fixed the day you retire. Each year, inflation will erode the purchasing power of that pension. Social Security is adjusted for inflation each year, but is likely to replace only a fraction of your pre-retirement income. At least 25 percent of your retirement income will likely have to come from money you've set aside.

These are some of the reasons why you can't afford not to begin saving for your retirement as soon as possible. The earlier you start and the more you save, the easier it will be for you to build the nest egg you will need. Keep in mind, too, that **Individual Retirement Accounts (IRAs)**, **Roth IRAs**, and tax-deferred **annuity contracts** also offer tax advantages for retirement savings.

The table on page 48 shows how fast John Doe's savings will grow depending on how much of his annual salary he contributes to his employer's tax-deferred savings plan. It assumes that John receives a 5 percent pay raise each year, and does not include any contributions by his employer. At a 2 percent contribution rate, John will have a nest egg of $10,769 in 10 years. At a 6 percent contribution rate, his savings would total $32,307. The benefits of socking away as much as possible are even more impressive over time.

(continued on next page)

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	Percentage of $26,000 Salary Contributed				
Years in Plan	2 percent	4 percent	6 percent	8 percent	10 percent
1	$ 520	$ 1,040	$ 1,560	$ 2,080	$ 2,600
5	$ 4,277	$ 8,554	$ 12,832	$ 17,109	$ 21,387
10	$ 10,769	$ 21,538	$ 32,307	$ 43,076	$ 53,845
15	$ 21,546	$ 43,093	$ 64,639	$ 86,186	$ 107,732
20	$ 38,963	$ 77,926	$116,889	$ 155,852	$ 194,815
25	$ 66,571	$133,143	$199,715	$ 266,287	$ 332,859
30	$109,713	$219,427	$329,140	$ 438,854	$ 548,568
35	$176,390	$352,780	$529,170	$ 705,561	$ 881,950
40	$254,531	$509,063	$763,595	$1,018,128	$1,272,660

Excerpted with permission from Standard & Poor's *Your Financial Future*.

Vocabulary

annuity contract a contract purchased from an insurance company that provides for a sum of money to be paid to a person at regular intervals for a certain number of years or for life.

Individual Retirement Account (IRA) a retirement savings plan created especially for an individual.

Roth IRA a form of IRA (individual retirement account). It doesn't provide a tax deduction for the contribution, but it allows a tax-free distribution after five years and at age 59 1/2 or older.

tax-deferred income that is taxed at a later date. 401(k)s and IRAs are probably the most common opportunities for tax-deferred income.

tax-exempt income that is not taxed.

Fact and Idea Review

1. What two tax advantages do company-sponsored retirement savings plans provide?

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2. What is the effect of an employer's matching contribution to your plan?

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3. What percentage of your annual retirement income may have to be provided from your personal retirement savings?

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4. In addition to a company-sponsored retirement plan, what other types of accounts offer tax advantages for retirement savings?

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5. If you contribute 6 percent of your $26,000 per year salary for the next 20 years, how much money will you have invested? (Use the table on page 48).

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Student Class Instructor

Critical Thinking

1. It is estimated that your annual spending in retirement will be about 80 percent of what you earned each year before retirement. For example, someone who earned $40,000 a year before retiring should plan on needing retirement income of $40,000 × .80 = $32,000. What types of expenses do you think you will need to pay for each year you are in retirement? What expenses will likely decline, and which will increase?

2. If John contributed just 2 percent of his annual salary to his retirement plan, he could have a balance of $254,531 after 40 years. That 2 percent contribution works out to $10 a week in John's first year of employment. Looking at your own spending habits, what types of purchases do you think John might forgo in order to free up an extra $10 a week to save toward retirement?

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Extension Activity

Many people who are in their 40s and 50s today are just beginning to save for their retirement, and many will have difficulty meeting their retirement savings needs. As a class, calculate your minimum retirement savings needs if you earn $40,000 a year. Brainstorm a list of ways for you to reach this goal. (Hint: 25 percent of your retirement income will likely have to come from money you have set aside, and your annual retirement spending is estimated to be 80 percent of what you earned each year before retirement.)

Student | Class | Instructor

Date Assigned | Date Completed

ACTIVITY 16 Types of Business Ownership

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Planning to Pass on the Family-Owned Business

More than 90 percent of American businesses—including 33 percent of **Fortune 500** firms—are family-owned or controlled. Altogether, they employ more than one-half of the U.S. workforce and generate 45 percent of U.S. Gross Domestic Product. However, statistics show that the long-term survival rate of these successful businesses is low, primarily because the business owner does not have a **succession** plan. Fewer than 50 percent of these companies survive into the second generation, and only 15 percent survive into the third generation. Business owners can increase the chances that their business will continue to thrive by planning for the **transition** of management and the transition of ownership.

Management transition involves the selection and grooming of a successor who will assume leadership of the company's organizational structure. A transition plan will outline the expected management succession within the company and also outline the role of the owner during and after the transition period.

Planning for the transition of ownership includes identifying and providing for the needs of the owner and spouse, providing for the requirements of the business, valuing the company, creating a buy-sell agreement, and putting funding in place to carry out the plan.

Needs of the owner and spouse: The retirement funding and lifestyle needs of the owner should be considered. For example, does the retiring owner desire to continue to work part-time, start a new business, or enjoy an active retirement? Is cash needed to fund the planned post-retirement lifestyle?

Requirements of the business: The financial needs of the business can significantly affect decisions about ownership transition and how to fund the transition plan. For example, is investment capital required to maintain or expand the business, or is a portion of the business to be divested?

Business valuation: A business valuation includes tangibles that make the firm a success, including assets, profits, and sales forecasts. A good valuation, which a certified appraisal company or full-service accountant can perform, also includes **intangibles** such as goodwill, market position, quality, and reputation.

Buy-sell agreement: A buy-sell agreement details who will receive what portion of the business and under what circumstances, including premature death or disability.

Funding the plan: Lack of funding for succession is a major cause of family business failure. If the value of the business is substantial, the funding plan may need to be implemented many years before the actual transition of ownership takes place to ensure that the money is available when needed. Without adequate planning, family members who have no interest in maintaining the business may end up remaining part owners, to the detriment of those who actively work to keep the business going. For example, if Jane Smith has two children and wishes them to share equally in the value of the business, yet only one is interested in actually owning the business, a plan will need to be put in place for one to effectively buy the other's share. A funding mechanism may also be required to compensate the owner for the sale of the business, or to provide for payment of estate taxes.

A professional advisor can help create a formal, written succession plan that can help increase the chances of a successful transfer of a family-owned business to the next generation.

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Student Class Instructor

Vocabulary

Fortune 500 a listing of the largest 500 companies in the country by *Fortune* magazine.

intangibles assets that have no physical substance but are still valuable to a company, such as a trademark, a patent, reputation, or goodwill.

succession the process of one person taking the place of another in rights and duties.

transition the act or process of passing from one condition, form, or place to another.

Fact and Idea Review

1. What percentage of family-owned businesses survive into the second generation?

2. How can business owners increase the chances that their business will continue to thrive?

3. What components, including tangibles and intangibles, are included in a good business valuation?

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4. What is included in a buy-sell agreement?

5. What is the major cause of family business failure?

Critical Thinking

1. Why might a business owner decide to sell the family business to family members rather than leave ownership to them through a will?

2. Why does the lack of funding for passing on the ownership of a business frequently result in the failure of the business?

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Extension Activity

Working in small groups, research the corporate history of a large, publicly traded company that had its beginnings as a small, family-owned business. Examples of such companies include DuPont, McGraw-Hill, Hershey's, Ford, Time-Warner, and Disney. How did the company originate? Which family members chose to continue to participate in the business? What is the family's representation in the business today? Present your group findings to the class.

Student Class Instructor

Date Assigned Date Completed

ACTIVITY 17 Developing a Business Plan

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Staying Insured When You're on Your Own

Obtaining health insurance if you're leaving the corporate fold or already on your own can be a grueling endeavor. Comparison-shopping is a must if you're self-employed and in the market for health coverage. Not only does coverage vary from state to-state, but **premiums** can also differ widely even within one state. A study by Alpha Center, a Washington, D.C., nonprofit health policy center, showed that the monthly premium for an individual California Blue Cross/Blue Shield policy for a 45-year-old could cost anywhere from $97 to $211; for a 60-year-old it ranged from $172 to $339. A-commercial insurer offering a similar policy charged 45-year-olds $229 to $403 per month, and-as-much as $807 for someone 60 years of age.

Despite the **disparate** choices, there are some common options that experts recommend you check out in your search. If you're leaving a corporate job, you may continue your health insurance under the federal Consolidated Omnibus Budget Reconciliation Act (COBRA). However, you must pay the entire premium, including the portion that your employer paid before, and the insurer may charge up to 102 percent of the total charged to the employer for current employees. Remember that you're only guaranteed coverage for 18 months. Ask your employer for details before you leave your job.

The federal Health Insurance Portability & Accountability Act provides extra protection for individuals with preexisting medical conditions that limit access to coverage. If they have exhausted their COBRA or other options for continuing their policy, they must be offered at least two individual insurance options. The rules are complex, though, and states have wide latitude in implementing the law. To find out if you qualify, check with your state insurance department. Be forewarned that policies that cover a preexisting condition—for example, diabetes—often cost more than a standard policy.

If your COBRA coverage has ended or if you want a less pricey policy, you might consider calling your state insurance department for a list of companies that offer individual policies. Many states provide consumer tips and summaries of the benefits they mandate. You can also ask an insurance agent to search for you.

A few states, including Florida, require insurers to offer the same coverage to a self-employed individual as to employees of a business with up to 50-workers. To verify that you really are in business, these states allow the insurance company to ask to review your tax forms and other relevant information. The least expensive way to buy coverage is usually as a member of a group rather than as an individual. Organizations that offer such insurance include local chambers of commerce, alumni associations, professional organizations such as the American Bar Association, or national small-business groups. Some private companies provide business services including insurance coverage to small businesses.

In recent years, Uncle Sam has created a new health insurance option. Called a Medical Savings Account (MSA), it's available only to the self-employed or people who work for businesses with 50 or fewer employees. Modeled on the Individual Retirement Account, the MSA is an account to pay medical bills that allows you to receive a tax deduction for money you stash in it. Along with the account, you buy a catastrophic health insurance policy, with a deductible of $1,500 to $2,250 a year.

You may put up to 60 percent of the amount of the deductible on your insurance policy (and up to 75 percent for a family policy) into the savings account. The account can be located at an insurance company, a bank, or other financial institution. The money in the MSA will pay deductibles and other medical expenses not covered by the policy. When you've used up the deductible, the policy kicks in.

However you go about it, insurance shopping is not easy. With careful research, you can find options that will give you peace of mind and protection against medical bills draining your savings.

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Student **Class** **Instructor**

Vocabulary

disparate different, unlike, dissimilar.

premiums fees paid by a policyholder to an insurer.

Fact and Idea Review

1. If you have had health insurance through an employer and you leave your job, how long can you continue your employer's insurance coverage under COBRA?

2. What is the least expensive way for small-business owners to purchase health insurance?

3. What is an MSA?

4. What tax benefits does an MSA provide?

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5. How much of the annual insurance policy deductible can be contributed to an MSA?

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Critical Thinking

1. Why do you think group insurance policies are less expensive than individual policies?

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2. What is a primary drawback of the practice of obtaining health insurance through employers?

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Extension Activity

Many people like the idea of being their own boss, but do not realize that there are a number of "hidden" costs to being self-employed. As a class, list some of the benefits that a corporate employee might enjoy, including health and disability insurance, life insurance, paid vacations and holidays, and pension plan. Estimate the annual dollar value of these benefits. (Among large companies, benefits average 27 percent to 30 percent of annual salaries.)

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Student Class Instructor

Date Assigned Date Completed

ACTIVITY 18 Developing a Financial Plan

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

The Federal Reserve and the FOMC

Federal Reserve Chairman Ben Bernanke has often been called the second most powerful man in the United States, and it's not surprising that investors hang on his every word. After all, the Federal Reserve has the tools and legal **mandate** to change the direction of interest rates, economic growth, and **inflation**—the very same levers that move stock and bond prices as well as the dollar.

How can you know what the Federal Reserve is thinking? Luckily, the Federal Reserve has shifted toward greater **transparency** in its decision-making. The chairman typically telegraphs coming monetary policy changes in speeches, although don't expect him to say, ''We're raising rates next week.'' It's all in the emphasis.

The **federal funds rate** is what one bank charges another to borrow money overnight. The Federal Reserve Bank of New York's Open Market Desk implements any rate change as required. When the Federal Reserve wants to raise the funds rate, it sells U.S. government securities to commercial banks. In so doing, it takes money, or liquidity, out of the banking system. When it wants rates to fall back down, it can pump money into the market by purchasing securities from banks.

The Federal Reserve can also change the **discount rate** when it alters the federal funds rate, a one-two punch called ''banging the gong'' because it reverberates across global markets. The discount rate is charged when a member bank borrows directly from the Federal Reserve, a move done when the bank can't borrow anywhere else. The discount rate is usually set equal to or a half-point below the funds rate. Lastly, the Federal Reserve can change the amount of reserves a bank is required to keep on hand, but that's rarely done.

The Federal Reserve lifts the funds rate, or tightens policy, because it wants to slow the economy and head off inflationary pressures. As the funds rate rises, banks increase their lending rates as well. Higher borrowing costs flatten consumer and business-demand for big-ticket items that must be-financed. Interest rates all along the yield curve rise, which means bond prices fall. In addition, stock prices may slip because higher-yielding bonds become more attractive to investors and higher borrowing costs and slower demand endanger future corporate profits.

Despite its new openness, the Federal Reserve still conducts its main work in relative secrecy for a government agency. Interest rate policy is determined at meetings of the Federal Open Market Committee (FOMC), which are not open to the public or press. The FOMC meets eight times a year, on a Tuesday, although twice a year the meeting spills over into Wednesday. Emergency meetings may also be called. The FOMC is made up of the seven Federal Reserve governors, the president of the New York Federal Reserve, and a rotating panel of four presidents of the other Federal Reserve district banks. According to economists, the incoming Federal Reserve presidents are more hawkish about inflation than their outgoing colleagues, signaling that they may argue for moves designed to curb price pressures.

Although you can't peer into the FOMC's inner **sanctum**, you can get a feel for what goes on by perusing an April 1998 speech by [former] Federal Reserve Governor Laurence H. Meyer that's available on the central bank's Web site. It describes in detail what takes place around the huge oval table at the Federal Reserve's Washington headquarters, culminating in what Meyer describes as the "critical moment...the time to vote'' on the course for monetary policy for the next six weeks or so. More often than not, the vote's outcome is pretty well set by the time ballots are cast. This is because Bernanke and the FOMC strive for a consensus vote.

The Federal Reserve reports its judgment on the economy in the ''foreseeable future,'' meaning a period well beyond the next FOMC meeting. There will be only three boilerplate assessments: heightened inflationary pressures, economic weakness, or a balanced outlook for growth and inflation.

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Student **Class** **Instructor**

Vocabulary

discount rate one of two interest rates that is controlled by the Federal Reserve. The discount rate is the rate that the Federal Reserve charges member banks to borrow money.

federal funds rate the interest rate one bank charges another to borrow money overnight.

Federal Reserve the central banking organization of the United States; also known as the Fed.

inflation the general rise in the level of prices for goods and services over time.

mandate an order or a command, especially one in writing.

sanctum a sacred place.

transparency condition of being easily understood, recognized, clear, or obvious.

Fact and Idea Review

1. Name three market variables that the Federal Reserve has the legal mandate to change.

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2. What are three methods the Federal Reserve might use to control the supply of money in the economy?

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3. What happens when the Federal Reserve lifts the funds rate?

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Student Class Instructor

4. What governing body determines interest rate policy in the U.S.?

5. How often is the Federal Reserve's interest rate policy reviewed?

Critical Thinking:

1. When the Federal Reserve raises short-term interest rates, what is the likely effect on companies and individuals that borrow using adjustable-rate loans and credit lines? On companies that issue fixed-rate debt?

2. In the event the Federal Reserve chairman expresses concern about weakness in the economy, what monetary policy would you expect the FOMC to support? Why?

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Extension Activity

The Federal Reserve uses monetary policy to control the economy. A single change in policy can impact businesses and consumers in many ways. As a class, create a diagram of possible changes in monetary policy and their likely effects on a startup business and its financial plan. Discuss the positive and negative effects of these changes on a startup business. Brainstorm on how a financial plan might utilize such policy to the advantage of a business.

Student Class Instructor

Date Assigned Date Completed

ACTIVITY 19 Sources of Funding

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

Tips for Obtaining a Business Loan

Banks are earmarking billions for them, but would-be business borrowers need to do their credit homework. Business owners must satisfy a bank's credit qualifications to obtain a loan. Among the factors a bank will consider are the applicant's personal credit history, their willingness to pledge personal assets for **collateral**, including real estate, and the **cash flow** generated by the business.

A knowledgeable loan officer can help by suggesting ways a business owner can strengthen a loan application to become creditworthy. The loan officer can even suggest that the bank take a chance on a character loan. With a **character loan**, requirements are less stringent based on strength of character.

The Small Business Administration provides the following tips for business borrowers:

• Establish a good credit history.

Whether you're a startup or an existing business, you must have a good personal-credit history. Loan programs look very closely at this. While blemishes such as slow payments or collections don't automatically disqualify you, it may make it more difficult to qualify. If you've had significant problems in the past 10 years, you'll need to do some credit repair. In that case, contact credit- and debt-counseling services. Also, make sure your personal and business income taxes are paid up.

• Establish a banking relationship.

Don't wait until you need a loan to go to a bank. It's important to build up a banking relationship so that the institution knows you and your needs when it comes time to apply. Have your local bank handle your business-banking needs, so that you can establish a record with them. From the beginning of your business, keep good financial records. The bank will want to see three years of records, such as sources of revenues and the company's profitability.

• Be willing to commit personal assets.

If your business is a startup, the bank will want the business owner to personally guarantee the loan by putting up their personal assets as collateral. If it's an ongoing business, some banks will also accept the company's cash flow as collateral. Banks also like to see that you have some of your own money, anywhere from 10 percent to 30 percent of assets, invested in the business.

• Present a sound financial analysis.

Banks will look to see whether or not your business is capable of paying off the loan. Get help with creating a financial analysis showing how funds are used in the business and expected **revenue** and cash flow. Remember that when you go to a bank, you're bringing them a business proposition. They loan money because they want to make money. You need to show them how their money will be protected, how you'll use their money, and how you'll pay them back.

• Compare alternatives.

Shop around at several different banks before making an application. Some banks are more receptive to service and retail businesses, while others are better with businesses that have **tangible** assets. Compare banks' loan terms as well as interest rates.

When you are offered a loan, make sure that the terms will meet your needs before accepting. If the repayment terms or interest rate are different than you had planned, rework your financial analysis to verify that the loan will work for you. You'll also want to make sure that the amount of the loan will be enough to meet your needs. For information on business lenders in your area, contact the Small Business Administration's Office of Advocacy.

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Vocabulary

cash flow the amount of cash that is available to a business at any given time.

character loan a loan based on the reputation and/or personal credit history of a borrower, rather than collateral.

collateral a form of security to help guarantee that a creditor will be repaid.

revenue a general term that refers to the income produced from investments or production.

tangible investments that one can actually touch, such as real estate or gold.

Fact and Idea Review

1. What factors does a bank use when considering a loan application?

2. When obtaining a loan for an existing business, how many years of business records will a loan officer expect to review?

3. What percentage of assets do banks generally expect business owners to have personally invested in their businesses?

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4. What information should a financial analysis provide?

5. What factors should a business owner consider before accepting a loan offer?

Critical Thinking

1. In what circumstances might a loan officer be required to consider a character loan to a potential business owner?

2. Do you think that your chances for getting a loan for a start-up business would be better before the business begins operations or after it has been active for a few months?

Extension Activity

Many banks offer a variety of small business loan programs. Some loans even include guarantees from state or federal aid programs. Research loan programs offered by local and regional banks in your area. How do the repayment terms and interest rates differ? What are the criteria for qualifying for different loan programs? Discuss and compare your findings in class.

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ACTIVITY 20 Financial Accounting

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

What to Do with All Those Stock Options?

People who got in on the ground floor of fast-growth **startup companies**, especially in high tech fields, often have a problem many **plodders** in the corporate world would gladly take on: Their stock options can be worth so much money that they don't know how to handle them. Microsoft millionaires were the early notables, but they're now joined by legions of **entrepreneurs** and employees who, thanks to huge runups in their company's stock, have paper profits in the six or seven digits.

A stock option is a contractual agreement allowing you to purchase the underlying stock at a stated price by "exercising" the option. Usually, exercise of employee stock options is permitted only after a period of time. When you exercise the option, the stock price should be above the exercise price, so that you end up owning shares that are worth considerably more than you paid for them.

Exercise of stock options must be carefully timed. One danger with waiting, of course, is that the stock price may fall. Even if you think your company has tremendous future prospects, it could be wise to diversify your assets.

Exercising options and selling company stock is further complicated by tax concerns, many of which are avoidable. First, the two different types of stock options get different tax treatments. Nonqualified options (NSOs) generally go to the broadest group of employees. With NSOs, you must pay income tax on the spread between your "strike price" (the price you pay for the stock when you exercise the option) and the market price when you exercise them. If your strike price is $8 and you exercise at $80, you'll owe income tax on the $72 gain per share that year.

Incentive stock options (ISO), which have some tax benefits, usually go to top executives. These options aren't taxed until you sell the shares, and as long as you hold the stock for a year, you can pay the lower capital-gains rate on the spread between the strike price and the market price at the date of sale. In this case, using the above example, after five years you would owe capital gains tax on $72 ($80 share price minus your $8 strike price) for each ISO share.

In most cases, you should hold the company stock, once you've exercised your ISOs, for at least one year to get the favorable capital-gains treatment. However, if the stock is volatile, it may be worth paying the higher income tax rate to lock in gains. For example, if you exercise an ISO trading at $100 now and sold the share immediately, you would get roughly $60 in cash. If you wait a year and the price stays the same, you would net $80 in cash. If the stock fell to $75 in a year, you would net $60 a share.

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Vocabulary

entrepreneur an individual who follows his or her dreams by assuming the risk of starting a new business.

plodder someone who works in a slow, steady way, especially when doing something dull.

startup companies new businesses just getting off the ground.

Student Class Instructor

Fact and Idea Review

1. What is a stock option?

2. What is the risk of holding options rather than exercising them?

3. How is the gain on exercise of non-qualified stock options taxed?

4. How long must shares received from exercising incentive stock options be held in order to be taxed at the capital-gains rate?

5. Why might an immediate sale of shares received from exercising an ISO be a good idea?

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Critical Thinking

1. Why do you think many startup companies today offer employees stock options as part of their compensation?

2. Why might an employee exercise stock options as soon as possible, even if he or she believes the company will do very well and that the value of the stock will rise?

Extension Activity

Suppose that you have a choice of two identical jobs, both with private companies. One pays a starting salary of $50,000 a year. The second pays a starting salary of $30,000 a year, along with stock options for 1,000 shares of the company's stock, valued at $50 a share. The company also expects to go public in two years, at which time the options can be exercised. Which job would you take? As a class, tally up your responses to create a class profile. What factors were most important in making this decision? How many shares would have to be offered before all students would accept the lower-paying job?

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Student Class Instructor

Date Assigned Date Completed

ACTIVITY 21 Managing Payroll and Inventory

AS YOU READ, learn the *Vocabulary.* AFTER YOU READ, check your understanding through *Fact and Idea Review, Critical Thinking Questions,* and *Extension Activity.*

SIMPLE Retirement Plan Basics for Small Businesses

Congress created the Savings Incentive Match Plan for Employees (SIMPLE) retirement plan in 1996 to help more people save for retirement. A company may qualify for a SIMPLE plan if it does not already sponsor a retirement plan and has no more than 100 eligible employees on any one day of the year. Many small businesses will find SIMPLE plans less expensive and easier to administer than other types of retirement plans. Providing employees with a tax-advantaged retirement savings vehicle can help small businesses attract talented people.

Like other company-sponsored retirement plans, a SIMPLE plan allows participants to make **tax-deductible** contributions—up to $6,000 annually—and enjoy tax-deferred growth of investment earnings. Owners and employees who have earned at least $5,000 in **compensation** during any two earlier years and are expected to earn at least that much in the current year are eligible to participate.

The plan can be set up either as an Individual Retirement Account (IRA) for each employee, or as part of a **401(k).** If established as a SIMPLE IRA, the company must either match the contribution the employee has chosen to make dollar-for-dollar up to 3 percent of compensation, or make a 2 percent-of-compensation contribution for each eligible employee. (An employer can match the contributions of as little as 1 percent of compensation in two out of five years.)

A company's eligible employees can decide to participate, or to change the amount of their contribution, within 60 days before the start of a new year, or 60 days before they are eligible to participate. Employees must also be allowed the flexibility to terminate their participation at any time during the year. An employee's elective deferrals to his or her account must be made within 30 days of the end of the month for which the contributions were made.

Contributions are excluded from the employee's income and are not considered taxable until they are withdrawn. Contributions made by the employer are not considered wages for either employment-tax or withholding purposes. The company's contributions are generally deductible for a particular year if they are made by the due date, including extensions, of that year's return.

If an employee terminates participation in the plan, the SIMPLE IRA distributions can be rolled over into another IRA or SIMPLE plan and continue to benefit from tax deferral. However, withdrawals made by employees before reaching age 59 1/2 are subject to the 10 percent penalty applicable to IRAs. To further encourage employees to keep the funds in their SIMPLE accounts until they retire, a higher 25 percent early withdrawal tax applies should the employee withdraw any contributions that were made during the two-year period beginning on the date the employee first participated.

A SIMPLE 401(k) requires additional reporting but also provides some additional protection to companies and financial services firms. The SIMPLE 401(k) plan does not have to satisfy special 401(k) nondiscrimination tests provided the employer matches elective deferrals up to 3 percent of employee's compensation, or makes an annual 2 percent-of-compensation contribution for all eligible employees.

Companies that establish SIMPLE 401 (k) plans do not have the flexibility to reduce their matching contributions to 1 percent of compensation in two out of five years, as do companies that establish their plans as SIMPLE IRAs.

The Internal Revenue Service has released a model SIMPLE plan that companies can adopt by using IRS Form 5305-SIMPLE. In addition, this package contains a model notification form for eligible employees that meet notification requirements for the SIMPLE plan. It also includes a model salary reduction agreement. The plan is in force once the company and the participating financial institution have completed and signed it.

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Student Class Instructor

Vocabulary

401(k) a retirement plan in which employees set aside a portion of their salary from each paycheck to be deducted from their gross pay and placed in a special account.

compensation wages or other payment for services.

tax-deductible an item that can be subtracted from a person's adjusted gross income to arrive at his or her taxable income.

Fact and Idea Review

1. Why are SIMPLE plans an attractive choice for small business owners?

2. How does a business owner benefit by offering a retirement savings plan such as SIMPLE?

3. How much can an employee or a business owner contribute to their SIMPLE plan account each year?

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4. What contributions must the employer make on behalf of employees eligible to participate in the plan?

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5. What tax penalties may apply on withdrawals from a SIMPLE account before the participant reaches age 59 1/2?

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Critical Thinking

1. If you earned $30,000 a year, which type of plan would allow you to make a larger contribution to your retirement savings: a SIMPLE plan, or a regular 401(k) plan that limits contributions to a maximum of 10 percent of income?

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2. What factors would you consider in deciding whether or not to offer a retirement plan that requires you to make contributions on behalf of your employees?

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Extension Activity

A self-employed individual, sole proprietor, or small-business owner has several options for building retirement savings. As a class, discuss why it is important for business owners to set aside funds for retirement rather than reinvesting all of their assets in the business.

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ACTIVITY 22 Pricing, Costing, and Growth

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Retail's Details: Why Monthly Sales Reports Are Required Reading

As the consumer goes, so goes the expansion. That's an essential **mantra** among economy watchers because consumer spending accounts for over two-thirds of **real gross domestic product**. Not surprisingly, the monthly retail sales report produced by the Census Bureau of the Commerce Department is a must-have for business managers and investors.

Since the advance data—the first tally of sales—are released about nine business days after the end of every month, the retail sales report is the government's first look at how consumers are behaving. The report that Wall Street follows with such keen interest has a complex makeup. It starts out as mail-in surveys to stores ranging from mom-and-pop establishments to megachains. The advance report carries results from about 4,100 retailers. In the following month, the number will be revised to cover more complete sales totals for up to 10,000 vendors. However, adjustments tend to be modest. Retailers from car dealers to department stores to restaurants are covered in the government's report.

Given that most Americans are **inveterate** shoppers, you may think that interpreting the retail numbers is a straightforward matter, but analyzing the numbers can be as tricky as finding a swimsuit that fits well. For one thing, the data are grouped by stores, not by types of merchandise. Buy a bottle of aspirin at the local Food Lion, and it shows up as a grocery-store receipt, not as a pharmacy sale. Sales of motor vehicles, some 20 percent of all retail buying, are notoriously volatile. That's why Census publishes a nonauto retail number. Look at that figure for the real trend in consumer spending, especially if dealer incentives have temporarily boosted car sales for a month.

Because retail sales are not adjusted for inflation, the numbers may be affected by price changes. For example, rising energy prices can boost sales at gasoline stations, even though the sales tallied by gallons may show no increase at all. The retail sales data eventually work their way into the monthly consumer spending report as well as into the quarterly GDP release. Policymakers use the report as a major clue for tracking the economy's health. That's why if you're looking for early information on how the economy is doing, the retail sales report should be high on your shopping list.

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Vocabulary

inveterate chronic, doing a certain thing by habit; habitual.

mantra a word or a phrase which is often repeated and which expresses a belief.

real gross domestic product the total value of goods and services produced within a country measured in dollars adjusted for inflation.

Fact and Idea Review

1. What percentage of real gross domestic product reflects consumer spending?

2. When is the monthly retail sales report released by the Census Bureau of the Commerce Department?

3. How is the information contained in the report collected?

4. Why is it often difficult to interpret the retail sales figures?

5. Why should investors and business managers pay attention to the retail sales report?

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Critical Thinking

1. How might business managers use the retail sales report and similar government publications to manage their businesses?

2. What action would you take if you owned a clothing store and noticed from the monthly report that retail clothing sales have declined for four months in a row?

Extension Activity

The U.S. government provides a wealth of statistical information to the public. In groups of two to three students, research an industry sector such as transportation, construction, banking, agricultural products, chemicals, insurance, automobiles, or shipping. Prepare an oral report on the types of information the government compiles that is particularly useful for businesses in that particular industry.

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