THEME 3

Tomorrow's Money: Getting to the End of the Rainbow

OVERVIEW

Student Letter

Have your parents told you that money doesn't grow on trees? This is good advice as far as it goes. Although money most definitely doesn't grow on trees, it can grow. It grows when you save and invest wisely. If you want to be wealthy, start by saving and investing regularly. Begin saving now and save as much as you can afford. Pay yourself first by putting money in a savings account or money market fund every time you are paid.

Because of the power of compounding, your money will grow *big time*. *Compounding* means that you earn interest on the interest earned in previous years. For example, if you save $2,000 and earn 8 percent annual interest, you will have $2,160 at the end of the first year. You earned $160 in interest. The second year, however, you will earn more than $160 in interest because you earn 8 percent of $2,160, not $2,000. This is $172.80 in interest, or $12.80 more than the first year.

So you earned $12.80 more the second year. Big deal. How much difference does this compounding make? If you save $2,000 a year at 8 percent annual interest from age 22 to age 65, you will have saved $86,000 over 43 years. How much money would you have at age 65? You would have a total of $713,899, or $627,899 more than you saved. Think of compound interest as the fertilizer that makes money grow. (Example from Dwight Lee and Richard McKenzie, *Getting Rich in America*.)

Of course, with a higher rate of return, money grows even faster. An 8 percent annual rate of return is not that difficult to achieve. The value of stocks has increased more than that, on average, over the last 60 years. If you earned 15 percent annual interest, your $86,000 would grow to $6,230,000 by the time you reach 65. Because of compounding, doubling the rate of return increases your stash of cash eight times. Obviously, the interest rate makes a huge difference.

But the people competing for your savings will not pay you a high interest rate out of kindness. Saving and investing will not only enrich you, but your investment dollars help businesses and the economy to grow. That's why banks, savings and loans, credit unions, governments, and companies pay you for the use of your money. *They* hope to gain by using *your* savings.

Some of these people competing for your savings will be taking more risks than others. They pay more to get you to take more risk. *Risk* is the chance that you might not get your money back. The higher the risk, the higher the potential reward. You might want to take some high risks with some of your savings but not with all of it. That is why you need to diversify your investments. *Diversification* means that you should not put all your eggs in one basket. Although diversification will not guarantee that your investments will not lose money, it should decrease the chance of that happening.

Money can work for you, but you will have to work to make it grow as much as possible, consistent with the risks you are willing to take. Investigate before you invest. There are millions of places you can invest, from very safe insured savings accounts to speculative stocks, commodity futures, and collectibles. A successful investor learns a lot about investing before making investment choices.

The lessons that follow will get you started, but you will never be able to stop learning if you want to invest successfully over your lifetime. There is a pot of gold at the end of that rainbow, but getting there takes hard work.

Questions

1. Why do people save and invest?

2. When is the best time to begin investing?

3. Why do savings grow so quickly?

4. Why do saving and investing help the overall economy?

5. What is the relationship between investment risk and reward?

6. What does it mean to diversify investments?

FAQs

ABOUT TOMORROW'S MONEY: GETTING TO THE END OF THE RAINBOW

1. Can most Americans become rich?

Yes. No matter what your income, regular saving and investing can make you rich. The key is to live below your means, save regularly, and find good investments. The earlier you start this, the richer you will become.

2. What is the difference between saving and investing?

The words, saving and investing, are used a lot in these lessons. Saving is putting money aside—not spending it now for goods and services. Individuals may place their money in savings accounts. These include passbook savings accounts and certificates of deposit that are insured by the Federal Deposit Insurance Corporation (FDIC). Investing generally is seen as putting saved money into stocks, corporate bonds, mutual funds, commercial real estate, and other financial instruments or ventures. Each of these investments carry more risk than savings accounts.

Don't be too concerned about the differences between savings and investing. We sometimes use these words interchangeably in these lessons.

3. Why shouldn't I just keep my money in a savings account where it will be safe?

This depends on your definition of "safe." The money is perfectly safe in an insured savings account, but what if the annual interest rate is less than the rate of inflation? With inflation, your money loses purchasing power. What if you save enough to buy a mountain bike, but when you take the money out, it buys only half a bike? That's why some people put money in riskier, long-term investments that can provide a greater return—one where the purchasing power of your savings/investment keeps pace with or exceeds inflation.

4. What is the difference between investing and gambling?

Some people say that purchasing stocks or mutual funds is the same as buying a lottery ticket, betting on a sporting event, or playing the slot machines. Gambling and investing both involve risk, but there are big differences. Gambling involves random chance and is what economists call a "zero-sum game." In other words, for every winner, there is a loser. It is a win-lose deal. Investing is not random and is a positive-sum game. Informed, deliberate choices increase your chances of making

FAQs

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continued

money on your investments. A positive-sum game is an activity involving more than one person in which one person can gain without reducing another person's gain. It is a win-win deal. For example, the Standard & Poor's 500 Stock Index increased at a compounded annual rate of 12.7 percent from 1926 to 1997. This means a lot of people made money and no one had to lose money. It was a win for long-term investors.

5. Are good investments hard to find?
The problem is not finding good investments but evaluating them. For example, there are thousands of stocks traded on the New York Stock Exchange, Nasdaq, and the American Stock Exchange. Over 9,000 mutual funds fall into 33 broad categories. The federal, state, and local governments and corporations sell bonds. Thousands of banks, savings and loans, and credit unions offer all kinds of investment options.

6. Is there a secret to good investing?
There is no secret, but a few basic rules help:

- *Live below your means.*
- *Save early and often.*
- *Take prudent risks to achieve higher returns. Remember that the stock market has beaten the returns on every other type of investment over the long term.*