Building Wealth

A BEGINNER'S GUIDE TO SECURING YOUR FINANCIAL FUTURE

FEDERAL RESERVE BANK OF DALLAS

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Accumulating wealth—as distinct from just making a big income—is the key to your financial independence. It gives you control over assets, power to help shape the corporate and political landscape, and the ability to ensure a prosperous future for your children and their heirs….

Rev. Jesse L. Jackson, Sr. and Jesse L. Jackson, Jr., *It's About the Money!*

Building Wealth: A Beginner's Guide to Securing Your Financial Future offers introductory guidance to individuals and families seeking help to develop a plan for building personal wealth. While a comprehensive discussion of accounting, finance and investment options is beyond the scope of this workbook, it presents an overview of personal wealth-building strategies. For more information and assistance, consult the resource list in the back pocket. For additional copies of this workbook, call (800) 333-4460, ext. 5254. An interactive version of this workbook can be found on the Dallas Fed's web site, at www.dallasfed.org.

Building Wealth

You can create personal wealth. It's possible to meet your financial goals. By choosing to budget, save and invest, you can pay off debt, send your child to college, buy a comfortable home, start a business, save for retirement and put money away for a rainy day. Through budgeting, saving and investing, and by limiting the amount of debt you incur, all these goals are within your reach.

DEFINING WEALTH

Some people consider themselves wealthy because they live in a very expensive house and travel around the globe. Others believe they are wealthy simply because they're able to pay their bills on time. What we are talking about here is financial wealth and what it means to you. In the following space, write your definition.

Examples: Wealth is…

1. *being able to put my kids through college.*
2. *having enough money to buy a house.*

Wealth is…

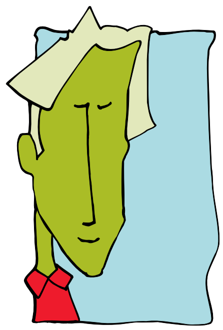
1. ____________________
2. ____________________
3. ____________________

Now that you have defined what wealth means to you, how do you acquire it?

Building wealth requires having the right information, planning and making good choices. This workbook provides basic information and a systematic approach to building wealth. It is based on time-honored principles you probably have heard many times before—budget to save; save and invest; control debt.

① Wealth Creation: Learn the Language

You want to create personal wealth, right? So does Bob.



Bob

Bob is 35 and works for a manufacturing company. He looked at his finances and realized that at the rate he was going, there wouldn't be enough money to meet his family's financial goals. So he chose to embark on a personal wealth-creation strategy. His first major step was to pick up a copy of this workbook for guidance. Bob began by learning the language of wealth creation. The first lesson was to understand the meaning of **assets**, **liabilities** and **net worth**. They make up this very important formula:

ASSETS – LIABILITIES = NET WORTH

An investment in knowledge always pays the best interest.
Benjamin Franklin

A wealth-creating ***asset*** is a possession that generally increases in value or provides a return, such as:

- A savings account.
- A retirement plan.
- Stocks and bonds.
- A house.

A new car drops in value the second it's driven off the lot. Your car is a tool that takes you to work, but it's not a wealth-creating asset.

Some possessions (like your car, big screen TV, boat and clothes) are assets, but they aren't wealth-creating assets because they don't earn money or rise in value.

The market value of a home is an asset; the mortgage, a liability. Let's say your house is worth $120,000, but your mortgage is $80,000. That means your equity in the home is $40,000. Equity contributes to your net worth.

A ***liability***, also called debt, is money you owe, such as:

- A home mortgage.
- Credit card balances.
- A car loan.
- Hospital and other medical bills.
- Student loans.

Net worth is the difference between your assets and liabilities. Your net worth is your wealth.

To calculate how much he is worth, Bob used the following formula: **Assets – Liabilities = Net Worth.** He made a balance sheet listing all his assets and all his liabilities. He listed his wealth-building assets first.

Bob discovered his net worth is $21,600. Using Bob's balance sheet as an example, figure your own net worth. Be sure to add any assets and liabilities you have that are not listed here. Remember that net worth is your wealth. Are you worth as much as you want to be?

Bob's Balance Sheet

Wealth-building assets	Amount
Cash	$ 1,500
Savings account	1,000
Stocks, bonds and other investments	5,000
401 (k) retirement plan/IRA	25,000
Market value of home	0
Other assets	
Market value of car	14,000
Total assets	$ 46,500

Liabilities	Amount
Home mortgage	$ 0
Car loan balance	13,000
Credit card balances	3,000
Student loan	5,000
Child support*	2,400
Miscellaneous liabilities	1,500
Total liabilities	$ 24,900
Net worth	$ 21,600

My Balance Sheet

Wealth-building assets	Amount
Cash	
Savings account	
Stocks, bonds and other investments	
401 (k) retirement plan/IRA	
Market value of home	
Other assets	
Market value of car	
Total assets	

Liabilities	Amount
Home mortgage	
Car loan balance	
Credit card balances	
Student loan	
Child support*	
Miscellaneous liabilities	
Total liabilities	
Net worth	

* Represents one year of payments.

② Budget to Save

What would you like your net worth to be

5 years from now? $ ____________________

10 years from now? $ ____________________

SET FINANCIAL GOALS

If you make a good income each year and spend it all, you are not getting wealthier. You are just living high.

Thomas J. Stanley and William D. Danko, *The Millionaire Next Door*

Most people who have built wealth didn't do so overnight. They got wealthy by setting goals and striving to reach them. Bob set two short-term goals: (1) to save and invest enough in four years to have $6,000 for a down payment on a house, and (2) to pay off his $3,000 credit card debt within two years. Bob also set two long-term goals: (1) to save and invest enough to have $25,000 in 15 years for his children's college education, and (2) to have $5,000 a month to live on when he retires in 30 years.

A personal wealth-creation strategy is based on specific goals. In preparing your goals:

- Be realistic.
- Establish time frames.
- Devise a plan.
- Be flexible; goals can change.

In the space provided, list your top goals.

Example: Short-term

1. *In three years save $5,000 for a down payment on a house.*

My short-term goals are:

1. ____________________
2. ____________________
3. ____________________

Example: Long-term

1. *In eight years save $15,000 to help my child with college.*

My long-term goals are:

1. ____________________
2. ____________________
3. ____________________

Now you, like Bob, can choose how to meet those goals. This is where budgeting to save comes into play.

DEVELOP A BUDGET AND LIVE BY IT

When it comes to finances, people generally fall into the following groups. Where do you fit in?

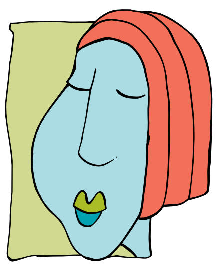
Planners control their financial affairs. They budget to save.

Strugglers have trouble keeping their heads above rough financial waters. They find it difficult to budget to save.

Deniers refuse to see that they're in financial trouble. So they don't see a need to budget to save.

Impulsives seek immediate gratification. They spend today and let tomorrow take care of itself. They couldn't care less about budgeting to save.

Knowing what kind of financial manager you are will help determine what changes to make. To maximize your wealth-creating ability, you want to be a planner, like Betty.



Betty

Betty is a single parent with one child. "I have to budget in order to live on my modest income. I have a little notebook I use to track where every dime goes. Saving is very important to me. When my son was born, I started investing every month in a mutual fund for his college education. I am proud to say that I control my future. I have bought my own home and provided for my son, and I've never bounced a check. You must have common sense regarding money!"

Lynne

Lynne, by contrast, is a struggler. Lynne has a good job, makes good money and lives a pretty comfortable life, but her bankbook tells a different story. She has no savings or investments, owns no property and has no plans for retirement. Plus, she's got a lot of credit card debt, lives from paycheck to paycheck and doesn't budget.

You can choose to be like Lynne, or you can follow Betty's road to wealth creation by learning to budget and save.

A budget allows you to:
- Understand where your money goes.
- Ensure you don't spend more than you make.
- Find uses for your money that will increase your wealth.

To develop a budget, you need to:
- Calculate your monthly income.
- Track your daily expenses.
- Determine how much you spend on monthly bills.

Track Day-to-Day Spending

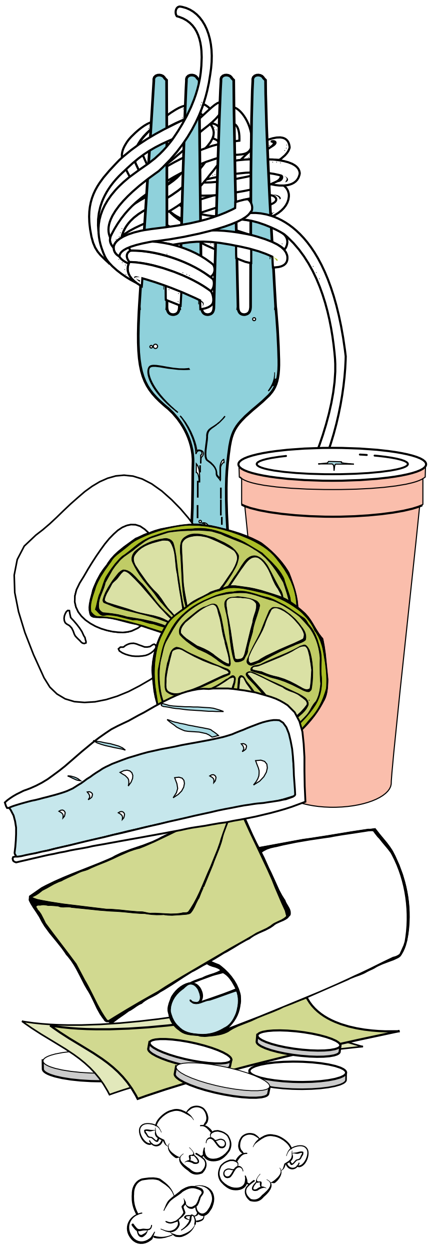
One day Lynne, the struggler, realized that to create wealth she had to become more like Betty and plan her financial future. To start, Lynne analyzed her finances to see how much money she made and how she was spending it. She set a goal to save $125 a month to put toward her wealth-creation goals. First, she calculated her income. Then she added up her monthly bills.

She also carried a little notebook in her purse for jotting down her daily spending, whether by cash, check or credit card. Here is a page from her notebook.

Lynne's Day-to-Day Expenses

Date	Expense	Cash/check	Charge
1/2	Breakfast, Get-N-Go	$ 3.56	
1/2	Coffee (two cups)	.90	
1/2	Lunch		$ 6.75
1/2	Soft drink and candy bar	1.25	
1/2	Gas for car		22.00
1/2	Drinks with friends	10.00	
1/2	Groceries		50.00
1/2	Dinner	10.00	
1/2	Newspaper	.50	
1/3	Bacon and eggs, Moonlight Diner	4.95	
1/3	Newspaper	.50	
1/3	Coffee (two cups)	.90	
1/3	Lunch with coworkers		5.72
1/3	Dinner		15.00
1/3	Dress		45.00
1/3	Soft drink and candy bar	1.25	
1/3	Trip to the movies	15.00	
1/4	Breakfast	3.50	
1/4	Coffee (two cups)	.90	
1/4	Lunch	5.75	
1/4	Soft drink and candy bar	1.25	
1/4	Newspaper	.50	
1/4	Birthday present	15.00	
1/4	Dinner		6.77
1/5	Breakfast	3.25	
1/5	Coffee (two cups)	.90	
1/5	Soft drink and candy bar	1.25	
1/5	Newspaper	.90	
1/5	Magazine	3.95	
1/6	Breakfast	3.25	
1/6	Coffee (two cups)	.90	
1/6	Newspaper	.50	
1/6	Lunch	4.50	
1/6	Soft drink and candy bar	1.25	
1/6	Jacket		50.00
1/6	Video rental	3.50	

You can study your own spending habits by using this sheet to track daily expenses. Be sure to include items purchased with credit cards, as well as those purchased with cash or check.



My Day-to-Day Expenses

Date	Expense	Cash/check	Charge

Get a Handle on Income and Expenses

Lynne used the information from tracking her day-to-day expenses to develop a monthly budget. When Lynne reviewed her budget, she realized she was spending more than she earned. Lynne knew if she were ever going to save $125 a month, she had to cut her expenses, earn more money, or both. She worked overtime at her company, which increased her take-home pay. She bought fewer clothes, discontinued premium cable TV channels, carpooled to work to cut gas consumption and reduced her spending on eating out and entertainment. Tracking her expenses paid off. Lynne successfully developed a budget that enables her to save $125 each month.

Here is her budget. If Lynne sticks to it, she will have $125 a month that she can:

- Put in a savings account.
- Invest in a 401(k) retirement plan at work.
- Invest in an individual retirement account (IRA).
- Invest in stocks, bonds or mutual funds.
- Use to pay off debt.

These are just some of the choices available when you budget to save.

Lynne's Monthly Budget

	Current income	Income changes	New budget
Take-home pay	$ 2,235		$ 2,235
Overtime pay		$ 40	40
Pension, Social Security benefits			
Investment earnings not reinvested			
Interest on savings accounts			
Alimony/child support			
Other income			
Total income	$ 2,235	$ 40	$ 2,275

	Current expenses	Spending changes	New budget
Rent	$ 680		$ 680
Renter's insurance	20		20
Electricity	60		60
Gas	30		30
Water	25		25
Telephone	50		50
Cable TV	55	–20	35
Life insurance	25		25
Credit card interest payment	25		25
Groceries	200		200
Clothing	130	–30	100
Day care/tuition	0	0	
Car loan	300		300
Car insurance	75		75
Gas for car	120	–20	100
Meals out & entertainment	425	–50	375
Miscellaneous daily expenses	100	–50	50
Total expenses	$ 2,320	–$ 170	$ 2,150
Monthly net (income – expenses)	–$ 85		$ 125

Available to save or invest	$ 0		$ 125

Using Lynne's budget as an example, track your income and expenses. Identify changes you can make to increase your income or decrease your expenses, and develop a new budget that includes more savings. Be sure to make reasonable budget changes that you can live with month to month.

To help you maintain the discipline to save:

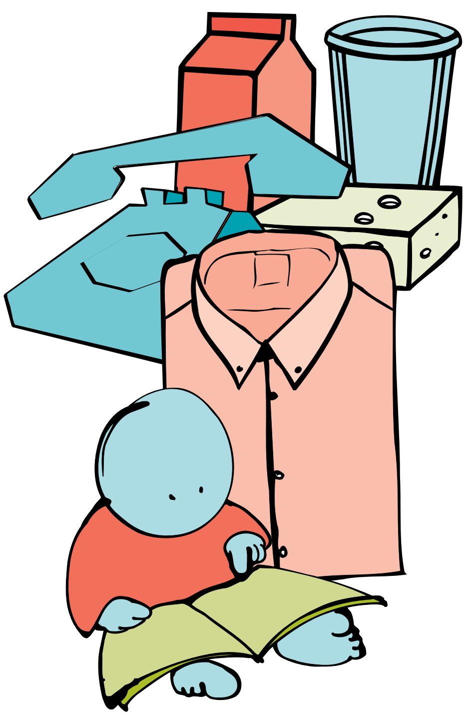
- Save every month.
- Have savings automatically deducted from your paycheck or checking account.
- Base your budget on what's left.

In other words, get on automatic pilot and stay there.

How much do you currently save each month? $ ______

How much are you ***going*** to save each month? $ ______

You have now successfully budgeted to save. The next step is saving and investing.



My Monthly Budget

	Current income	Income changes	New budget
Take-home pay			
Overtime pay			
Pension, Social Security benefits			
Investment earnings not reinvested			
Interest on savings accounts			
Alimony/child support			
Other income			
Total income			

	Current expenses	Spending changes	New budget
Rent			
Renter's insurance			
Electricity			
Gas			
Water			
Telephone			
Cable TV			
Life insurance			
Credit card interest payment			
Groceries			
Clothing			
Day care/tuition			
Car loan			
Car insurance			
Gas for car			
Meals out & entertainment			
Miscellaneous daily expenses			
Total expenses			
Monthly net (income – expenses)			

Available to save or invest			

③ Save and Invest

Take the power of compound interest seriously—and then save.
Dwight R. Lee and Richard B. McKenzie, *Getting Rich in America*

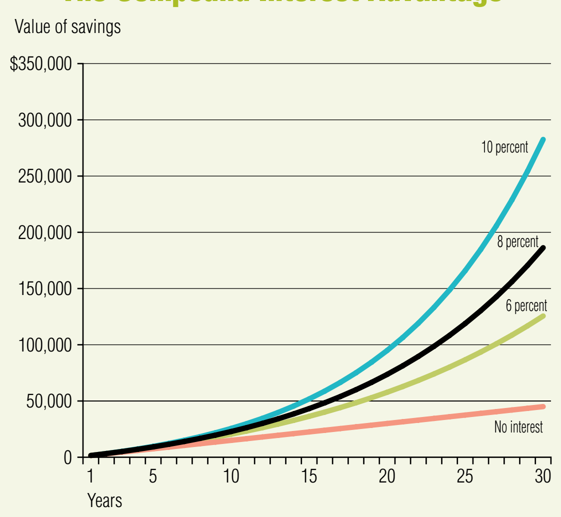
You have budgeted and identified an amount to save monthly. Where are you going to put your savings? By investing, you put the money you save to work making more money and increasing your wealth. An ***investment*** is anything you acquire for future income or benefit. Investments increase by generating income (interest or dividends) or by growing (appreciating) in value. Income earned from your investments and any appreciation in the value of your investments *increase* your wealth.

GET GUIDANCE

There is an art to choosing ways to invest your savings. Good investments will make money; bad investments will cost money. Do your homework. Gather as much information as you can. Seek advice from personnel at your bank or other trained financial experts. Read newspapers, magazines and other publications. Identify credible information sources on the Internet. Join an investment club. Check out the information resources listed in the back pocket of this publication.

TAKE ADVANTAGE OF COMPOUND INTEREST

The Compound Interest Advantage



Examples assume $125 monthly deposits; the compound interest examples assume monthly compounding.

Compound interest helps you build wealth faster. Interest is paid on previously earned interest as well as on the original deposit or investment. For example, $5,000 deposited in a bank at 6 percent interest for a year earns $415 if the interest is compounded monthly. In just 5 years, the $5,000 will grow to $7,449.

Let's see how interest compounds on Lynne's savings. Assume that Lynne saves $125 a month for 30 years and the interest on her savings is compounded monthly.

The chart to the left shows how compound interest at various rates would increase Lynne's savings compared with simply putting the money in a shoebox. This is compound interest that you earn. And as you can see from Lynne's investment, compounding has a greater effect after the investment and interest have increased over a longer period.

There is a flip side to compound interest. That is compound interest you are charged. This compound interest is charged for purchases on your credit card. Chapter 4, "Take Control of Debt," discusses this type of interest.

UNDERSTAND THE RISK–EXPECTED RETURN RELATIONSHIP

When you are saving and investing, the amount of expected return is based on the amount of risk you take with your money. Generally, the higher the risk of losing money, the higher the expected return. For less risk, an investor will expect a smaller return.

For example, a savings account at a financial institution is fully insured by the Federal Deposit Insurance Corp. up to $100,000. The return—or interest paid on your savings—will generally be less than the expected return on other types of investments.

On the other hand, an investment in a stock or bond is not insured. The money you invest may be lost or the value reduced if the investment doesn't perform as expected.

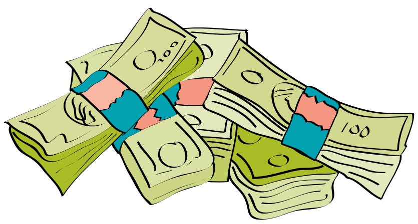
How much risk do you want to take? Here are some things to think about when determining the amount of risk that best suits you.

Financial goals. How much money do you want to accumulate over a certain period of time? Your investment decisions should reflect your wealth-creation goals.

Time horizon. How long can you leave your money invested? If you will need your money in one year, you may want to take less risk than you would if you won't need your money for 20 years.

Financial risk tolerance. Are you in a financial position to invest in riskier alternatives? You should take less risk if you cannot afford to lose your investment or have its value fall.

Inflation risk. This reflects savings' and investments' sensitivity to the inflation rate. For example, while some investments such as a savings account have no risk of default, there is the risk that inflation will rise above the interest rate on the account. If the account earns 5 percent interest, inflation must remain lower than 5 percent a year for you to realize a profit.



Investment Risk Assessment

My financial goals are: ______________________

____

____

My time horizon is: ______________________

My financial risk tolerance is:

☐ SMALL

☐ MODERATE

☐ SIGNIFICANT

TOOLS FOR SAVING

The simplest way to begin earning money on your savings is to open a savings account at a financial institution. You can take advantage of compound interest, with no risk.

Financial institutions offer a variety of savings accounts, each of which pays a different interest rate. The box below describes the different accounts. You can choose to use these typical accounts to save for the near future or for years down the road.

Individual Development Accounts

In some communities, people whose income is below a certain level can open an individual development account (IDA) as part of a money-management program organized by a local non-profit organization. IDAs are generally opened at a local bank. Deposits made by the IDA account holder are often matched by deposits from a foundation, government agency or other organization. IDAs can be used for buying a first home, paying for education or job training, or starting a small business.

Training programs on budgeting, saving and managing credit are frequently part of IDA programs.

Find out about IDAs by calling the Corporation for Enterprise Development at (202) 408-9788, or visit its web site, at www.idanetwork.org.

Types of Savings Accounts

Savings account (in general)

- Access your money at any time.
- Earn interest.
- Move money easily from one account to another.
- Have your savings insured by the FDIC up to $100,000.

Money market savings account

- Earn interest.
- Pay no fees if you maintain a minimum balance.
- May offer check-writing services.
- Have your savings insured by the FDIC up to $100,000.

Certificate of deposit (CD)

- Earn interest during the term (three months, six months, etc.).
- Must leave the deposit in the account for the entire term to avoid an early-withdrawal penalty.
- Receive the principal and interest at the end of the term.
- Have your savings insured by the FDIC up to $100,000.

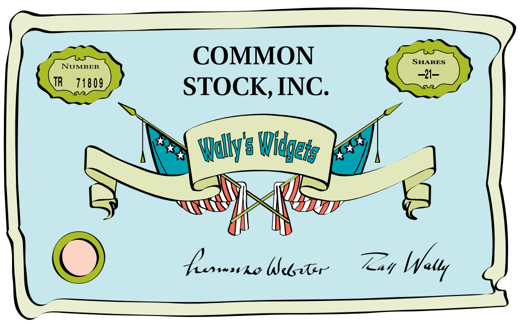
TOOLS FOR INVESTING

Investing is not a get-rich-quick scheme. Smart investors take a long-term view, putting money into investments regularly and keeping it invested for five, 10, 15, 20 or more years.

Stocks—Owning Part of a Company

Stocks. Shares of stock may be acquired on an organized exchange such as the Nasdaq or New York Stock Exchange, through a stockbroker, over the counter or by direct purchase in some cases. When you buy stock, you become a part owner of the company and are known as a ***stockholder***, or ***shareholder***. Stockholders can make money in two ways—receiving dividend payments and selling stock that has appreciated. A ***dividend*** is an income distribution by a corporation to its shareholders, usually made quarterly. ***Stock appreciation*** is an increase in the value of stock in the company, generally based on its ability to make money and pay a dividend. However, if the company doesn't perform as expected, the stock's value may go down.

There is no guarantee you will make money as a stockholder. In purchasing shares of stock, you take a risk on the company making a profit and paying a dividend or seeing the value of its stock go up. Before investing in a company, learn about its past financial performance, management, products and how the stock has been valued in the past. Learn what the experts say about the company and the relationship of its financial performance and stock price. Successful investors are well informed.



Stock options. Some companies offer employees stock options, which they can use to buy stock in the company at a fixed price. For example, your employer, Wally's Widgets, offers a stock-option plan, and its stock is valued at $30 a share. The stock-option price is set at $40 a share. As part of your compensation for meeting company goals and contributing to increased profits, you receive options to purchase 100 shares. Over time the value of the Wally's Widgets shares appreciates to $50 a share. You may now want to exercise your stock options and purchase the shares valued at $50 for $40.

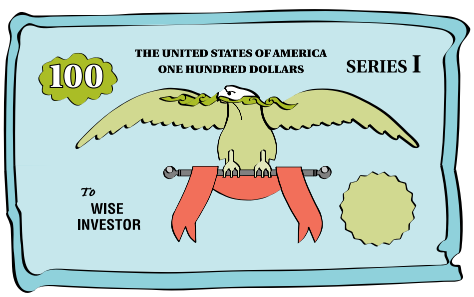
Bonds—Lending Your Money

Bonds. When you buy bonds, you are lending money to a federal or state agency, municipality or other issuer, such as a corporation. A bond is like an IOU. The issuer promises to pay a stated rate of interest during the life of the bond and repay the entire face value when the bond comes due, or reaches maturity. The interest a bond pays is based primarily on the credit quality of the issuer and current interest rates. Firms like Moody's Investor Service and Standard & Poor's rate bonds. With corporate bonds, the company's bond rating is based on its financial picture. The rating for municipal bonds is based on the creditworthiness of the governmental or other public entity that issues it. Issuers with the greatest likelihood of paying back the money have the highest ratings, and their bonds will pay an investor a lower interest rate. Remember, the lower the risk, the lower the expected return.

A bond may be sold at face value (called ***par***) or at a premium or discount. For example, when prevailing interest rates are lower than the bond's stated rate, the selling price of the bond rises above its face value. It is sold at a premium. Conversely, when prevailing interest rates are higher than the bond's stated rate, the selling price of the bond is discounted below face value. When bonds are purchased, they may be held to maturity or traded.

Treasury bonds, bills and notes. The bonds the U.S. Treasury issues are sold to pay for an array of government activities and are backed by the full faith and credit of the federal government. ***Treasury bonds*** are securities with terms of more than 10 years. Interest is paid semiannually. The U.S. government also issues securities known as Treasury bills and notes. ***Treasury bills*** are short-term securities with maturities of three months, six months or one year. They are sold at a discount from their face value, and the difference between the cost and what you are paid at maturity is the interest you earn. ***Treasury notes*** are interest-bearing securities with maturities ranging from two to 10 years. Interest payments are made every six months. ***Inflation-indexed securities*** offer investors a chance to buy a security that keeps pace with inflation. Interest is paid on the inflation-adjusted principal.

Bonds, bills and notes are sold in increments of $1,000.



Savings bonds. ***U.S. savings bonds*** are government-issued and government-backed. There are different types of savings bonds, each with slightly different features and advantages. ***Series I*** bonds are indexed for inflation. The earnings rate on this type of bond combines a fixed rate of return with the annualized rate of inflation. Savings bonds can be purchased in denominations ranging from $50 to $10,000.

Some government-issued bonds offer special tax advantages. There is no state or local income tax on the interest earned from Treasury and savings bonds. And in most cases, interest earned from municipal bonds is exempt from federal and state income tax. Typically, higher income investors buy these bonds for their tax benefits.

Mutual Funds—Investing in Many Companies

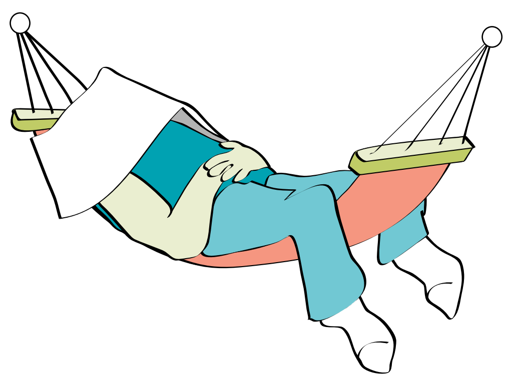
Mutual funds are established to invest many people's money in many firms. When you buy mutual fund shares, you become a shareholder of a fund that has invested in many other companies. By diversifying, a mutual fund spreads risk across numerous companies rather than relying on just one to perform well. Mutual funds have varying degrees of risk. They also have costs associated with owning them, such as management fees, that will vary depending on the type of investments the fund makes.

Before investing in a mutual fund, learn about its past performance, the companies it invests in, how it is managed and the fees investors are charged. Learn what the experts say about the fund and its competitors.

Remember, when investing in stocks, bonds and mutual funds:

- Find good information to help you make informed decisions.
- Make sure you know and understand all the costs associated with buying, selling and managing your investments.
- Beware of investments that seem too good to be true; they probably are.

INVEST FOR RETIREMENT



Have you ever thought about how much money you will need when you retire? Many people don't save enough for retirement. Use the following chart to calculate how much you need to invest today to achieve your retirement goal. For example, suppose you are 20 years old and would like to have $1 million when you retire at age 65. If you can invest $13,719 today, it will grow to $1 million over the next 45 years if it earns a constant 10 percent return, compounded annually. You never have to add another dime to your initial investment.

How old are you? ______________________

How much do you want saved by retirement? ________________

Invest Today to Meet Retirement Goals at Age 65

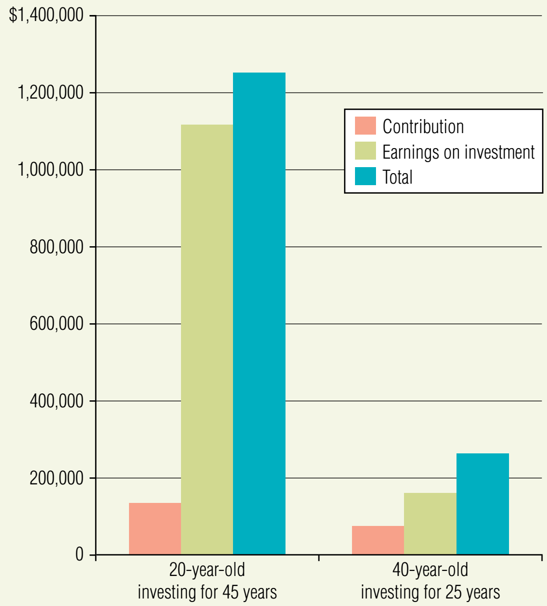
Age	Amount invested				
20	$ 2,743	$ 5,487	$ 8,232	$ 10,976	$ 13,719
25	4,419	8,838	13,257	17,676	22,095
30	7,117	14,234	21,351	28,468	35,585
35	11,462	22,924	34,386	45,847	57,309
40	18,460	36,919	55,378	73,838	92,296
45	29,729	59,458	89,186	118,915	148,644
50	47,879	95,757	143,635	191,514	239,392
55	77,109	154,217	231,326	308,435	385,543
60	124,185	248,369	372,553	496,737	620,921
65	$ 200,000	$ 400,000	$ 600,000	$ 800,000	$1,000,000

Assumes a 10 percent return that is compounded annually.

Individual Retirement Accounts

An individual retirement account (IRA) lets you build wealth and retirement security. The money in the IRA grows tax-free until you retire and are ready to withdraw it. You can open an IRA at a bank, brokerage firm, mutual fund or insurance company. IRAs are subject to certain income limitations and other requirements you will need to learn more about, but here is an overview of what they offer.

Invest in an IRA: The Sooner You Start, the Better



Assumes an annual investment of $3,000 and an 8 percent rate of return.

Maximize Your IRA

Tax year	Individual	Married couple with one spouse working	Catch-up contribution (50 or older)
2002–04	$3,000	$6,000	
2005–07	$4,000	$8,000	
2008	$5,000	$10,000	
2002–05			$500
2006 and thereafter			$1,000

You can contribute up to $3,000 a year to a ***traditional IRA***, as long as you earn $3,000 a year or more. A married couple with only one person working outside the home may contribute a combined total of $6,000 to an IRA and a ***spousal IRA***. Individuals 50 years of age or older may make an additional "catch-up" contribution of $500 a year, for a total annual contribution of $3,500. Money invested in an IRA is deductible from current-year taxes if you are not covered by a retirement plan where you work and your income is below a certain limit.

You don't pay taxes on the money in a traditional IRA until it is withdrawn. All withdrawals are taxable, and there generally are penalties on money withdrawn before age 59½. However, you can make certain withdrawals without penalty, such as to pay for higher education, to purchase your first home, to cover certain unreimbursed medical expenses or to pay medical insurance premiums if you are out of work.

A ***Roth IRA*** is funded by after-tax earnings; you do not deduct the money you pay in from your current income. However, after age 59½ you can withdraw the principal and any interest or appreciated value tax-free. Other rules for withdrawing money from a Roth IRA are less stringent than those for a traditional IRA.

An ***education IRA*** is an educational savings account, not a retirement account. A parent, grandparent or other person can contribute up to $2,000 annually to an education IRA on behalf of a child under the age of 18. The big advantage of an education IRA is that withdrawals are tax-free if they are used for qualified postsecondary educational expenses, such as room, board and tuition. The money contributed to an education IRA is not tax-deductible.

401(k) Plans

Many companies offer a 401(k) plan for employees' retirement. Participants authorize a certain percentage of their before-tax salary to be deducted from their paycheck and put into a 401(k). Many times, 401(k) funds are professionally managed and employees have a choice of investments that vary in risk. Employees are responsible for learning about the investment choices offered.

By putting a percentage of your salary into a 401(k), you reduce the amount of pay subject to federal and state income tax. Tax-deferred contributions and earnings make up the best one-two punch in investing. In addition, your employer may match a portion of every dollar you invest in the 401(k), up to a certain percentage or dollar amount.

How Much Extra Savings Is a Tax-Deferred Investment Worth?

If you pay taxes, which most of us do, a tax-deferred investment will be worth the amount you invest multiplied by the tax rate you pay. For example, if your federal tax rate is 15 percent and you invest $3,000 in an IRA, you'll save $450 in taxes. So in effect, you will have spent only $2,550 for a $3,000 investment on which you will earn money. A good wealth-creation plan maximizes tax-deferred investments.

As long as the money remains in your 401(k), it's tax-deferred. Withdrawals for any purpose are taxable, and withdrawals before age 59½ are subject to a penalty. Take full advantage of the retirement savings programs your company offers—and understand thoroughly how they work. They are great ways to build wealth.

Qualified Plans

If you're self-employed, don't worry. There is a retirement plan for you. A qualified plan (formerly referred to as a Keogh plan) is a tax-deferred plan designed to help self-employed workers save for retirement.

The most attractive feature of a qualified plan is the high maximum contribution—up to $35,000 annually. The contributions and investment earnings grow tax-free until they are withdrawn, when they are taxed as ordinary income. Withdrawals before age 59½ are subject to a penalty.

OTHER INVESTMENTS

Investing in Your House

Remember Bob in Chapter 1, who started reading this workbook to create wealth? Practicing what he read, Bob reduced his debt, increased his savings and is now ready to buy a house. He has a sizable down payment saved, so right from the beginning he will have equity in his home.

Equity, in this case, is the difference between the market value of the house and the balance on Bob's mortgage. As Bob pays his mortgage, he increases his equity. Plus, over time, his house may rise in value—giving him more money if he chooses to sell it. Knowing that the more equity he has in his house, the wealthier he will be, Bob takes a 15-year mortgage rather than the more traditional 30-year mortgage. This will enable him to own his house in 15 years. Of course, Bob will make higher monthly payments on his mortgage than he would have, but he will build equity quicker and ultimately pay less interest.

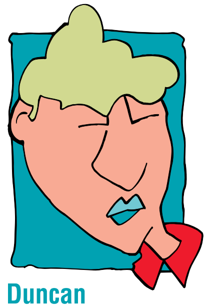
Building Equity Quicker—A Comparison

Mortgage term	30 years	15 years
Loan amount	$ 118,000	$ 118,000
Months to pay	360	180
Annual percentage rate	7.5%	7.0%
Monthly payment	$ 825	$ 1,061
Total interest	$ 179,030	$ 72,911
Interest savings	—	$ 106,119

By making higher monthly payments, Bob not only will own his house outright in 15 years, but he will save $106,119 in interest. That's $106,119 Bob can invest as part of his wealth-creation plan. Making higher monthly payments, of course, means budgeting. Bob chose to budget extra money each month out of his paycheck—and make wise spending choices—so he can do just that.

Start Your Own Business

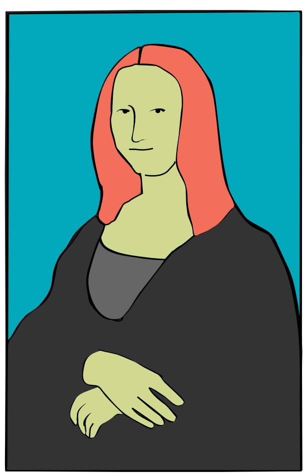
You can also start and invest in your own business as part of a wealth-creation plan. This requires planning, know-how, savings and an entrepreneurial spirit. Starting a small business can be risky, but it is one of the most significant ways individuals have to create personal wealth.


Duncan

Duncan had a dream—he wanted to own a business. He worked for a printing company for 10 years and learned every aspect of the business. He and his wife saved every month until they had a sizable nest egg. When they felt the timing was right, they bought a printing press and computer equipment and set up shop in an old warehouse. Duncan's wife kept her job so they would have steady income and benefits while the business got off the ground.

For the next five years, Duncan worked long hours and put all the income back into the business to help it grow. He gave his customers good service, attracted more customers and paid close attention to his expenses. By the sixth year, the business was profitable and Duncan and his wife were well on the way to owning a successful, ongoing enterprise that will increase their personal wealth.

None of this would have been possible without budgeting and saving. Duncan was able to use the couple's savings to invest in his talents and entrepreneurial spirit.



Other Investment Alternatives

You also can invest in other things that may not earn a dividend or interest but may rise in value over time, such as land, rare coins, antiques and art. If you are knowledgeable about these types of investments, they might be the right choice for you.

Now it's time to plan your investment strategy. List the investment options you are going to learn more about and weigh them against your wealth-creation goals, time frame and risk tolerance.

1. ______________________________

2. ______________________________

3. ______________________________

4. ______________________________

5. ______________________________

Use the table on the opposite page to track your present and future investments.

We have seen that by budgeting to save, saving and investing, wealth can be created. But what if debt limits your ability to save and invest? The next chapter discusses controlling debt.

Track Your Financial Investments

Type of investment	Amount invested monthly	Balance or value of investment	Interest rate or annual rate of return	Term
Example:				
Savings accounts				
1. General				
2. Money market savings account	$ 50	$1,000	4.5%	Indefinite
Company stock				
1. Stock in Steady Steel Co. (200 shares)		5,000	7.5	Indefinite
Savings accounts				
1. General				
2. Money market savings account				
3. Certificates of deposit (CDs)				
Company stocks				
1.				
2.				
Corporate bonds				
1.				
2.				
Government securities				
1.				
2.				
3.				
Mutual funds				
1.				
2.				
3.				
Other investments				
1.				
2.				
Investments for retirement				
1. Individual retirement account (IRA)				
2. 401(k) plan				
3. Qualified plan				
Total				

④ Take Control of Debt

Remember the definition of net worth (wealth)?

Assets – Liabilities = Net Worth

I owe, I owe, so it's off to work I go.

Bumper sticker on a 1972 Chevy

Liabilities are your debts. Debt reduces net worth. Plus, the interest you pay on debt, including credit card debt, is money that cannot be saved or invested—it's just gone. Debt is a tool to be used wisely for such things as buying a house. If not used wisely, debt can easily get out of hand. For example, putting day-to-day expenses—like groceries or utility bills—on a credit card and not paying off the balance monthly can lead to debt overload.

WHY PEOPLE GET INTO TROUBLE WITH DEBT

More than 1.4 million individuals filed for bankruptcy in 2001, a significant increase from the 316,000 individuals who filed in 1981. That means lots of people are mired in debt. In some cases, they could not control the causes of their debt. However, in some instances they could have.

Many people get into serious debt because they:

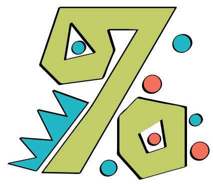
- Experienced financial stresses caused by unemployment, medical bills or divorce.
- Could not control spending, did not plan for the future and did not save money.
- Lacked knowledge of financial and credit matters.

WEALTH-BUILDING TIPS

- Develop a budget and stick to it.
- Save money so you're prepared for unforeseen circumstances. You should have at least three to six months of living expenses stashed in your rainy day savings account, because as the poet Longfellow put it, "Into each life some rain must fall."
- When faced with a choice of financing a purchase, it may be a better financial decision to choose a less expensive model of the same product and save or invest the difference.
- Pay off credit card balances monthly.
- If you must borrow, learn everything about the loan, including interest rate, fees and penalties for late payments or early repayment.

SPEAKING OF INTEREST

When you take out a loan, you repay the ***principal***, which is the amount borrowed, plus ***interest***, the amount charged for lending you the money.



Remember the discussion about earning compound interest in Chapter 3? The interest on your monthly balance is a good example of compound interest that you pay. The interest is added to your bill, and the next month interest is charged on that amount *and* on the outstanding balance. For example, if you have a $1,000 balance that you do not pay off at the end of the monthly billing period and the annual interest rate is 20 percent, your bill next month will be $1,016.67, even though you made no additional purchases. In a year's time you will have paid more than $219 in interest.

The bottom line on interest is that those who know about interest earn it; those who don't, pay it.

AVOID CREDIT CARD DEBT

Planners, like Betty, rarely use credit cards. When they do, they pay off their balances every month. When a credit card balance is not paid off monthly, it means paying interest—often 20 percent or more a year—on everything purchased. So think of credit card debt as a high-interest loan.

Do you need to reduce your credit card debt? Here are some suggestions.

- Pay cash.
- Set a monthly limit on charging, and keep a written record so you don't exceed that amount. (Remember your daily expense sheet from Chapter 2? Use it to keep track.)
- Limit the number of credit cards you have. Cut up all but one of your cards. Stash that one out of sight, and use it only in emergencies.
- Choose the card with the lowest interest rate and no (or very low) annual fee. But beware of low introductory interest rates offered by mail. These rates often skyrocket after the first few months.
- Don't apply for credit cards to get a free gift or a discount on a purchase.
- Steer clear of blank checks that financial services companies send you. These checks are cash advances that may carry a higher interest rate than typical charges.
- Pay bills on time to avoid late charges.

The Tale of Two Spenders and the Big-Screen TV

Remember Betty, the planner? She saved up for the "extras." When she had enough money in her savings account, she bought a big-screen TV for $1,500. She paid cash.

Her friend Tim is an impulsive spender. He seeks immediate gratification using his credit cards, not realizing how much extra it costs. Tim bought the same TV for $1,500 but financed it for one year using a store credit card with an annual interest rate of 18 percent. His monthly payments were $137.52.

At the end of the year, Tim discovered that he had paid $150.24 in interest. He paid $1,650.24 for the big-screen TV—the cost of the TV plus interest—and Betty paid only $1,500. Tim not only paid an extra $150.24, he lost the opportunity to invest the $150.24 in building his wealth.

BEWARE THE PERILS OF PAYDAY LOANS AND PREDATORY LENDERS

People can get deep in debt when they take out a loan against their paycheck. They write a postdated check in exchange for money. When they get paid again, they repay the loan, thus the name ***payday loan***. These loans generally come with very high, double-digit interest rates. Borrowers who can't repay the money are charged additional fees for an extension, which puts them even deeper in debt. Borrowers can continue to pay fees to extend the loan's due date indefinitely, only to find they are getting deeper in debt because of the steep interest payments and fees.

Pauline

Predatory lenders often target elderly and low-income people they contact by phone, mail or in person. After her husband died, 73-year-old Pauline got plenty of solicitations from finance companies. She was struggling to make ends meet on her fixed income. To pay off her bills, she took out a $5,000 home equity loan that carried a high interest rate and excessive fees. Soon she found she was even deeper in debt, so she refinanced the loan once, then again, and again, paying fees each time.

Pauline's children discovered her situation and paid off the loan. The lessons here are:

- Don't borrow from Peter to pay Paul.
- Never respond to a solicitation that makes borrowing sound easy and cheap.
- Always read the fine print on any loan application.

Seek assistance from family members, local credit counseling services or others to make sure a loan is right for you.

KNOW WHAT CREDITORS SAY ABOUT YOU

Those who have used credit will have a credit report that shows everything about their payment history, including late payments.

A history of paying bills late can have a negative impact on your credit record. Banks and other lenders use credit reports when deciding whether to loan money. Insurance companies and potential landlords and employers may also check credit reports. A person's history of paying bills is a good predictor of how he or she will pay future debts. Creditors generally look for a two-year history of consistently paying bills on time to establish good credit.

A credit report that includes late payments, delinquencies or defaults could mean not getting a loan or having to pay a higher interest rate because the borrower has a greater risk of default.

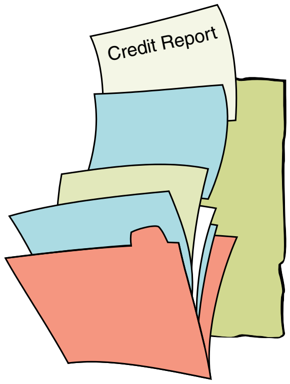
What's on YOUR Credit Report?

To learn what is on your credit report, you can order a copy for a fee from the following major credit bureaus:

Equifax
1-800-685-1111; www.equifax.com

Experian
1-888-397-3742; www.experian.com

Trans Union
1-800-888-4213; www.transunion.com



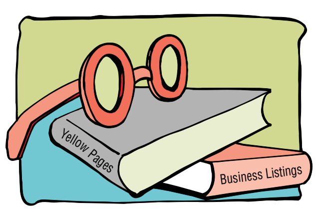
Review your credit report at least once a year to make sure all information is accurate. Correct errors on your report by:

- Alerting the credit bureau to the error.
- Sending the credit bureau copies of canceled checks or other payment information.
- Explaining the problem in a brief letter. The credit-reporting agency must investigate your complaint within 30 days and get back to you with its results.
- Contacting the creditor if the credit bureau disagrees with you. When you resolve the dispute, ask the creditor to send the credit bureau a correction.

If the issue remains unresolved, you have the right to explain in a statement that will go on your credit report. For example, if you did not pay a car repair bill because the mechanic didn't fix the problem, the unpaid bill may show up on your credit report, but so will your explanation.

KEEP YOUR GOOD NAME

Every month, go back to your budget and plan carefully to ensure your bills are paid before their due dates. Betty, the planner, makes sure she pays her bills on time. Betty gets paid twice a month. Out of her first check, she pays her mortgage, cable TV and utility bills. Out of the second check, Betty pays her car payment, telephone bill, student loan, newspaper and health insurance by their due dates. She sticks faithfully to that schedule. You, too, can keep your good name by being a planner.



If you believe you are too deep in debt:

- Discuss your options with your creditors before you miss a payment.
- Seek expert help, such as Consumer Credit Counseling Services, listed in your local telephone directory.
- Avoid "credit repair" companies that charge a fee. Many of these are scams.

SAVE MONEY BY CHOOSING THE RIGHT LOAN

$15,000 Car Loan for 5 Years		
Lender	Interest rate	Total interest
Pixley Bank and Trust	6.5%	$2,609.53
XYZ Savings and Loan	7.5%	$3,034.15
Bank ABC	8.75%	$3,573.51

If you have good credit, you may want to take out a loan for a house or to pay your children's college tuition—both are investments in the future. But regardless of how the money is spent, a loan is a liability, or debt, and decreases your wealth. So choose loans carefully.

Shop and negotiate for the lowest interest rate. The interest you save can be invested to build wealth. Take a look at the chart to the left. It is obvious that Pixley Bank and Trust would charge the lowest interest over the term of the loan.

SAVE MONEY BY PAYING LOANS OFF EARLY

$15,000 Car Loan at 10 Percent Interest			
	3-year	4-year	5-year
Number of payments	36	48	60
Payment	$ 484	$ 380	$ 318
Total paid	$17,424	$18,261	$19,122
Interest saved	$ 1,698	$ 861	—

You can save interest expense by increasing your monthly payments or choosing a shorter payment term on your loan.

Betty, the planner, knew her new car would cost more than the sticker price because she would have to pay interest on the loan from the bank. After checking her options, she chose a shorter payment term with higher payments. Betty budgeted enough money each month to make the higher payments. By doing this, she will reduce the amount of interest she ultimately pays.

The chart on the left shows how shorter terms with higher payments would affect the total amount and interest on Betty's $15,000 car loan.

Betty's car will be paid for in three years, and she plans on driving it for at least eight years. Once her car is paid for, she will continue to budget for the car payment but will invest the money to further build her wealth.

TAKE STEPS TO CONTROL YOUR DEBT

Credit card	Debt	Interest rate	Monthly interest*
Department Store A	$ 500	19.5%	$ 8.13
XYZ Bank	$ 1,250	17%	$ 17.71
BHA Finance Co.	$ 1,000	22%	$ 18.33
Store B	$ 250	15%	$ 3.13
Total	$ 3,000		$ 47.30

*Interest rate divided by 12 months multiplied by the amount of debt.

Credit card	Debt	Interest rate	Monthly interest
Total			

As you can see, a big part of building wealth is making wise choices about debt. You need to maximize assets and minimize liabilities to maximize net worth. To manage debt you need to know how much you have and develop strategies to control it. When Bob decided to reduce his credit card debt of $3,000 (see page 4), he analyzed his debt and developed a strategy to reduce it.

To reduce his credit card debt and the monthly interest he paid, Bob also decided to find a card with a lower interest rate and transfer the $3,000 balance to that account. Bob reviewed his budget and cut expenses. He found a card with an interest rate of 9 percent, reducing his monthly interest expense by $24.80. He cut up the old credit cards and used the $24.80 in interest savings to pay more of the debt principal each month. He only used the new card for emergencies.

What is your credit card debt situation? Using the chart to the left, do an analysis of your own.

My strategy for reducing credit card debt includes:

1. ______________________________

2. ______________________________

3. ______________________________

Review

Redefining Wealth

Now that you've read this workbook and thought about the information it contains, how would you define wealth? In the space provided, write your definition. Then compare it with the definition you wrote back on page 1. Has your definition of wealth changed?

Resetting Your Financial Goals

Now, write your financial goals and compare them with your original goals. Keep these new goals with your definition of wealth. Periodically refer to your goals and measure your **Assets – Liabilities = Net Worth** to make sure your wealth-building program stays on track.

Using Key Wealth-Building Strategies

Now, write your own strategies for building wealth. Keep in mind the following:

- Educate yourself about money.
- Establish financial goals.
- Create a budget.
- Save each month, using automatic deduction.
- Take advantage of compound interest.
- Take advantage of tax-deferred investments.
- Research and learn about the best investments for you based on your financial goals, time horizon and tolerance for risk.
- Control debt.

Start budgeting, saving and investing *today*. Every day counts in building wealth.

Wealth is:

____

____

____

____

____

My short-term goals are:

1. ______________________________
2. ______________________________
3. ______________________________

My long-term goals are:

1. ______________________________
2. ______________________________
3. ______________________________

My strategies for building wealth are:

1. ______________________________
2. ______________________________
3. ______________________________

My strategies for controlling debt are:

1. ______________________________
2. ______________________________
3. ______________________________

Clip the box and put it where you will see it often: inside your checkbook, on your computer monitor, where you pay your bills, on your bathroom mirror. Keep your definition of wealth and your goals firmly implanted in your mind and use your wealth-creating and debt-controlling strategies every day.


budget to save
save & invest
control debt
build wealth

GLOSSARY

Acceleration clause A stipulation in a loan contract stating that the entire balance becomes due immediately if other contract conditions are not met.

Accrued interest Interest that has been earned but not received or recorded.

Amortization Liquidation of a debt by making periodic payments over a set period, at the end of which the balance is zero.

Annuity A series of equal payments made at regular intervals, with interest compounded at a specified rate.

Appreciation An increase in the value or price.

Asset Anything an individual or business owns that has commercial or exchange value.

Balance The amount owed on a loan or credit card or the amount in a savings or investment account.

Balance sheet A financial statement showing a "snapshot" of the assets, liabilities and net worth of an individual or organization on a given date.

Bankruptcy A legal proceeding declaring that an individual is unable to pay debts. Chapters 7 and 13 of the federal bankruptcy code govern personal bankruptcy.

Budget An itemized summary of probable income and expenses for a given period.

Capital Cash or other resources accumulated and available for use in producing wealth.

Cash flow Money coming to an individual or business less money being paid out during a given period.

Certificate of deposit (CD) A type of savings account that earns a fixed interest rate over a specified period of time.

Collateral Assets pledged to secure a loan.

Common stock A kind of ownership in a corporation that entitles the investor to share any profits remaining after all other obligations have been met.

Compound interest Interest computed on the sum of the original principal and accrued interest.

Credit The granting of money or something else of value in exchange for a promise of future repayment.

Credit bureau An organization that compiles credit information on individuals and businesses and makes it available to businesses for a fee.

Credit card A plastic card from a financial services company that allows cardholders to buy goods and services on credit.

Credit rating An estimate of the amount of credit that can be extended to an individual or business without undue risk.

Credit report A loan and bill payment history, kept by a credit bureau and used by financial institutions and other potential creditors to determine the likelihood a future debt will be repaid.

Credit union A cooperative organization that provides financial services to its members.

Creditor A person, financial institution or other business that lends money.

Debt Money owed; also known as a *liability.*

Debt service Periodic payment of the principal and interest on a loan.

Debit Charges to an account.

Debit card A plastic card similar to a credit card that allows money to be withdrawn or the cost of purchases paid directly from the holder's bank account.

Delinquency The failure to make timely payments under a loan or other credit agreement.

Diversification The distribution of investments among several companies to lessen the risk of loss.

Dividend A share of profits paid to a stockholder.

Equity Ownership interest in an asset after liabilities are deducted.

Face value The principal amount of a bond, which will be paid off at maturity.

Fair market value The price a willing buyer will pay and a willing seller will accept for real or personal property.

Federal Deposit Insurance Corp. (FDIC) A federally chartered corporation that insures bank deposits up to $100,000.

Finance company A company that makes loans to individuals.

Financing fee The fee a lender charges to originate a loan. The fee is based on a percentage of the loan amount; one point is equivalent to 1 percent.

Foreclosure The legal process used to force the payment of debt secured by collateral whereby the property is sold to satisfy the debt.

401(k) plan A tax-deferred investment and savings plan that serves as a personal retirement fund for employees.

General obligation bond A type of municipal bond backed by the full faith and credit of the governmental unit that issues it.

Individual development account (IDA) A type of savings account, offered in some communities, for people whose income is below a certain level.

Individual retirement account (IRA) A retirement plan, offered by banks, brokerage firms and insurance companies, to which individuals can contribute each year on a tax-deferred basis.

Industrial bond A financial instrument issued by businesses primarily to fund expansion or acquisitions.

Interest A fee for the use of money over time. It is an expense to the borrower and revenue to the lender. Also, money earned on a savings account.

Interest rate The percentage charged for a loan, usually a percentage of the amount lent. Also, the percentage paid on a savings account.

Investor An organization, corporation, individual or other entity that acquires an ownership position in an investment, assuming risk of loss in exchange for anticipated returns.

Installment plan A plan requiring a borrower to make payments at specified intervals over the life of a loan.

Investing The act of using money to make more money.

Leverage The ability to use a small amount of money to attract other funds, including loans, grants and equity investments.

Liability Money an individual or organization owes; same as *debt.*

Lien A creditor's claim against a property, which may entitle the creditor to seize the property if a debt is not repaid.

Liquidity The ease with which an investment can be converted into cash.

Load The fee a brokerage firm charges an investor for handling transactions.

Loan A sum of money lent at interest.

Management fee The fee paid to a company for managing an investment portfolio.

Market value The amount a seller can expect to receive on the open market for merchandise, services or securities.

Maturity The time when a note, bond or other investment option comes due for payment to investors.

Money market savings account A type of savings account offered by a financial institution.

Mortgage A temporary and conditional pledge of property to a creditor as security for the repayment of a debt.

Municipal bond A bond issued by cities, counties, states and local governmental agencies to finance public projects, such as construction of bridges, schools and highways.

Mutual fund A pool of money managed by an investment company.

Net worth The difference between the total assets and total liabilities of an individual.

Par value The nominal, or face, value of a stock or bond, expressed as a specific amount on the security.

Pretax A person's salary before state and federal income taxes are calculated.

Predatory lending Targeting loans to elderly, low-income and other people to take advantage of their financial status or lack of financial knowledge.

Prime rate The lowest interest rate on bank loans, offered to preferred borrowers.

Principal The unpaid balance on a loan, not including interest; the amount of money invested.

Promissory note A written promise on a financial instrument to repay the money plus interest.

Qualified plan A tax-deferred retirement plan for the self-employed.

Risk The possibility of loss on an investment.

Return The profit made on an investment.

Revenue bond A type of municipal bond backed by revenue from the project the bond finances.

Savings account A service depository institutions offer whereby people can deposit their money for future use and earn interest.

Stockholder A person who owns stock in a company and is eligible to share in profits and losses; same as *shareholder.*

Tax-deferred Phrase referring to money that is not subject to income tax until it is withdrawn from an account, such as an individual retirement account or a 401(k) account.

Term The period from when a loan is made until it is fully paid.

Terms Provisions specified in a loan agreement.

Treasury bill A short-term investment issued by the U.S. government for a year or less.

Treasury bond A government security with a term of more than 10 years; interest is paid semiannually.

Treasury note A government security with a maturity that can range from two to 10 years; interest is paid every six months.

U.S. savings bond A nontransferable, registered bond issued by the U.S. government in denominations of $50 to $10,000.

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