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Starting Your Investment Program With $1 to $1,000

Lesson Four: What's What in Savings and Investments? Savings

Lesson Handout

Savings provide money for you to use to pay for debts, seasonal expenses, emergencies or other things you will need in near future. Savings allows you to store money temporarily and keep it safe until you need it. When choosing savings accounts, you want to place your money so it is safe, liquid, and gets as much earnings as you can. This lesson identifies financial products you can use to save money for your short-term goals. Having money automatically deducted into savings will help you meet your short-term needs and goals.

Savings Accounts or Share Accounts

Savings accounts are a safe way to accumulate money, have your money readily available, and earn interest. Interest rates paid on passbook savings accounts vary according to current market interest rates. Currently, they pay around .75%. They pay less during low interest rate periods and more during high interest rate periods. Your earnings will depend on the interest rate and how frequently it is compounded. Some banks require a minimum deposit to open an account.

A savings account has several advantages. It is a convenient way to save regularly. You can establish a payroll deduction plan or have it deducted from your checking account. Savings accounts have high liquidity. They are available on demand. They are safe. There is low risk. There is little or no minimum balance. Deposits and withdrawals can be made at any time.

There are also disadvantages. They pay low interest rates compared to other investments. There may be service charges for low balances or too many withdrawals in a specific period of time. Some limit the amount of cash you can withdraw at one time. They are not a good hedge against inflation.

Holiday Club Account

Holiday club accounts are a special-purpose savings account. These accounts require a fixed monthly or biweekly deposit over a period of months, usually through a payroll deduction. You withdraw the balance at the end of the period. Interest rates on these accounts vary.

Interest Checking Accounts

Interest checking accounts are checking accounts that pay interest. You must maintain a minimum or average monthly balance to earn interest and avoid charges. Interest rates vary. Minimums and average monthly balances vary from $300 to more than $1,000. Deposits and withdrawals are unlimited.

Most financial institutions offer packages that include interest bearing checking accounts and a bundle of other services, such as a debit card, on-line banking and free ATM services. Review very carefully the terms offered by your bank, credit union or other financial institution. You may be charged fees if you have more than the allowed number of transactions in any month, or if your balance falls below a certain amount.

Certificates of Deposit (CD)

A Certificate of Deposit (CD) is a time deposit account. You promise to leave a lump sum in the account for a specified period of time. If you cash a CD before it matures, there will be a penalty for early withdrawal. The time period may range from seven days to several years. CDs have minimum deposit requirements usually starting at $500. They pay higher interest rates than standard savings accounts and the rate increases as the length of the deposit period increases. The longer the deposit period, the higher the yield. CDs are available from a bank, brokerage firm, savings association or credit union.

CDs sold by brokerage firms frequently pay higher yields than banks and savings and loan associations. They can be redeemed early without penalty. But, if interest rates rise after your certificate is issued, you'll take a loss. Your principal will be reduced by an amount sufficient to make the yield competitive with rates on newly issued securities.

CDs are insured up to $250,000 for each depositor at banks, savings banks, savings and loans, and credit unions. Banks, savings banks and savings and loans are insured by the Federal Deposit Insurance Corporation (FDIC). Federal Credit

Unions are insured by the National Credit Union Administration (NCUA). If you buy from a brokerage firm, your account is insured by the Security Investor's Protection Corporation (SIPC). The SIPC insures an account up to $500,000. Of this amount, no more than $100,000 may be cash left with the firm. The SIPC insures you against the firm going bankrupt. It does **not** insure you against trading and transaction losses. Most financial institutions are insured, but not all are. So you may want to check to see that the financial institution you place your money with is insured.

Money Market Deposit Account (MMDA)

Money market deposit accounts earn fluctuating market rates. Rates are tied to current market interest rates. They rise as interest rates rise and fall as interest rates fall. They require a minimum balance of $1,000 to $2,500 depending on the institution. If your balance drops below the minimum, your interest rate will drop to a lower rate or there will be a monthly fee. Often, the higher your balance, the higher your interest rate will be. You are limited to three check withdrawals and three telephone transfers per month. They are available from banks, savings banks, savings and loans, and credit unions. They are insured up to $250,000 per depositor.

Money Market Mutual Fund

A money market fund is a mutual fund that pools the money from many investors and invests in short-term debt instruments or securities. Short-term securities include Treasury bills, certificates of deposit, bankers acceptance and commercial paper.

Treasury bills are obligations issued by the U.S. government in maturities of three, six and twelve months. *Certificates of Deposit* of banks are obligations of the issuing bank to pay the face amount plus interest at maturity. Most CDs mature from 30 days to four months after purchase. *Commercial paper* is a negotiable short-term promissory note issued by a major corporation. A *banker's acceptance* is a short-term credit instrument that a bank has promised to honor at maturity. The maximum maturity is nine months.

Money market funds provide income, liquidity and a high degree of safety. An account may be opened in some funds for as little as $500. You can add to a money market fund at anytime in varying increments depending on the fund. Interest is paid daily and compounded. You may receive your dividends by check each quarter or month or you may have them automatically reinvested. Yields are tied to the current cost of money. There is generally a slight lag when rates shift.

The yield varies daily, depending on changes in the actual money market securities in which the fund invests. If interest rates rise, so will your earnings. If interest rates go down, so will your earnings.

There are no sales commissions, or loads, on the purchase of shares in money market funds. The entire purchase price is invested.

Money market funds offer liquidity. You may transfer into other mutual funds offered by the same advisory service. They are generally considered safe, because they buy U.S. government-backed debt or that of well-rated corporations. Money market funds are available through major insurance companies, brokerage firms and mutual fund investment companies.

Life Insurance Cash Value

Whole life insurance offers protection and cash value. The cash value grows over the life of the policy. You can borrow against the cash value while keeping the policy in force. Or you can take out your cash value and cancel the policy. If you no longer need life insurance protection when you reach retirement age, you can use the cash value, if it is of sufficient size to buy an annuity. The annuity can provide monthly payments for as long as you live. There are several variations of whole life insurance.

Whole life insurance provides permanent insurance protection. The policy stays in force for the lifetime of the insured, unless the policy is canceled or lapses. The premium is fixed. It requires a specific, regular payment. The death benefit and cash value are fixed also. Earnings generated by the policy are not taxed while the policy is in force.

Universal life insurance provides permanent insurance protection. The premium and death benefits are flexible. Premium payments can be made at any time and in any amount after the initial payment—provided enough cash value has accumulated to pay for the cost of the insurance protection. You can reduce or increase the amount of death protection in the same policy with satisfactory evidence of insurability. Acquiring more insurance in a traditional term or whole life policy usually means buying new policies. There is a yearly charge for the insurance protection and for administrative expenses. These charges might result in a loss to policyholders if surrendered shortly after issue.

The funds not used to buy insurance protection or pay administrative fees build up as cash value. The cash value depends on the amount of premiums you have paid. Your cash value is credited with tax-deferred interest that reflects current market conditions. The earnings are not taxed while the policy is in force.

Variable life insurance provides permanent protection. Life insurance premiums are fixed. Policyholders control the investment of their cash values in separate stock, bond, money market or other accounts. The death benefit and cash value vary in relation to the performance of funds in a separate account. Earnings generated by the policy are not taxed while the policy is in force.

Summary

Savings provide money to pay for debts, seasonal expenses, emergencies or other things you will need in the near future. Savings allow you to save money for your short-term needs in a way that is safe, liquid, and pays you some earnings. Having money automatically deducted into savings will help you meet your short-term goals.