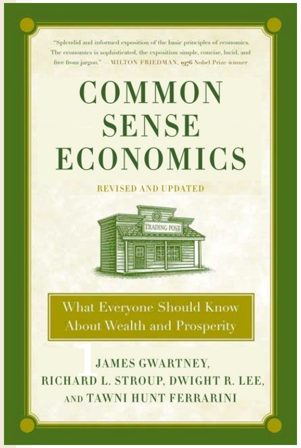
Part 4: Twelve Key Elements of Practical Personal Finance



Common Sense Economics ~
What Everyone Should Know About Wealth and Prosperity

http://CommonSenseEconomics.com/

Turn on the learning light!

Introduction to PowerPoint Slides

- The PowerPoint slides for the Common Sense Economics (CSE) electronic package provide an overview of the most important points covered in the text. Students should read the text, watch the assigned videos, and listen to the podcasts prior to reviewing the slides.

- The PowerPoint slides are organized by module, which reflects the approximate amount of material most instructors will cover weekly during a regular school term. The 15 core modules cover all of the CSE text. Modules 12, 13, 14, and 15 covering part 4 of CSE are presented here. The slides for each module are organized as follows: (1) module title and list of concepts covered, (2) highlights and explanation of text material, including the CSE elements covered by the module, and (3) questions for thought.

- Some instructors may want to use the PowerPoint slides for classroom instruction. The slides will provide students with a comprehensive set of notes and explanatory material for the CSE text.

Module 12: Earning, Budgeting, and Spending Wisely

- CSE Part 4, Elements 1, 2, and 3
- Concepts Covered:
  - Comparative advantage and discovery of career opportunities
  - Entrepreneurship, productivity, and personal success
  - Attitudes, productivity, and personal success
  - Budgeting and getting more out of your income

Financial Anxiety of Americans

- Compared to Americans a couple of generations ago and their contemporaries worldwide, Americans have incredibly high incomes. Yet, many are under financial stress. Why?
  - Most Americans spend without a plan, save very little and are heavily indebted. Financial insecurity is mainly the result of the choices we make, not the incomes we earn.

Planning for Financial Success

- If you do not take charge of your finances, they will take charge of you.
  - As Yogi Berra, the great American philosopher (and late baseball star) said, “You’ve got to be very careful if you don’t know where you are going, because you might not get there.”

- Each of us needs a plan. The twelve elements in this part form the core of a practical plan. They will help you make better financial decisions whatever your current age, income level, or background.

Thoughts on The Importance of Money and Wealth

- There is more to a good life than making money. When it comes to happiness, nonfinancial assets such as a good marriage, family, friends, fulfilling work, religious convictions, and enjoyable hobbies are more important than money.

- However, there is nothing wrong with a desire to make more money and spend it wisely. No matter what our objectives in life, they are easier to achieve if we have higher earnings, less debt, and more wealth. Thus, all of us have an incentive to improve our financial decision-making.

Element 1. Discover your comparative advantage.

Discover Your Comparative Advantage

- You need to take charge of your career development and plan how you can best develop your talents and use market cooperation to achieve your goals. No one else cares more about your personal success than you do. Neither does anyone else know more about your interests, skills, and goals.

- No matter how talented you are, you will be relatively more productive in some areas than others. You need to discover those areas where you have a comparative advantage.

Thinking About your Career

- Two factors that are crucially important when making career choices.
  1. You need to develop skills and cultivate attitudes that will enhance your ability to provide others with goods and services that they value highly. People earn income by helping others. If you want to achieve earning success, you need to figure out how you can help others a lot.
  2. You need to discover where your passions lie—those productive activities that provide you with the most fulfillment. Competency and passion for an activity go together. If you enjoy what you do and believe it is important, you will be happy to do more of it and work to do it better. Moreover, real wealth is measured in terms of personal fulfillment.

Element 2. Cultivate skills, attitudes, and entrepreneurship that increase productivity and make your services more valuable to others.

Productivity and Earnings

- How can you increase your productivity, and therefore your earning power?
  - Improved knowledge, higher skill level, and experience generally increase productivity and enhance one's ability to provide valuable services to others. As a result, investments in human capital—education, training, and other forms of skill acquisition—can improve both productivity and earnings.

- But, other personal attributes also influence productivity. Two of the most important are personal attitudes and thinking entrepreneurially.

Cultivating Attitudes That Will Improve Your Productivity

- **Success oriented attributes:**
  - honesty, dependability, persistence, reliability, trustworthiness, respect for others, desire to learn and improve, and ability to work with others.

- **Failure oriented attitudes:**
  - disrespect for others, unreliability, quarrelsome, contempt for education, vulgarity of speech, blaming others for problems, dishonesty, and reliance on alcohol and drugs.

Cultivating Attitudes That Will Improve Your Productivity continued…

- If you want to be successful, you need to cultivate, develop, and strengthen the first set of attributes.

- They need to become habits—the core values of your life. Equally important, you need to cast the second set out of your life. Do not let anyone, including friends, convince you that any of the failure attributes are “cool”.

Cultivating the Entrepreneurial Way of Thinking

- Entrepreneurial thinking is also a personal attribute that can enhance your productivity. While entrepreneurship is often associated with business, in a very real sense all of us are entrepreneurs. We are constantly making decisions about the development and use of knowledge, skills, and other resources under our control.
- Entrepreneurial thinking focuses on how to develop and use talents and mobilize available resources to provide others with things that they value highly.

Characteristics of Self-Employed Entrepreneurs

- Self-employed entrepreneurs are disproportionately represented among the financially successful.
- Four major factors contribute to the financial success of self-employed entrepreneurs. They:
  1. identify and act on attractive opportunities overlooked by others,
  2. have a willingness to take risk,
  3. have high rates of saving and investment, and
  4. have a willingness to work long hours because they love what they do.

Employees and Entrepreneurial Characteristics

- Employees can also make choices like those of successful entrepreneurs. They can:
  - focus on making their services valuable to employers, both current and prospective.
  - invest their savings in stocks and thereby achieve the above-average returns that come with the risk of business ownership.
  - generate more income and accumulate wealth through higher rates of investment and more hours of work.

Development of Talents and Earned Success

- Development and use of your talents in ways that provide large benefits to others is a key to financial success.

- It is also central to what Arthur Brooks calls "earned success." Moreover, earned success is the central element of happiness and life satisfaction.

- Earned success is present when your education, work, and lifestyle choices reflect the purpose of your life.

ELEMENT 3. USE BUDGETING TO HELP YOU SPEND YOUR MONEY EFFECTIVELY AND SAVE REGULARLY.

Money is only a tool. It will take you wherever you wish, but it will not replace you as the driver.

—Ayn Rand

WHAT IS BUDGETING?

- What is the purpose of a budget?
  - A budget is an instrument that will help you channel your funds toward sound spending, regular saving, and diversified investments in a manner that will provide you with the most value from your income.

WHAT IS BUDGETING? CONTINUED…

- Effective budgeting is an ongoing process, not a one-time event. It is comprised of two specific actions.
    1. You must create the initial budget which is simply a document that identifies all of your planned or expected spending for a period of time, generally a month.

    2. You need to keep track of your actual spending and make needed budget adjustments. This will provide you with a feedback mechanism that will help you develop a better, more precise budget in the future.

Importance of Saving in Your Budget

- Saving and investment should be specific items in your budget, not just a leftover balance.
  - You need to save for unexpected expenditures, repayment of outstanding debts, down payments for large purchases, the achievement of important goals, and retirement.

- Consuming less and saving more today will make it possible for you to consume more in the future.

- Saving and investment will help you build wealth.

Steps for Successful Budgeting

- Budgeting your income and monitoring your behavior will help you evaluate your spending and direct it toward the categories that will provide you with the most value. Four simple steps will get you on the path to financial stability.
  - **Step 1. Start now as this will increase the likelihood of success!**
    - Don’t fool yourself into thinking that budgeting is only for people with jobs, or high salaries, or that you’ll start “later.”
  - **Step 2. Set goals.**
    - Use your goals to motivate your actions. Set short-, medium-, and long-term financial goals and incorporate a plan to achieve them into your budget.

Steps for Successful Budgeting continued…

- **Step 3. Get tools to assist with your budgeting.**
  - Don’t recreate the wheel by starting with a blank piece of paper to develop a budget. With today’s websites, spreadsheets, and apps, budgeting has never been easier.

- **Step 4. Devise a plan of action.**
  - Create a personal budget with actual and proposed items.

"An Afternoon Coffee Anyone?" An Example of the Power of Saving

- Many people buy a premium cup of coffee, soda, bottled water, caffeinated drink or some other beverage each day. Assume each drink costs $2.
  - At the age of 22, stop buying a drink each day and place that $2 per day into an investment.
  - At the age of 24 bump it up by $1 and save $3 a day. Your income will likely increase. So, it should be easy.
  - At the age of 26, increase your daily savings to $4 a day.
  - Do this until you are 30 years of age and you will have saved $9,490 plus interest. Pretty good.
  - By the time you retire at age -sixty--seven, that early start can easily add $153,305 to your wealth if invested wisely at about 7 percent a year. (More on this expected rate of return later.)

Commitment is Essential for Successful Budgeting.

- Dave Ramsey, one of the nation's leading financial advisors, highlights the importance of making a personal commitment to forming sound money habits. He claims:
  - "The thing I have discovered about working with personal finance is that the good news is that it is not rocket science. Personal finance is about 80 percent behavior. It is only about 20 percent head knowledge."
- After reading Part 4, you will have the head knowledge. Are you ready to commit to aligning your consumption, saving, borrowing, and earning decisions with those that promise financial stability and lead to a rewarding life?

Module 12: Questions for Thought

1. Identify a failure oriented attitude in your life and develop a plan for self-improvement in this area.

2. Suppose someone tells you that your attitudes are your own business and that you should not let others change them. Is this good advice? Why or why not?

Module 12: Questions for Thought

3. How would entrepreneurial thinking influence your educational choices? How would it influence your actions as an employee?

4. Are goals important in formulating your budget? Explain how you can use budgeting to achieve personal goals to motivate yourself.

Module 13: Saving and Wise Use of Credit

- CSE Part 4, Elements 4, 5, and 6
- Concepts Covered:
  - Strategic spending: used versus new
  - Dangers of debt and credit card use
  - Prudent saving: planning for a “rainy day”

Element 4. Don't finance anything for longer than its useful life.

The Economics of Financing

- Financing makes it possible for you to buy now and pay later.
- Financing an item over a time period lengthier than the useful life of the asset will force you to pay in the future for something that is no longer of value.
- This will increase you indebtedness and make you poorer in the future.

When Does Financing Make Sense?

- There are two major situations that justify financing.
  - Long lasting assets that provide service. When a long-lasting asset is financed and paid for before the asset is worn out, you are merely paying for the good as you use it. Finance of housing and automobiles provide examples.
  - Assets that will yield future income. Investments are sound when they enhance future income by an amount sufficient to repay the borrowed funds with interest. Educational investments often, but not always, meet this criteria.
- Rule of thumb: Do not borrow to finance anything other than housing, automobiles, and education.

When is Financing Dangerous?

- It does not make sense to finance consumer non-durables, goods that are consumed immediately or depreciate in value quickly.
  - Examples: food, clothing, vacations, nights-out-with-friends, concerts, and tickets to ballgames.

- Borrowing for these items will lead to future payments, reductions in wealth, frustration, bitterness, and financial insecurity.

ELEMENT 5. TWO WAYS TO GET MORE OUT OF YOUR MONEY: AVOID CREDIT-CARD DEBT AND CONSIDER PURCHASING USED ITEMS.

Prudent Use of a Credit Card

- Pay off the balance in full each month
- Do not buy the item if you cannot afford to pay for it immediately.
- If you are unable to discipline yourself in this area, cut up your credit card and use only cash.

Prudent Use of a Credit Card continued…

- Paying with a credit card is not spending your own money, but borrowing someone else's if you do not pay right away.

- Interest rates on credit cards are high because they are unsecured. Interest rate charges will be far greater than what you can earn on savings and investments.

- Think of your credit card as an extension of your checking account; always pay off your credit card balance each month.

It Takes How Long?

- You buy new clothes, go to a once-in-a-life-time concert with friends and buy more and more until you gradually hit your credit limit of $3000 at 18%. You can only manage to pay the minimum of $50 each month.

- How many months will it take you to pay the credit card off?
  - 47, 80, 100 or 155 months?
  - 155 months, almost 13 years!

You Paid How Much?

- You buy new clothes, go to a once-in-a-life-time concert with friends and buy more and more until you gradually hit your credit limit of $3,000 at 18%. You can only manage to pay the minimum of $50 each month.
- How much does the $3,000 end up costing you in interest?
  - $360, $720, $1,300, or about $4,700?
  - $4,745.35 in interest! And the items costing $3,000 are gone, and it will take you 155 months to be rid of your debt—so don't do it!

Consider Buying Used

- Is buying new worth it?
- Depreciation costs make new cars expensive. They depreciate substantially when driven off the lot and they depreciate rapidly in the first three years.
- Used cars may have slightly higher maintenance costs but their depreciation costs are much lower.
- Consider buying used! Visit Edmunds.com and compare.

Consider Buying Used

- Many items are just as functional used as new and often much less expensive.
- Craigslist, eBay, and apps provide alternatives which reduce transaction costs and make it easy to buy used items.

Element 6. Begin paying into a "rainy day" savings account every month.

Rainy Days and the Real World

- Life is full of surprises, and they're usually expensive.
  - Cars break down.
  - Computers crash and smart phones die.
  - Heaters and air conditioners go out.
  - People get sick or injured.

Plan for Your Rainy Days

- Put a plan in place to cover expenses that are uncertain with regard to timing, but certain with regard to their occurrence.

- You need a rainy day savings fund for these expenses in your budget.
  - Make contributions into your rainy day fund a mandatory part of your monthly budget.
  - You can purchase peace of mind by building a rainy day fund.

Module 13: Questions for Thought

1. What are the major costs of owning and operating a car? Note: the following website will be useful: Edmunds.com

2. What are some items that can safely be purchased with borrowed funds? What are some items that definitely should not be purchased with borrowed funds? Why?

3. What are the dangers involved in the use of credit cards? How can you reduce these risks?

Module 13: Questions for Thought

4. What is the purpose of a rainy day fund? How much saving should you keep in your rainy day fund? Why?

Module 14: Investing and Building Wealth

- CSE Part 4, Elements 7, 8, and 9
- Concepts Covered:
  - Power of compound interest
  - Diversification and reducing investment risk
  - Risk and return: stocks versus bonds
  - Random walk theory and stock prices
  - Indexed versus managed equity funds

Element 7. Put the power of compound interest to work for you.

Compound interest is the most powerful force in the universe.

—Albert Einstein

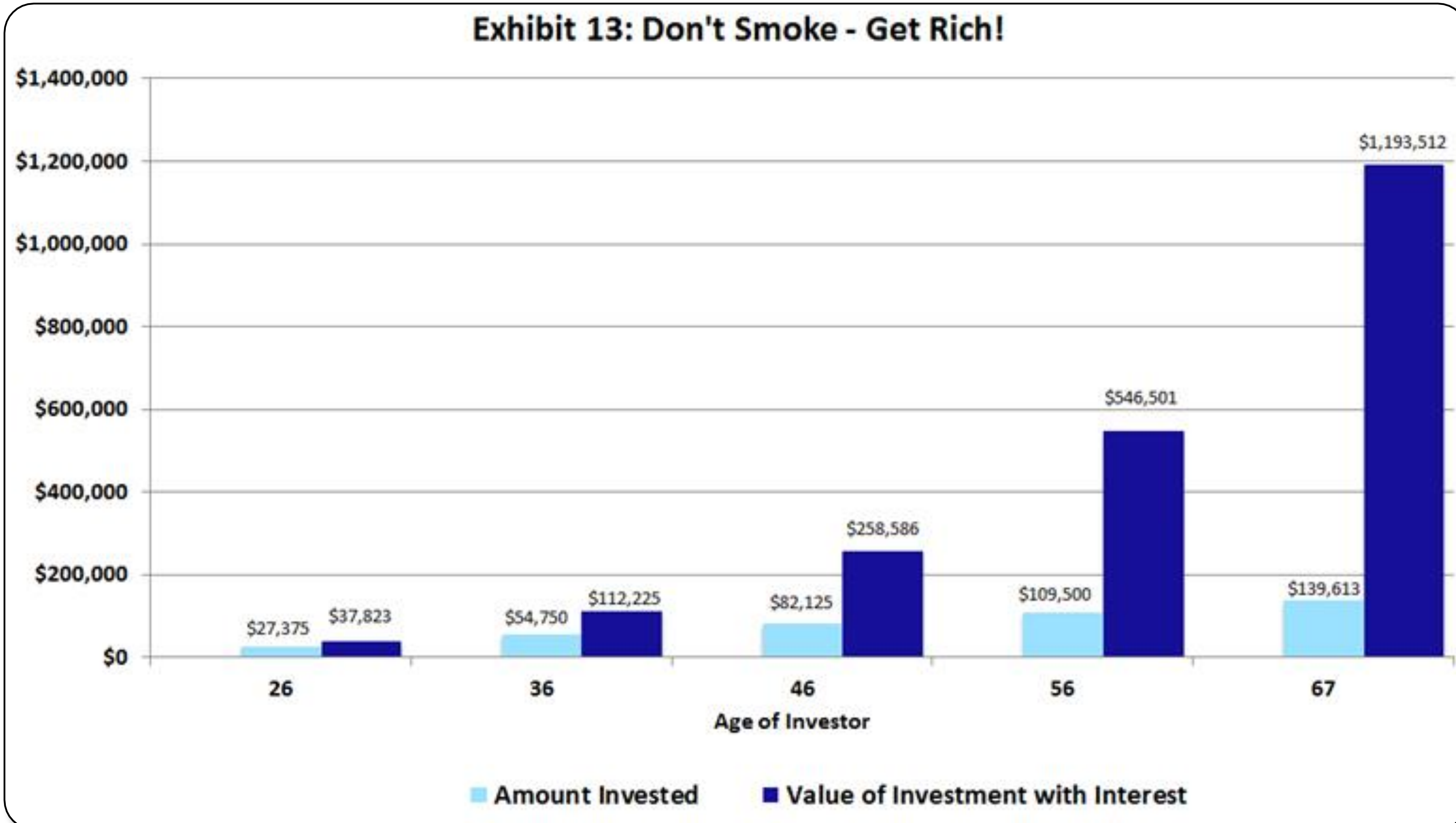
The Power of Compound Interest

- Save and invest regularly; there is a large payoff.

- Compound interest is simply earning interest on interest.
  - If you don't spend the interest earned on your savings this year, the interest will add to both your savings and the interest earned next year.
  - By doing the same thing each year in the future, you then earn interest on your interest on your interest, continuously.
  - It's like a small snowball rolling down a snow-covered mountain.

Compound Interest and the Rule of 70

- The rule of 70 estimates the length of time it will take for your money to double.
  - Dividing 70 by the annual rate of return indicates the number of years it will take for your funds to double.
  - For example, if the interest rate were 5 percent, it would take 14 years for the funds to double (70 divided by 5 = 14).



- This exhibit illustrates the power of compound interest with a hypothetical sixteen year-old who decides to save $7.50 per day (the cost of a pack of cigarettes) instead of smoking.
- By retirement at age 67, the amount saved will grow to $1,193,512 at a 7 percent annual interest rate!

Compound Interest: Key Lessons

- In order to accumulate substantial funds for retirement,
  - start early, make minor sacrifices to save regularly, know how to get a reasonable return on your savings, and take advantage of the power of compound interest.
- Ordinary people can have a high standard of living and still accumulate a lot of wealth because it does not take much savings to get a big payoff.
  - As the prior exhibit illustrates, of the $1,193,512 accumulated by not smoking, only $139,613 came from reducing consumption.
  - Over the long-term, people who save and invest will be able to consume far more than those who do not.

Element 8. Diversify—don't put all your eggs in one basket.

Stocks and Bonds

- The two most common financial assets are stocks and bonds.
  - **Stock:** Ownership shares of a corporation. Corporations raise funds by issuing stock ownership shares, which entitle the owners to a proportional share of the firm's profits. The stock owners are not liable for the debts of the corporation beyond their initial investment. However, there is no assurance that the owners will receive either their initial investment or any return in the future.

  - **Bond:** A promise to repay the principal (amount borrowed) plus interest at a specified time in the future. Organizations such as corporations and governments issue bonds as a method of borrowing from bondholders.

Diversification and Reducing Risk

- You can reduce your risk through diversification—holding a large number of unrelated assets.
  - Diversification puts the law of large numbers to work for you. While some of the investments in a diversified portfolio will do poorly, others will do extremely well. The performance of the latter will offset that of the former, and the rate of return will converge toward the average.

Diversification and Reducing Risk continued…

- Historically, stock ownership has been a source of high returns.
  - During the last two centuries, corporate stocks yielded a real rate of return (real means adjusted for inflation) of approximately 7 percent per year, compared to a real rate of return of about 3 percent for bonds.

- Mutual funds provide a low-cost method for small investors to diversify their stock holdings.
  - **Equity mutual fund:** An entity that pools the funds of investors and uses them to purchase a bundle of stocks.

Avoid Double Jeopardy

- Some employers offer investment programs that will match your purchases of company stock. If you have substantial confidence in the company, you may want to take advantage of this offer.
- After a holding period, typically three years, you may sell the shares of the company stock and use the proceeds to undertake other investments. As soon as you are permitted to do so, you should choose this option.
  - Failure to sell the company stock, puts you in double jeopardy. You would be beholden to your company both for current employment and retirement income. If your company fails, you would lose both.

Element 9. Indexed equity mutual funds can help you beat the experts without taking excessive risk.

The Random Walk Theory

- The **random walk theory** indicates:
  - Current stock prices reflect the known information about a company.
  - Unforeseeable events drive changes in stock prices.
  - Since future changes are driven by unforeseen events, no one can persistently pick the winners.

- **Implications of Random Walk Theory:** The future movement of stock prices will be determined by surprise occurrences, which will cause prices to change in an unpredictable or random fashion.

Two Types of Equity Funds

- **Managed Equity Mutual Fund:** An equity mutual fund that has a portfolio manager who decides what stocks will be held in the fund and when they will be bought or sold. A research staff generally provides support for the fund manager.
- **Indexed Equity Mutual Fund:** An equity mutual fund that holds a portfolio of stocks that matches their share (or weight) in a broad stock market index such as the S&P 500. The overhead of these funds is usually quite low because their expenses on stock trading and research are low. The value of the mutual fund shares will move up and down along with the index to which the fund is linked.

Indexed Equity Funds vs. Managed Funds

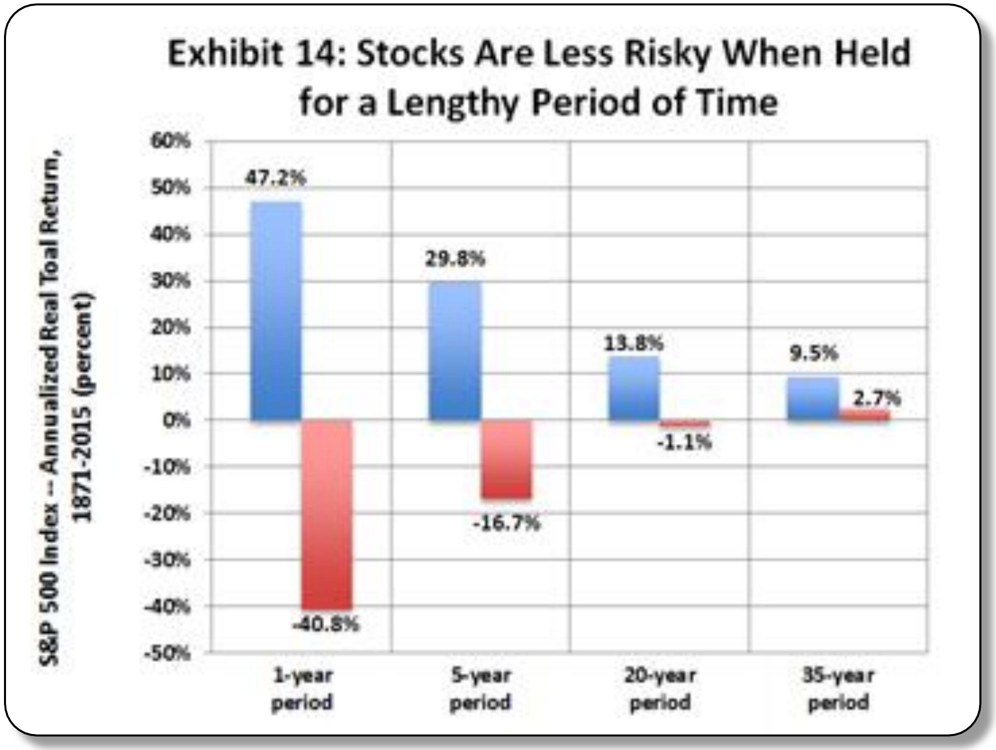
- **Managed funds:** administrative costs are generally high because of (a) the costs of employing a research staff and (b) the costs associated with a high volume of stock trading.
- **Indexed funds:** administrative costs are lower than managed funds because (a) there are no costs of employing a research staff and (b) the volume of stock trading is low.
  - Thus, a larger share of the investor's funds are channeled into stock investments.
- An equity mutual fund indexed to a broad stock market indicator such as the S&P 500 will earn approximately the average stock market return for its shareholders.

Indexed Equity Funds vs. Managed Funds continued…

- Historically, the average long-term yield of indexed equity funds has been higher than that of managed funds. This is not surprising because, as the random walk theory indicates, not even the experts will be able to forecast consistently the future direction of stock prices with any degree of accuracy.
  - Over a typical decade, index funds tied to the S&P 500 have yielded a higher return than 85 percent of the actively managed funds.
  - Over twenty-year periods, the index funds have outperformed about 98 percent of the actively managed funds.

STOCK RETURNS AND THE LONG-RUN

- This exhibit shows the highest and lowest average annual returns of the S&P 500 for various time intervals.
- When held over a lengthy period of time, this diverse holding of stocks has historically yielded both a high and relatively stable rate of return.



Source: Linqun Liu, Andrew J. Rettenmaier, and Zijun Wang, "Social Security and Market Risk," National Center for Policy Analysis Working Paper Number 244 (July 2001).

Stock Returns and the Long-Run

- As the previous exhibit indicates, the highest and lowest returns on stocks converge as the length of the investment period increases.
  - When a 35-year period is considered, the compound annual rate of return for the highest 35 years between 1871 and 2015 was 9.5 percent, compared to 2.7 percent for the lowest 35 years.
  - The annual real return of stocks during the worst-case scenario was about the same as the real return for bonds.
- When held over a lengthy time period, the high and relatively stable return of stocks makes them particularly attractive as a retirement investment.

Module 14: Questions for Thought

1. What is compound interest? How does compound interest affect the importance of starting a saving and investment program at an early age? Explain.

2. Historically, stocks have earned a higher rate of return than bonds. What is the primary reason why this has been the case?

3. What are the implications of the random walk theory of stock prices with regard to the ability of "experts" to forecast accurately the future direction of stock prices?

Module 14: Questions for Thought

4. If Microsoft constitutes a sizeable share of your current stock holdings, the purchase of which of the following stocks would provide you with the greatest increase in diversification and reduction in risk?
   a) Lowe's Home Improvement
   b) Apple Computer
   c) Google
   d) Dell Computers

- Answer: Lowe's

Module 15: Wealth and Transitions of Life

- CSE Part 4, Elements 10, 11, and 12
- Concepts Covered:
  - Risk and insurance
  - Risk and investments
  - Portfolio adjustments and phases of life

ELEMENT 10. INVEST IN STOCKS FOR LONG-RUN OBJECTIVES, BUT AS THE NEED FOR MONEY APPROACHES, INCREASE THE PROPORTION OF BONDS.

- Strategic Plan:
  - Start saving for retirement early.
  - Stay with diversified portfolios of stocks until the need for retirement funds approaches.
  - Take advantage of the favorable tax treatment provided for retirement plans.

Risk Associated With Bonds

- Two major types of risk accompany bonds.
  1. **Inflation risk:** Unexpected inflation erodes the purchasing power of the face value of the bond and the earned interest.
     - Treasury Inflation Protected Securities (TIPS) help protect against this risk.
  2. **Interest rate risk:** Unexpected increases in the interest rate reduce the value of outstanding bonds.
     - This risk increases with the length of time to maturity.

Shift to Bonds as Retirement Approaches

- For short time periods, such as five years or less, the return on bonds is generally less volatile than stocks.

- Transfer funds in a diversified portfolio gradually from stocks to bonds as you approach retirement, thus reducing your vulnerability to volatile changes in the stock market.

Two Types of Retirement Plans

- There are two broad types of retirement plans: traditional plans and Roth IRA plans.

- Traditional plans include Individual Retirement Accounts (IRA), 401(k) plans offered by employers, and equivalent 403(b) plans provided by non-profit organizations.

Tax Treatment of Traditional Retirement Plans

- Contributions to traditional plans are deductible from taxable income. Because of this tax saving, your after-tax income will fall by less than your contribution.

- The contributions into the account, as well as the earnings, are tax-deferred until they are withdrawn during retirement.
  - This will be particularly advantageous if you expect to be in a lower tax bracket during your retirement years.

Tax Treatment of Roth IRAs

- Contributions into a Roth IRA are not tax deductible. Thus, there is no tax advantage at the time the contributions are made.

- However, the value of your investments grow tax-free and during your retirement years, both the contributions and investment earnings of a Roth IRA can be withdrawn without any payment of taxes.

Traditional vs. Roth Plans

- A traditional retirement plan will generally be a better option if you believe your current tax rate is higher than it is likely to be during your retirement years.
- In contrast, a Roth IRA will probably be better for you if you believe your current marginal income tax rate is about the same or lower than what you expect it to be when you are making withdrawals during retirement.
- Factors other than present and future income can also be important. Therefore, you should seek some impartial and expert advice before making a decision.

ELEMENT 11. TAKE STEPS THAT WILL REDUCE RISK WHEN MAKING HOUSING, EDUCATION, AND OTHER INVESTMENT DECISIONS.

Purchasing a Home: Pitfalls to Avoid

- The purchase of a home is one of the most important investment decisions most of us will confront.
- Pitfalls to avoid when purchasing a home:
  - **Renting versus ownership:** There is a tendency to believe that when you are purchasing a home your monthly mortgage payment will build equity. However, during the first few years, almost all of your monthly mortgage payment will merely cover interest charges. Your outstanding debt will be reduced by only a small amount. You are simply paying the bank interest instead of paying rent to a landlord.

Purchasing a Home: Pitfalls to Avoid continued…

- **Expected length of tenure:** Buying and selling real estate is expensive and therefore it is not a good idea to purchase a house unless you expect to live in it at least three years.

- **Down payment:** Do not buy a house until you have saved for a sizeable down payment, preferably at least 20 percent. If your down payment is less than 20 percent, you will have to pay mortgage insurance, which increases your monthly payment.

Purchasing a Home: Pitfalls to Avoid continued…

- **Maintenance and other costs:** Just because you can afford a mortgage payment doesn't mean you can afford the house. In addition to the mortgage payment, home owners will also incur property taxes, insurance, maintenance, and other expenses. Do not forget these costs!
- **Eroding your equity:** As you build up equity in your house, do not take out another mortgage or borrow against your equity in order to increase your current consumption.

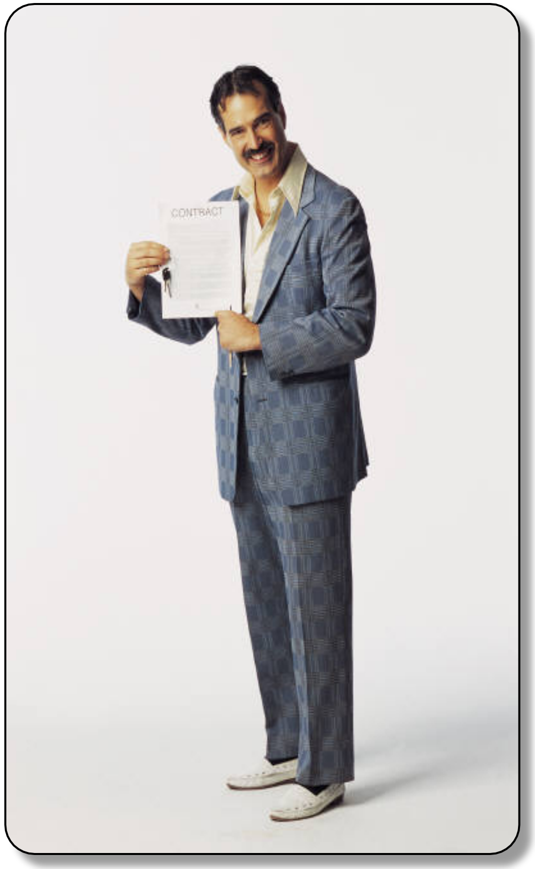
- The above guidelines will encourage you to live within your means, economize on housing, and minimize the risks involved in housing decisions.

EDUCATION: PITFALLS TO AVOID

- Pitfalls to avoid when investing in education.
  - College is not for everyone. Going to college is expensive, particularly when the earnings foregone are considered. Going to college for a couple of years and then dropping out is often a bad investment.
  - It is risky to borrow large amounts for the finance of education leading to low wage occupations. For information on earnings in various occupations, consult resources like PayScale.com and the BLS Occupational Outlook Handbook.
  - Students overuse debt. Some view the student loan check as free money and borrow too much. Many young people are ill-prepared to judge how difficult it will be to squeeze the funds for repayment of student loans out of their monthly budget after graduation.

Investment Pitfalls to Avoid

- It is important to recognize that when making investments, you are vulnerable; you need to think about whether your interests are aligned with the party offering the investment.
- Whenever you are offered something that seems to be an extremely attractive proposition, it pays to step back and carefully examine the incentives behind why this proposition is being presented to you.
- Beware of deals that sound too good to be true!



Tips for Avoiding Investment Fraud

- If it looks too good to be true, it probably is.
- Deal only with parties that have a reputation to protect.
- Never purchase an investment solicited by telephone or email.
- Do not allow yourself to be forced into a quick decision.
- Do not allow friendship to influence an investment decision.
- If high-pressure marketing is involved, grab your checkbook or debit card and run!

Element 12. Use insurance to help manage risk.

Managing Risk

- Life involves risks. You cannot eliminate risk, but you can take steps to reduce and manage it.

- Insurance can reduce the financial loss resulting from damages to possessions (such as your home or car), an illness, loss of income, or other harmful events.

What is Insurance?

- Insurance provides a way for a group of people to pool payments and share risks in order to offset the losses of members actually damaged by an adverse event.

- The principle of sharing risk is often forgotten because individuals pay premiums to an insurance company and have no interaction with the group members.
  - The insurance company collects premiums from each member of the group (its policyholders), then disburses payments when a covered loss occurs.

What is Insurance? Continued…

- In addition to the cost of covering the pooled risks, the insurer will also incur marketing, administrative, and handling costs. Thus, the insurance premiums will have to be somewhat higher than the expected costs of the losses of policyholders.
- Insurance reduces risk because it spreads the burden of unfortunate events that a few experience over a larger group of people.
- When it comes to large sums, most of us are risk-averse. Thus, we are willing to pay a premium in order to reduce the adverse consequences of various events.

Insurance is Not Always Cost-Effective

- It will make sense to insure against events that, if they occur, will impose severe financial hardship. Examples include: a severe illness that prevents you from working for an extended period of time, a car accident, or a flood that damages your home.
- However, insuring against relatively small adverse events such as a breakdown of an appliance or television is generally not cost-effective. Providing the risk-sharing service will be expensive relative to the potential harm. Thus, it will generally be more economical to accept these risks and use your rainy day fund to plan for and cover their costs.

Some Key Insurance Terms

- Alternative Types of Automobile Insurance
  - **Collision coverage:** pays for damages to your car in the event of an accident.
  - **Comprehensive coverage:** pays for non-collision damages such as theft, vandalism, and acts of nature like a tree branch falling on your windshield.
  - **Liability coverage:** comes in two forms.
    1. It pays others for damages to their person or vehicle caused by the operation of your automobile.
    2. It pays damages to you and your passengers for medical expenses and death benefits.

Some Key Insurance Terms

- Additional Insurance Terms
  - **Deductibility:** The amount the policy holder must pay before the insurance coverage begins. For example, if the deductible for a homeowner or auto insurance policy was $500, the insured would be responsible for the first $500 of damage.
  - **Co-payment:** An upfront fee the insured must pay for a service. For example, a $20 co-pay for a doctor visit or prescription.
  - **Co-insurance:** The percent share of the cost of an adverse event that the policy holder must pay. For example, a health insurance policy may require the customer to pay 20 percent of the bill for a hospital stay or medical procedure.

Conclusion: Teaching your Children Principles of Success

- Money is earned by providing services others value.
  - Instead of an allowance, pay your children for performing certain tasks and educational successes.
- Money spent on one thing means less funds available for the purchase of other items or savings and investing.
  - Beginning at an early age, teach children about this reality and provide them with experiences that will help them learn to choose wisely.
- Money both helps us get what we want, and helps others get what they want.

Conclusion: Key Ingredients for Your Success

- To a large degree success in life is about setting goals, working hard to achieve them, figuring out how to make your services useful to others, saving for a specific purpose, and spending money wisely.

- We are now at the end of a journey. Our goal has been to provide you with information and tools that will help you live a more successful and fulfilling life. It is our hope that today you will start on a new journey–that you will earnestly resolve to take control of your life and choose options more consistent with success.

Module 15: Questions for Thought

1. What is the difference in the tax treatment of a traditional retirement plan and a Roth IRA? If you are currently in a high tax bracket and expect to confront a lower marginal tax rate during your retirement years, which of these two options would be most attractive? Explain.

2. Why is the default rate on student loans so high? What are some of the pitfalls one should avoid when considering borrowing funds to finance schooling?

Module 15: Questions for Thought

3. When does it make sense to purchase insurance? Under what circumstances is insurance likely to be a poor investment?

4. People tend to appreciate things they earn more than things that are given to them. Do you think this is true? How might this impact how parents should deal with their children?