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Kiplinger Financial Services, L.L.C.

Kiplinger Financial Services' COMMON CENTS MATTERS

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TEACHING CHILDREN ABOUT MONEY (Part 2 of 3)

We will be extending *Teaching Children About Money* from 2 to 3 parts to appropriately cover each section. In *Part 1 of 3*, we outlined the five steps in financial planning as well as the impact your career choice can have on your financial future. In this edition, we will discuss budgeting as well as saving and investing.

BUDGETING: DON'T GO BROKE

Having a plan for your money will make your financial life more meaningful. Thus, a budget is a plan for managing money during a given period of time.

INCOME – There are many ways you can receive money. Income comes not only from a job, but also from an allowance, a check from your birthday or other special occasions. In reviewing the income from a paycheck, you might want to look closely at your paycheck stub. It includes your gross income from wages as well as payroll deductions which include federal income tax, state income tax, possible local income tax, Social Security tax and Medicare tax. These various taxes are fees placed on income, property, or goods to support government programs to pay for a variety of services, such as retirement for the elderly, road maintenance, armed services, hospital insurance, etc. Your gross income minus the payroll deductions results in your net income or take-home pay. It's the amount you have available to spend.

EXPENSES - Your expenses are the money you spend on your needs and wants. There are generally two types of expenses, fixed and variable. Fixed expenses have the same amount due every time. An example of a fixed expense may be a car payment for $300 each month. Variable expenses can change which indicates that you may have some control over this type of expense. Some examples of variable expenses might be whether to go out with your friends for an evening of pizza and a movie or staying home to eat and renting a video or whether to buy a new outfit or wear something in your closet.

By putting together a budget of income and expenses you are able to make clear, planned decisions on the best way to spend your money and make your money work for you. In developing your budget, there is a way to become a disciplined saver called "Pay Yourself First" or PYF. PYF is simply setting aside money to spend later. Think of it as a bill you owe to yourself. The earlier you develop the habit of saving, the more likely you are to achieve your financial goals.

TOOLS TO HELP MANAGE CASH – A checking account is an essential tool in handling your money. You can deposit your paycheck into the account and when you need money, there are several options available to withdraw the funds. You can pay your regular bills by writing a check. If you need cash you can use an Automated Teller Machine (ATM) card by inserting the card and entering your personal identification number (PIN). It is important to remember to record your ATM withdrawals as a subtraction from your checkbook. You may also use a debit card linked to your checking account. A debit card is like using a credit card to make a purchase except the amount is immediately subtracted from your checking account. Again, be sure you record each debit as a subtraction from your checkbook. Checking accounts are available at banks and credit unions. Shop around to evaluate fees that are charged for minimum balance requirements, annual or monthly fees, ATM fees, overdraft protection, and insufficient funds.

If you don't have a regular paycheck, you may want to use an envelope system to organize your cash. Simply label envelopes for each spending category of your budget, such as savings, gas, food, fun, etc. As you receive money, place the planned amount in each envelope. When you need to spend the money, take the cash out of the envelope. If there are no more funds in that envelope, you could take money from another envelope, realizing that is less you will have in that spending category. It is helpful to write down the date and amount on the envelope that you put in and take out cash so you can recall how your money has been spent.

To stay organized, it may be a good idea to keep your records in file folders.

SAVINGS AND INVESTMENTS

There are two possible ways of making your money work for you. One is through savings which is usually set aside for short-term goals, and the second is investing where you set aside money to meet your long-term goals. Usually the earnings or appreciation from investments are more than you would earn in a savings account.

TIME VALUE OF MONEY – This is the relationship between time, money, rate of return (interest) and their effect on earnings/growth. Earned interest is the payment you receive for allowing the financial institution to use your money. Compound interest is earning interest on interest. The last sheet of this edition "The Time Value of Money" shows the value of investing earlier rather than later and how money compounds over time. Another example of compounding is the "Rule of 72" which tells you how long it takes your money to double in value. You divide 72 by your interest rate to determine the number of years it takes for your money to double (72 ÷ 6% = 12 years).

RISK AND RETURN - Rate of return is how fast your money grows. With a higher risk tolerance (your ability to handle declines in the value of your investments), there is a potential for higher returns and for a lower amount of risk, there is a lower amount of return.

DIVERSIFICATION – Some investors want to keep money someplace safe and others that are more aggressive are willing to invest it some place riskier, like the stock market. Regardless of your investment style, one important element of any investment plan is diversification. Diversification is the reduction of investment risk by spreading your invested dollars among several difference investment choices. In other words, you don't want to put all your eggs in one basket. By diversifying your investments, you are reducing the chance that any one investment will really hurt you financially with a drop in value.

INFLATION AND TAXES – Inflation is when the cost of goods and services rise. As an investor, you need to evaluate how the cost of inflation will influence the true amount needed for a goal and how that compares to your investment earnings. Taxes also can consume some of your earnings. The government taxes the income from investments. Earnings from interest or dividends are considered taxable income as well as any gain/profit from the sale of an investment.

SAVINGS AND INVESTMENT CHOICES - Investors put their money to work for them for two reasons: income or growth. Income involves a payment of cash and growth means they hold an investment with the hope that it will increase in value over time.

Income Investments

- *Savings Accounts* – Banks and credit unions pay investors to loan their money. These payments are called interest, or the price of borrowed money. These accounts have low risk and thus pay low income. There are usually no restrictions on taking your money out at any time.
- *U.S. Savings Bonds* – The U.S. government agrees to pay you interest in exchange for your loaning them money for months or years. There is usually a penalty of lost interest if you cash the bond in early. These bonds usually pay higher interest rates than savings accounts.
- *Certificates of Deposit (CD)* – Like a bond, banks will pay interest in exchange for loaning your money for a set period of time such as 3 months, 6 months, 1 year, etc. The rate is usually slightly higher than U.S. Savings Bonds and a penalty will be imposed if you cash in your CD prematurely.
- *Money Market Accounts* – Banks, credit unions and mutual fund companies offer accounts that work like checking accounts and often will pay a higher rate of interest than a savings account. There is no penalty when you take out your money. Be aware that it may require a higher deposit to open the account and there could be a limitation on the number of checks you can write per month.
- *Corporate (Company) and Government Bonds* – These bonds typically pay the highest interest rates. Government bonds tend to be safer than corporate bonds; therefore, corporate bonds usually pay a higher rate of interest. The longer the term of the bond, generally the higher the rate of interest.

Growth Investments

- *Stocks* – Investors who buy stock actually own part of a company. The company uses the money paid for stock to produce its product or service, hire employees, purchase equipment, etc. Ideally, the investor desires the price to increase after he/she purchases the stock. The difference between the purchase price and the selling price is called a capital gain.
- *Real Estate* – Investors buy homes, land, buildings, malls, apartment complexes, etc. hoping to make a profit.

- *Collectibles* – These are unique items that are rare in number such as paintings, works of art, etc. There is the hope that these items will go up in value over time. Collectibles are considered to be risky since what is in demand one year might not be the next, and prices can change quickly and significantly.
- *Mutual Funds* – Investors who want professional management will often invest in mutual funds. Money is pooled together from many investors and then used to buy investments, such as stocks. A fund manager makes the buying and selling decisions according to the purpose or objective of the fund. For example, some funds are designed to produce income and other are designed for growth. There are funds that invest in a variety of areas in the market and there are some that will invest in a concentrated sector of the market as well.

In next month's edition, *Teaching Children About Money, Part 3 of 3*, we will discuss Credit: Buy Now, Pay Later; and Insurance: Your Protection. We will also provide websites that are helpful and a fun way for young people to learn about their finances.