BUS 320: CONCEPTS IN PERSONAL FINANCE



Dipali Buch
Folsom Lake College

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Detailed Licensing

Licensing

*A detailed breakdown of this resource's licensing can be found in **Back Matter/Detailed Licensing**.*

CHAPTER OVERVIEW

1: Personal Financial Planning

This chapter introduces four major themes:

- Financial decisions are individual-specific
- Financial decisions are economic decisions
- Financial decision making is a continuous process
- Professional advisors work for financial decision makers

These themes emphasize the idiosyncratic, systemic, and continuous nature of personal finance, putting decisions within the larger contexts of an entire lifetime and an economy.

1.1: Introduction

1.2: Individual or "Micro" Factors That Affect Financial Thinking

1.3: Systemic or "Macro" Factors That Affect Financial Thinking

1.4: The Planning Process

1.5: Financial Planning Professionals

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1.1: Introduction

Mark and Alice are both one semester shy of graduating from a state college. Mark is pursuing a degree in protective services and is considering becoming certified as a fire protection engineer, which would incur an additional $4,500 cost. With his degree in protective services, many other fields will be open to him. He could become a first responder, a game warden, or a correctional officer. Mark will have to specialize right away and wants a job in his state with some occupational safety and excellent job security.

Alice is pursuing a Bachelor of Science degree in medical technology and hopes to leverage this degree into a career as a laboratory technician. She has interviews at a nearby regional hospital and a local pharmaceutical firm. She hopes to get the hospital job because it pays a little better and offers additional on-site training. Both Mark and Alice will need further training to have the jobs they want, and they are already in debt for their educations.

Alice qualified for a Direct loan, and the federal government subsidizes her loan by paying the interest on it until six months after she graduates. She will owe about $40,000 of principal plus interest at a fixed annual rate of 6.8 percent. Alice plans to start working immediately after graduation and to take classes on the job or at night for as long as it takes to get the extra certification she needs. Unsubsidized, the additional training would cost about $3,500. She earns about $5,000 a year working weekends as a home health aide and could easily double that after she graduates. Alice also qualified for a Pell grant of around $5,000 each year when she was a full-time student, which covered her room in an off-campus student co-op housing unit. Mark also lives in the co-op, and that's how they met.

Mark would like to propose to Alice and looks forward to being a family man one day. He was awarded a service scholarship from his hometown and received a windfall from his grandmother's estate after she passed away during his sophomore year. He also borrowed $30,000 for five years at an interest rate of only 2.25 percent from his local bank through a family circle savings plan. He has been attending classes part-time year-round so he can work to earn money for college and living expenses. He earns approximately $19,000 per year working for a catering service. Mark is committed to repaying his relatives who have helped finance his education; he is also willing to help Alice pay off her Stafford loan after they get married.

Alice has $3,000 in U.S. Treasury Series EE savings bonds, which mature in two years. She has also managed to put aside $600 in a savings account earmarked for clothes and gifts. Mark has sunk all his savings into tuition and books, and his only other asset is his trusty old pickup, which has no liens and a trade-in value of $3,900. Having reliable transportation is a big concern for both Alice and Mark. After graduating, Alice hopes to find a job with accessible public transportation. Mark and Alice are both savvy with their finances and have successfully avoided getting into credit card debt. Each keeps only one major credit card and a debit card. They generally pay their statements in full each month.

Mark and Alice will have to find new housing after they graduate. They could look for another cooperative housing opportunity or rent an apartment. They could get married now instead of waiting, but Mark has a rent-free option to move in temporarily with his brother. Alice feels strongly about saving money to buy a home and wants to wait until her career is well-established before having a child. Alice is concerned about getting good job benefits, especially medical insurance and family leave. Although still young, Mark is worried about being able to retire, the sooner the better, but he has no idea how that would be possible. He thinks he would enjoy running his own catering firm as a retirement business someday.

Alice's starting salary as a lab technician will be approximately $30,000, and as a fire protection engineer, Mark's starting salary will be around $38,000. Both have the potential to double their salaries after fifteen years on the job, but they are worried about the economy. Their graduations are coinciding with a downturn. Aside from Alice's savings bonds, she and Mark are not in the investment market. When he can, Mark wants to invest in a diversified portfolio of money market funds that include corporate stocks and municipal bonds.

Nevertheless, the state of the economy affects their situation. Money is tight, loans are hard to obtain, jobs are scarce and highly competitive, purchasing power and interest rates are rising, and pension plans and retirement funds risk losing value. It's uncertain how long it will be before the trend reverses, so for the short term, they need to play it safe. What if they can't land the jobs they're preparing for?

Alice and Mark certainly have a lot of decisions to make, and some of those decisions have high-stakes consequences for their lives. In making those decisions, they will have to answer some difficult questions:

1. What individual or personal factors will affect Alice's and Mark's financial thinking and decision-making?
2. What are Mark's best options for job specializations in protective services? What are Alice's best options for job placement in the field of medical technology?
3. When should Mark and Alice invest in the additional job training each will need, and how can they finance that training?
4. How will Alice pay off her college loan, and what will be the cost? How soon can she pay off her debt?
5. How will Mark repay his family's investment in his education?
6. What are Alice's short-term and long-term goals? What are Mark's? If they marry, how well will their goals mesh or need to adjust?
7. What should they do about medical insurance and retirement needs?
8. What should they do about saving and investing?
9. What should they do about getting married and starting a family?
10. What should they do about buying a home and a car?
11. What is Mark's present and projected income from all sources? What is Alice's?
12. What is the tax liability on their present incomes as singles? What would their tax liability be on their future incomes if they filed jointly as a married couple?
13. What budget categories should Alice and Mark create for expenses and expenditures over time?
14. How could Alice and Mark adjust their budgets to meet their short-term and long-term goals?
15. What five-year financial plan could Alice and Mark develop?
16. How will larger economic factors affect the decisions Mark and Alice make, and the outcomes of those decisions?

You will make financial decisions throughout your life. Sometimes you can see those decisions coming and plan deliberately; sometimes, however, things happen unexpectedly, and you are faced with a more sudden decision. Personal financial planning is about making deliberate decisions that allow you to get closer to your goals, or sudden decisions that allow you to stay on track if things take an unexpected turn.

Personal financial planning is a lifelong process. Your time horizon will arc until the very end of your life, and your circumstances will change in predictable and unpredictable ways. A financial plan has to be re-evaluated, adjusted, and re-adjusted. It must be flexible enough to respond to unanticipated needs, robust enough to advance toward goals, and prescient enough to protect against unforeseen risks.

One of the most critical resources in the planning process is information. We live in a world awash in information, and there is no shortage of advice. To utilize this information effectively, you must understand what it is telling you, why it matters, where it originates, and how to apply it in the planning process. You need to be able to put that information in context before you can use it wisely. That context encompasses factors specific to your situation that influence your financial thinking, as well as broader economic factors that impact your financial decision-making.

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1.2: Individual or "Micro" Factors That Affect Financial Thinking

Learning Objectives

1. List individual factors that strongly influence financial thinking.
2. Discuss how income, income needs, risk tolerance, and wealth are affected by individual factors.
3. Explain how life stages affect financial decision-making.
4. Summarize the basis of sound financial planning.

The circumstances or characteristics of your life influence your financial concerns and plans. What you want and need, and how and to what extent you protect those wants and needs, will depend on how you live now and how you hope to live in the future. Everyone is different, but ordinary life circumstances affect everyone's personal financial concerns, which in turn impact their financial planning. Factors that influence personal financial concerns include family structure, health, career choices, and age.

Family Structure

Partners and dependents affect your financial planning as you seek to provide for them, such as paying for children's education. Parents typically want to protect or improve the quality of life for their children and may choose to limit their fulfillment to achieve that end.

Providing for others increases your need for income. Being responsible for others also affects your attitude toward and tolerance of risk. Typically, the willingness and ability to assume risk diminishes with fewer dependents, and a desire for more financial protection grows. People often seek protection for their income or assets past their lifetimes to ensure the continued well-being of partners and dependents. Life insurance that names a spouse or dependents as beneficiaries is a good example.

Health

Your health is another key factor that influences your expected income needs and risk tolerance, and therefore your financial planning. Personal financial planning should include protection against the risks of chronic illness, accidents, or long-term disability, as well as provisions for short-term events, such as pregnancy and childbirth. If health issues limit your earnings or ability to work, or significantly increase your expenditures, your income needs may also increase. The need to protect yourself against further limitations or increased costs may also increase. At the same time, your risk tolerance may decrease, which can further impact your financial decisions.

Career Choice

Your career choices affect your financial planning. Careers have different hours, pay, benefits, risk factors, and advancement patterns over time. Your financial planning will need to reflect these realities. Table 1.2.1 displays 2023 data from the U.S. Bureau of Labor Statistics Occupational Outlook Handbook (www.bls.gov/ooh/most-new-jobs.htm), and compares the median salaries of several careers.

Table 1.2.1 : Median Salary Comparisons by Profession

Profession	2023 Median Salary
Financial managers	$ 156,100
Lawyers	$ 145,760
Software developers	$ 132,270
Management analysts	$ 99,410
Accountants and auditors	$ 79,880
Market research analysts and marketing specialists	$ 74,680
Construction laborers	$ 45,300
Medical assistants	$ 42,000
Stock and order fillers	$ 36,390
Cooks, restaurant	$ 35,780
Home health and personal care aides	$ 33,530

Most people begin their independent financial lives by selling their labor to earn an income through work. Over time, they may choose to change careers, develop additional sources of income, transition between employment and self-employment, become unemployed, or re-employed. Along with career choices, these changes affect personal financial management and planning.

Age

Needs, desires, values, and priorities change over a lifetime, and financial concerns change accordingly. Ideally, personal finance is a process of management and planning that anticipates or keeps abreast with changes. Although everyone is different, some financial concerns are common to most adults in various stages of life. Analysis of **life stages** is part of financial planning.

As income, spending, and asset base grow, the ability to assume risk grows, but the willingness to do so typically decreases. Now you have things that need protection: dependents and assets. As you age, you realize that *you* require more protection. You may want to stop working one day, or you may suffer a decline in health. As an older adult, you may want to establish alternative sources of income, such as a retirement fund, to serve as insurance against the loss of employment or income. Table 1.2.2 suggests the effects of life stages on financial decision making.

Table 1.2.2 : Financial Decisions Related to Life Stages

	Young Adulthood	Middle Adulthood	Older Adulthood	Retirement
Source of Income	Wages	Wages/ Investment	Wages/ Investment	Investment
Asset Base	None	Accumulating	Growing	Using up
Expenses	Low	Growing	Growing	Low
Risk: Ability	Low	Higher	Higher	High
Risk: Willingness	High	Lower	Lower	Low

Early and middle adulthood are periods of building: building a family, advancing a career, increasing earned income, and accumulating assets. Spending needs to grow, but so do investments and alternative sources of income.

Later adulthood is a period of spending down one's assets. There is less reliance on earned income and more on the accumulated wealth of assets and investments. You are likely to be without dependents, as your children have grown up or your parents have passed on, and so without the responsibility of providing for them, your expenses are lower. You are likely to have more leisure time, especially after retirement.

Effective financial planning primarily depends on being aware of how current and future life stages may impact your financial decisions.

Summary

- Personal circumstances that influence financial thinking include family structure, health, career choice, and age.
- Family structure and health affect income needs and risk tolerance.
- Career choice has a significant impact on income and wealth, as well as asset accumulation.
- Age and stage of life affect sources of income, asset accumulation, spending needs, and risk tolerance.
- Sound personal financial planning is based on a thorough understanding of your personal circumstances and goals.

Exercises

1. Create a personal financial journal to keep a written record of observations and insights about your financial thinking and behavior. Review How Journaling for Personal Finance Can Help You Manage Money (www.journling.com/journaling-for-personal-finance/). You may be surprised at what you discover. As you read, consider how the information in this text relates specifically to your observations and insights. After reading this chapter, for example, identify and describe your current life stage. How does your current age or life stage affect your financial thinking and behavior? To what extent and in what ways does your financial thinking anticipate your next stage of life? What financial goals are you aware of that you have set? How are your current experiences informing your financial planning for the future?
2. Continue your personal financial journal by describing how other micro factors, such as your present family structure, health, career choices, and other individual factors, affect your financial planning.
3. Consider the age range for your stage of life and read What To Know About Life Cycle Financial Planning (www.asset-map.com/blog/life-cycle-financial-planning). According to the articles on this page, what should be your top priorities in financial planning right now? Read the articles on the next life stage. How are your financial planning priorities likely to change?

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1.3: Systemic or "Macro" Factors That Affect Financial Thinking

Learning Objectives

1. Identify the systemic or macro factors that affect personal financial planning.
2. Describe the impact of inflation or deflation on disposable income.
3. Describe the effect of rising unemployment on disposable income.
4. Explain how economic indicators can have an impact on personal finances.

Financial planning must take into account the broader economic conditions and the markets that comprise them. The **labor market**, the **capital market** (which encompasses both cash and assets), and the **credit market** (where capital is loaned and borrowed) exist within a dynamic economic environment. Considering those dynamics and environmental realities is part of sound financial planning.

Business Cycles

An economy tends to be productive enough to meet the needs of its members. Typically, economic output increases as the population grows or people's expectations rise. An economy's output or productivity is measured by its G**ross Domestic Product (GDP)**, which represents the value of goods and services produced within a specific period. When the GDP increases, the economy is expanding, and when it decreases, the economy is contracting. An economy that contracts for half a year is said to be in **recession**; a prolonged recession is a **depression**. The GDP is a closely watched barometer of the economy (see Figure 1.3.1).

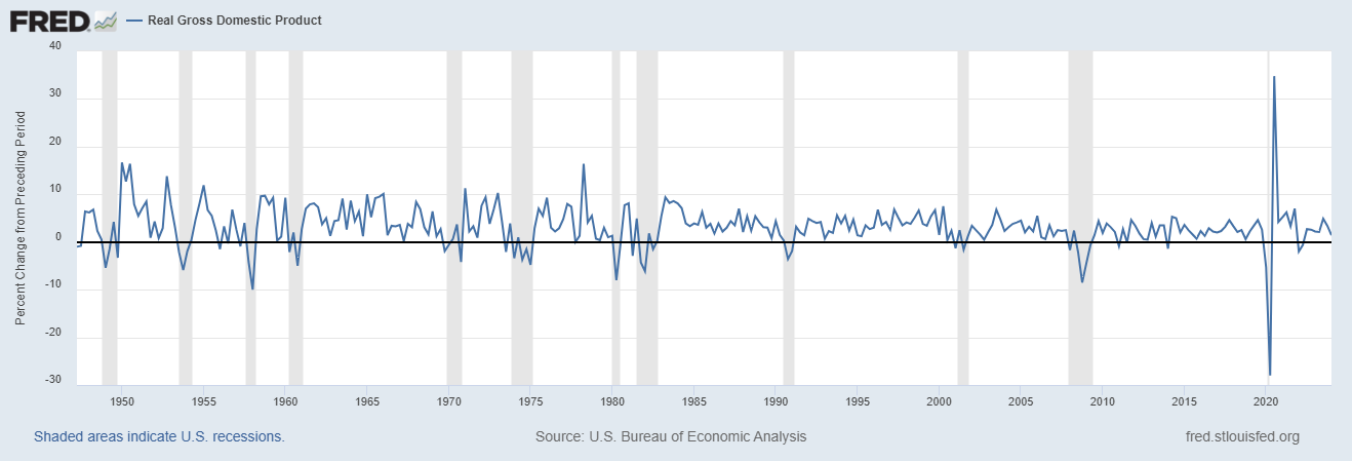


Figure 1.3.1 : GDP Percent Change[1]

The economy tends to be cyclical, usually expanding but sometimes contracting. This is called the **business cycle**. Periods of contraction are generally seen as market corrections or the market regaining its equilibrium after periods of growth. Growth is never perfectly smooth, so certain markets may become unbalanced and require self-correction. Over time, the periods of contraction seem to have become less frequent, as you can see in Figure 1.4. The business cycles still occur, nevertheless.

There are many metaphors to describe the cyclical nature of market economies, including "peaks and troughs," "boom and bust," "growth and contraction," and "expansion and correction," among others. While each cycle is born in a unique combination of circumstances, cycles occur because things change and upset economic equilibrium. Events alter the balance between supply and demand in the economy as a whole. Sometimes demand grows too quickly, and supply can't keep up; at other times, supply grows too quickly for demand. There are many reasons that this could happen, but whatever the reasons, buyers and sellers react to this imbalance, which then creates a change.

Employment Rate

An economy produces goods and services to meet the needs of its members and provides employment opportunities for its citizens. Most people participate in the market economy by trading their labor, and most rely on wages as their primary source of income. Therefore, the economy must provide opportunities for people to earn wages, allowing more individuals to participate in the

market. Otherwise, more people must be provided for in some other way, such as through a private or public subsidy (e.g., charity or welfare).

Unemployment also suggests that the economy is not efficient, as it cannot utilize all its productive human resources effectively. The **employment rate**, also known as the labor force participation rate, measures an economy's effectiveness in creating opportunities for labor and utilizing its human resources efficiently. A healthy market economy uses its labor productively, is productive, and provides employment opportunities and consumer satisfaction through its markets. Table 1.3.2 shows the relationship between GDP and unemployment during each stage of the business cycle.

Table 1.3.2 : Cyclical Economic Effects

	Boom	Expansion	Recession	Depression
Rate of GDP Increase	Unsustainably High	Positive	Negative	Unsustainably Low
Rate of Unemployment	Unsustainably Low	"Natural" or Minimal	Higher	Unsustainably High

At either end of this growth scale, the economy is in an unsustainable position: it is either growing too fast, with excessive demand for labor, or shrinking, with insufficient demand for labor.

If there is too much demand for labor (with more jobs than workers to fill them), wages will rise, which in turn will push up the cost of everything and cause prices to increase. Prices typically rise faster than wages for several reasons. Higher prices discourage consumption, and lower consumption in turn discourages production, causing the economy to slow down from its "boom" condition into a more manageable growth rate.

If there is too little demand for labor (with more workers than jobs), wages will fall or, more typically, there will be people without jobs (unemployment). If wages become low enough, employers will theoretically be encouraged to hire more labor, thereby raising employment levels. However, it doesn't always work that way, because people have job mobility; they are willing and able to move between economies to seek employment.

If unemployment is high and prolonged, then too many people will be without wages for too long and unable to participate in the economy because they have nothing to trade. In that case, the market economy is not working for too many people, and they will eventually demand a change. This is how most revolutions start.

Other Indicators of Economic Health

Other economic indicators give us clues as to how "successful" our economy is, how well it is growing, or how well positioned it is for future growth. These indicators include statistics such as the number of houses being built or existing home sales, orders for durable goods (e.g., appliances and automobiles), consumer confidence, producer prices, and others. However, GDP growth and unemployment are the two most closely watched indicators, because they get at the heart of what our economy is supposed to accomplish: to provide diverse opportunities for the most people to participate in the economy, to create jobs, and to satisfy the consumption needs of the most people by enabling them to get what they want.

An expanding and healthy economy will offer more choices to participants trading labor and capital. It will offer more opportunities to earn a return or income, and, therefore, offers more diversification and less risk.

Everyone would prefer to operate in a healthy economy, but this is not always possible. Financial planning encompasses preparing for the risk that economic factors may impact financial realities. A recession may increase unemployment, lowering the return on labor (wages) or making it harder to anticipate an income increase. Wage income could be lost altogether. A temporary, involuntary loss of wage income is likely to occur for most people at some point in life, as everyone inevitably experiences economic cycles.

Currency Value

Stable currency value is another important indicator of a healthy economy and a critical element in financial planning. Like anything else, the value of a currency is based on its usefulness. We use currency as a medium of exchange, so the value of a currency is based on how it can be used in trade, which in turn is based on what is produced in the economy. If an economy produces little that anyone wants, then its currency has little value relative to other currencies, because there is little use for it in trade. So a currency's value indicates how productive an economy is.

A currency's usefulness is based on what it can buy, or its **purchasing power**. The more a currency can buy, the more useful and valuable it is. When prices rise or things cost more, purchasing power decreases; the currency buys less and its value decreases.

When the value of a currency decreases, it indicates **inflation in an economy**. Its currency has less value because it is less useful. After all, less can be bought with it. Prices rise, and it takes more currency to buy the same amount of goods. When the value of a currency increases, on the other hand, an economy has **deflation**. Prices are falling; the currency is worth more and buys more.

If there is deflation, prices fall, so maybe a year later, you could buy ten video games with $20. Then, each game will cost only $2, and each dollar buys half a game. The same amount of currency buys more games: Its purchasing power has increased, as has its usefulness and its value (Figure 1.3.3).

Table 1.3.3 : Dynamics of Currency Value

	Inflation	Deflation
Prices	Rise	Fall
Purchasing Power	Decreases	Increases
Currency Value	Falls	Rises

Inflation is most commonly measured by the **Consumer Price Index** (CPI), an index created and tracked by the federal government. It measures the average nationwide prices of a "basket" of goods and services purchased by the average consumer. It is an accepted method of tracking rising or falling price levels, which are indicative of inflation or deflation. Figure 1.3.4 shows the percentage change in the Consumer Price Index as a measure of inflation from 1965 to 2020.

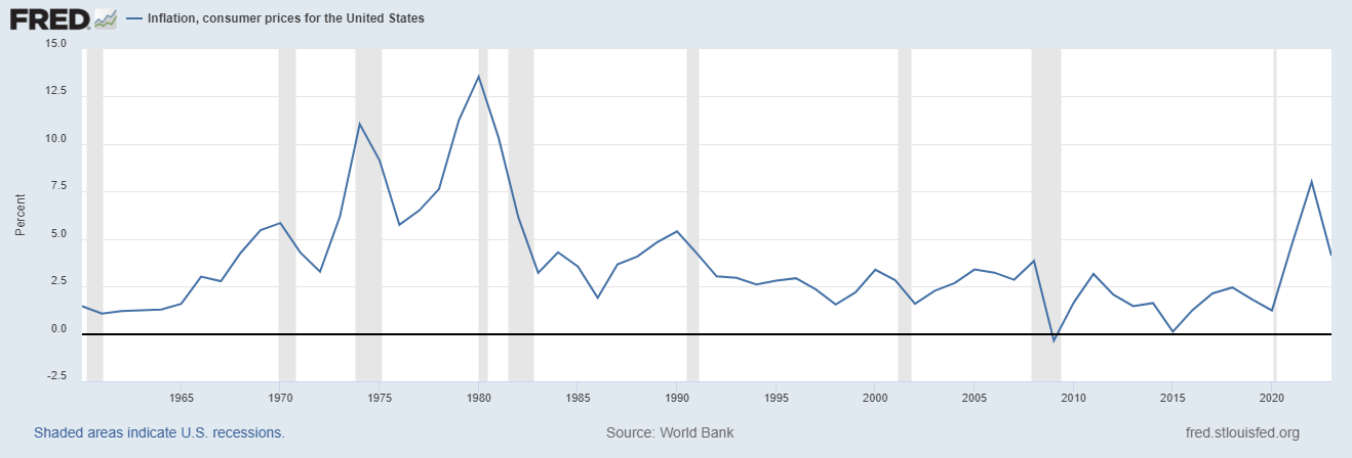


Figure 1.3.4 : Inflation, 1965-2020.[2]

Currency instabilities can also affect investment values, because the dollars that investments return don't have the same value as the dollars that the investment was expected to return. Say you lend $100 to your sister, who plans to pay you back one year from now. There is inflation, so over the next year, the value of the dollar decreases (it buys less as prices rise). Your sister pays you back on time, but now the $100 she gives back to you is worth less (because it now buys less) than the $100 you gave her. Your investment, although nominally returned, has lost value: You have your $100 back, but you can't do as much with it; it is less useful.

If the **currency value** - the units in which wealth is measured and stored - is unstable, then investment returns are more complex to predict. Under such circumstances, investment involves greater risk. Both inflation and deflation are currency instabilities that are troublesome for an economy and the financial planning process. An unstable currency affects the value of income purchasing power. Price changes affect consumption decisions, while changes in currency value impact investment decisions.

It is human nature to assume that things will stay the same, but financial planning must include the assumption that you will encounter and endure economic cycles throughout your life. You should try to anticipate the risks of an economic downturn and the possible loss of wage income and/or investment income. At the same time, you should not assume or rely on the windfalls of an economic expansion.

Summary

- Business cycles include periods of expansion and contraction (including recessions), as measured by the economy's productivity (gross domestic product).
- An economy is in an unsustainable situation when it grows too quickly or too slowly; each situation causes stress in the economy's markets.
- In addition to GDP, measures of the health of an economy include
  - rates of employment and unemployment
  - currency value (the consumer price index)
- Financial planning should consider that periods of inflation or deflation change the currency value, affecting purchasing power and investment values.
- Thus, personal financial planning should take into account changes in
  - business cycles
  - the economy's productivity
  - the currency value
  - other economic indicators

Exercises

1. Review the Business Cycle Dating chart published by the National Bureau of Economic Research (www.nber.org/research/business-cycle-dating). The chart illustrates the business cycles in the United States, along with their durations, starting in 1948. What patterns and trends do you see in these historical data? Which years saw the longest recessions? How can you tell that the U.S. economy has tended to become more stable over the decades?
2. Record in your financial journal the macroeconomic factors influencing your financial thinking and behavior today. What are some specific examples? How have large-scale economic changes or cycles, such as the pandemic or high inflation of 2022-2024, affected your financial planning and decision-making?
3. How does the health of the economy affect your financial health? How healthy is the U.S. economy right now? On what measures do you base your judgments? How will your appreciation of the big picture help you plan for your future?
4. How do business cycles and the economic health affect the value of your labor? In terms of supply and demand, what are the optimal conditions for selling your labor? How might further education increase your mobility in the labor market (the value of your labor)?
5. Consider effective personal financial strategies for
   - protecting against recession
   - hedging against inflation
   - mitigating the effects of deflation
   - taking realistic advantage of periods of expansion

[1] Based on data from the Bureau of Economic Analysis, U.S. Department of Commerce, St. Louis Fed. fred.stlouisfed.org/series/A191RL1Q225SBEA#.

[2] Based on data from the World Bank, U.S. Inflation 1965 - 2020. fred.stlouisfed.org/series/FPCPITOTLZGUSA#.

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1.4: The Planning Process

Learning Objectives

1. Trace the steps of the financial planning process and explain why that process needs to be repeated over time.
2. Characterize effective goals and differentiate goals in terms of timing.
3. Explain and illustrate the relationships among costs, benefits, and risks.
4. Analyze cases of financial decision-making by applying the planning process.

A **financial planning process** involves determining where you are, where you'd like to be, and how to transition from one to the other. More formally, a financial planning process includes the following:

- Defining goals
- Assessing the current situation
- Identifying choices
- Evaluating choices
- Choosing
- Assessing the resulting situation
- Redefining goals
- Identifying new choices
- Evaluating new choices
- Choosing
- Assessing the resulting situation over and over again

Personal circumstances change, and the economy changes. Your plans must be flexible enough to adapt to changes, yet steady enough to achieve your long-term goals. You must remain alert to those changes; however, as Bob Dylan advised in his classic tune "*Forever Young*", "May you have a strong foundation when the winds of change shift."

Defining Goals

Figuring out where you want to go is a process of defining goals. You have shorter-term (1-2 years), intermediate (2-10 years), and longer-term goals that are quite realistic, as well as more wishful goals. Setting goals is a skill that usually improves with experience. According to a popular model, to be effective, goals must be Specific, Measurable, Achievable, Relevant, and Time-bound (SMART). Goals change over time, and certainly over a lifetime. However, regardless of your goals, life is complex and unpredictable, and having a plan to achieve them increases the likelihood of success. Table 1.4.1 shows the relationship between timing, goals, and sources of income.

Table 1.4.1 : Timing, Goals, and Income

	Goals	Income Source
Short Term	Reduce Debt	Wages/Salary
Intermediate	Accumulate Assets	Wages/Salary
Long Term	Create Retirement Income	Investment

It's essential to understand where income will come from and how it will contribute to achieving your goals. That begins with assessing your current situation.

Assessing the Current Situation

Figuring out where you are or assessing the current situation involves understanding your present situation and the choices it creates. There may be many choices, but you want to identify those that will be most effective in helping you reach your goals.

Assessing the current situation is a matter of organizing personal financial information into summaries that show different and important aspects of financial life (assets, debts, incomes, and expenses). These numbers are expressed in financial statements, an income statement, a balance sheet, or a cash flow statement (see Chapter 3). Businesses also use these three types of statements in their financial planning.

For now, we can assess Alice's simple situation by identifying her assets and debts, as well as listing her annual income and expenses. That will show if she can expect a budget surplus or deficit. More importantly, it will show whether her goals are achievable and if she is making progress toward them. Even a ballpark assessment of the current situation can be illuminating.

Alice's assets include a car worth approximately $5,000 and a savings account with a balance of $250. Debts include a student loan with a balance of $53,000 and a car loan with a balance of $2,700; these are shown in Table 1.4.2 .

Table 1.4.2 : Alice's Financial Situation

Assets		Debt	
Car	$ 5,000	Car Loan	$ 2,700
Savings	$ 250	Student Loan	$ 53,000
Total	$ 5,250	Total	$ 55,700

Her annual disposable income (after-tax income or take-home pay) may be $35,720, and annual expenses are expected to be $10,800 for rent and $14,400 for living expenses (food, gas, entertainment, clothing). Her annual loan payments are $2,400 for the car loan and $7,720 for the student loan, as shown in Table 1.4.3 .

Table 1.4.3 : Alice's Income and Expenses

Income & Expenses	Value
After-tax income	$ 35,720
Rent	$ 10,800
Living expenses	$ 14,400
Remaining for debt reduction and savings	$ 10,520
Student loan payments	$ 7,720
Car loan payments	$ 2,400
Remaining for savings	$ 400

Alice will have an annual budget surplus of just $400 (income = $35,720 − $35,320 [total expenses + loan repayments]). She will achieve her short-term goal of reducing debt, but with a small annual budget surplus, it will be challenging for her to begin accumulating assets.

To reach that intermediate goal, she will need to either increase her income or decrease her expenses to create a larger annual surplus. When her car loan is paid off next year, she hopes to buy another car, but she will have at most only $650 (250 + 400) in savings for a down payment, assuming she can save all her surplus. When her student loans are paid off in about five years, she will no longer have student loan payments, and that will increase her surplus significantly (by $7,720 per year) and allow her to put that money toward asset accumulation.

Alice's long-term goals also depend on her ability to accumulate productive assets, as she aims to retire and live off the income from her assets. Alice is making progress toward meeting her short-term goal of reducing debt, which she must accomplish before she can work toward her intermediate and long-term goals. Until she reduces her debt, which would reduce her expenses and increase her income, she will not make progress toward her intermediate and long-term goals.

Assessing her current situation allows Alice to see that she needs to delay accumulating assets until she can reduce her expenses by paying off debt (and thus her student loan payments). She is now reducing her debt, and as she continues to do so, her financial

situation will begin to improve, and new choices will become available to her.

Alice learned about her current situation from two simple lists: one listed her assets and debts, and the other showed her income and expenses. Even in this simple example, it is clear that articulating a current situation can put information into a helpful context. These simple lists can help reveal the critical paths to achieving goals.

Evaluating Alternatives and Making Choices

Figuring out how to go from here to there is a process of making some immediate choices and then identifying their effect on longer-term strategies or a series of choices. To do this, you must be realistic yet imaginative about your situation. The choices you make now will affect many of the choices you will make in the future. The characteristics of your living situation (family structure, age, career choice, and health) and the broader economic context will influence or define the relative value of your choices.

In her current situation, Alice is reducing debt, so one choice would be to continue. If she could reduce expenses to create a larger budget surplus, she could begin to accumulate assets sooner and save even more. Alice looks over her expenses and decides she really can't reduce them much. She decides that reducing expenses is not a feasible alternative. However, she could increase her income. She has two choices: work a second job or take her chances in Las Vegas.

If Alice worked a second, part-time job, her after-tax income would increase, but extra work would leave her tired and without time for other interests. The economy is in a slump, and unemployment is up, so her second job probably wouldn't pay much. A big win in Vegas is unlikely, but her only initial cost would be the trip to Vegas. To evaluate her alternatives, Alice needs to calculate the benefits and costs of each (Table 1.4.4).

Table 1.4.4 : Alice's Choices: Benefits and Costs

Choices	Benefit	Explicit Cost	Implicit Cost
Continue	Reduce debt	None	None
Second Job	Reduce debt and increase surplus a little (more income)	None	Give up leisure pursuits
Vegas	Eliminate debt and increase surplus a lot (no debt payments)	Airfare and hotel in Vegas	Risk of increased deficit and debt

Laying out Alice's choices in this way shows the consequences more clearly. The alternative with the most significant possible benefit is the trip to Vegas. Still, it also carries the most considerable cost, as it poses the most significant risk: if she loses, she could incur even more debt. That would put her further from her goal of beginning to accumulate assets, which would have to be postponed until she could eliminate both the new debt and her existing debt.

Thus, she would have to increase her income and decrease her expenses. Continuing what she does now would no longer be an option because the new debt increases her expenses, creating a budget deficit. Her only alternative to increase her income would be to take the second job she had initially rejected due to its implicit cost. She would probably have to reduce expenses as well, an idea she initially had rejected as unreasonable. Thus, the risk of the Vegas option is that it could force her to choose alternatives that she had initially rejected as too costly (see Figure 1.4.5).



Figure 1.4.5 : Considering Risk in Alice's Choice

The Vegas option becomes the least desirable when its risk is factored into the calculations of its costs, especially when compared with its benefits.

The obvious risk is that Alice may lose wealth, but choosing to gamble in Vegas will limit future choices, too. Without including risk as a cost, the Vegas option looks attractive. That is, of course, why Vegas exists. However, when risk is considered, and the decision involves thinking strategically not only about immediate consequences but also about the choices it will preserve or eliminate, that option can be viewed in a very different light (Table 1.4.6).

Table 1.4.6 : Alice's Choices: Benefits and More Costs

Choices	Benefit	Explicit Cost	Implicit Cost	Strategic Cost
Continue	Reduce debt	None	None	Preserves alternatives
Second Job	Reduce debt and increase surplus a little (more income)	None	Give up leisure pursuits	Preserves alternatives
Vegas	Eliminate debt and increase surplus a lot (no debt payments)	Airfare and hotel in Vegas	Risk of increased deficit and debt	Eliminate alternatives

You may sometimes choose an alternative with less apparent benefit than another, but also with less risk. You may sometimes choose an alternative that provides less immediate benefit but more choices later. Risk itself is a cost, and choice is a benefit, and they should be included in your assessment.

Summary

- Financial planning is a recursive process that involves
  - defining goals
  - assessing the current situation
  - identifying choices
  - evaluating choices
  - choosing
- Choosing further involves assessing the resulting situation, redefining goals, identifying new options, evaluating these options, and so on.
- Goals are shaped by current and expected circumstances, family structure, career, health, and larger economic forces.
- Depending on the factors that shape them, goals can be categorized as short-term, intermediate, or long-term.

- Choices will allow for faster or slower progress toward goals and may lead to regression from previously set goals; these goals can be eliminated.
- You should evaluate your feasible choices by calculating the benefits, explicit costs, implicit costs, and the strategic costs of each one.

? Exercises

1. Assess and summarize your current financial situation. What measures are you using to describe where you are? Your assessment should include an appreciation of your financial assets, debts, incomes, and expenses.
2. Use the SMART planning model and information in this section to evaluate Alice's goals. Write your answers in your financial planning journal.
    1. Pay off student loans
    2. Buy a house and save for children's education
    3. Accumulate assets
    4. Retire
    5. Travel around the world in a sailboat
3. Identify and prioritize your immediate, short-term, and long-term goals at this time in your life. Why will you need different strategies to achieve these goals? For each goal, identify a range of alternatives for achieving it. How will you evaluate each alternative before making a decision?
4. In your personal financial journal, record specific examples of your use of the following kinds of strategies in making financial decisions:
    1. Weigh costs and benefits
    2. Respond to incentives
    3. Learn from experience
    4. Avoid a feared consequence or loss
    5. Avoid risk
    6. Throw caution to the wind
5. On average, would you rate yourself as more of a rational or non-rational financial decision maker?

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1.5: Financial Planning Professionals

Learning Objectives

- Identify the professions of financial advisors.
- Discuss how training and compensation may affect your choice of advisor.
- Describe the differences between objective and subjective advice and how that may affect your choice of advisor.
- Discuss how the kind of advice you need may affect your choice of advisor.

A multitude of **financial advisors** (such as accountants, investment advisors, tax advisors, estate planners, or insurance agents) can help with financial planning. They possess diverse training and qualifications, varying educational backgrounds, and distinct approaches to financial planning. To have a set of initials after their name, all have met educational and professional experience requirements and have passed exams administered by professional organizations, testing their knowledge in the field. Table 1.5.1 provides a perspective on the industry classifications of financial planning professionals.

Table 1.5.1 : Industry Classifications of Financial Planning Professionals.

	Function	Certification
Certified Public Accountant CPA	Qualified to audit publicly traded corporations. Often does accounting for individuals, especially tax accounting. Frequently helps with financial planning and advising, especially tax planning	Certified by the American Institute of Certified Public Accountants (AICPA)
Certified Financial Planner CFP (recognized globally)	Trained to assist with all aspects of the financial planning process	Certified by the Certified Financial Planner Board of Standards, Inc.
Chartered Financial Consultant ChFC	Trained to assist with aspects of the personal financial planning process relating to life insurance	Chartered by The American College
Chartered Life Underwriter CLU	Trained to structure and sell life insurance	Chartered by The American College
Accredited Financial Counselor AFC	Assists with financial planning	Certified by the Association for Financial Counseling and Planning Education (AFCPE)
Accredited Estate Counselor AEC	Specializes in the disposal of assets and wealth after someone's death	Certified by the National Association of Estate Planners and Councils
Registered Investment Adviser RIA	Advises on investment management	Registered with the Securities and Exchange Commission (U.S. government agency)
Enrolled Agent EA	Advises on tax issues	Certified by the Internal Revenue Service (of the U.S.)

Certifications are valuable because they demonstrate training and experience in a specific aspect of financial planning. However, when seeking advice, it is essential to understand the advisor's interests and how they align with your own. It is essential to understand the origin of your information and advice, and how that influences the quality of the information and advice. Specifically, how is the advisor compensated?

Some advisors simply offer advice and get paid for it. Others sell a product, such as a specific investment, mutual fund, or life insurance policy, and they receive payment when it is sold. Others sell a service, such as brokerage or mortgage servicing, and get

paid when the service is rendered. Although all may be highly ethical and well-intentioned, when choosing a financial planning advisor, it is essential to be able to distinguish among them.

Some financial professionals have a fiduciary duty, which means they are legally required to act in the best interest of their clients. This duty includes being honest, prioritizing the client's needs, and avoiding conflicts of interest. Fiduciaries must clearly explain any fees or potential conflicts they may have. Common fiduciaries include investment advisers, retirement plan managers, and people who manage mutual funds. Working with a fiduciary can give you more peace of mind, because their advice must focus on helping you, not on making money for themselves.

Sometimes, a friend or family member who knows you well and has your best interests in mind may be a terrific resource for information and advice; however, they may not be as objective or knowledgeable as a disinterested professional. It is beneficial to diversify your sources of information and advice, utilizing both professional and amateur advisors, as well as subjective and objective perspectives. As always, diversification decreases risk.

Now you know a bit about the planning process, the personal factors that affect it, the larger economic contexts, and the business of financial advising. The next steps in financial planning involve details, particularly how to organize your financial information to assess your current situation and how to start evaluating your alternatives.

References to Professional Organizations

The references that follow provide information for further research on the professionals and professional organizations mentioned in the chapter.

- The American Institute of Certified Public Accountants (AICPA) (www.aicpa-cima.com/home)
- The Association of Chartered Certified Accountants (ACCA) (www.accaglobal.com/us/en.html)
- The Chartered Financial Analyst (CFA) Institute (www.cfainstitute.org)
- The Certified Financial Planner Board of Standards (www.cfp.net)
- The Association for Financial Counseling and Planning Education (AFCPE) (www.afcpe.org)
- The National Association of Estate Planners and Councils (NAEPC) (www.naepc.org)
- The U.S. Securities and Exchange Commission (SEC) (www.sec.gov)
- The Internal Revenue Service (IRS) (www.irs.gov)

Summary

- Financial advisors may work as accountants, investment advisors, tax advisors, estate planners, or insurance agents.
- You should always understand how your advisor is trained and how that may affect the kind of advice you receive.
- You should always understand how your advisor is compensated and how that may be related to the kind of advice that you receive.
- You should diversify your sources of information and advice by using both subjective advisors (friends and family) and objective, professional advisors. Diversification, as always, reduces risk.

Exercises

1. Where do you get your financial advice? Identify all the sources. In what circumstances might you seek a professional financial advisor?
2. Watch Financial Planners Explained in 3 Minutes (www.youtube.com/watch?v=GZtfYKmE-bw). Which advice about getting financial advice do you find most valuable? Share your views with classmates. Also, view the 5:32-minute video from the Today Show on how to know if you need a financial advisor (www.youtube.com/watch?v=WAPnGu8rzhA).
3. Explore the following links for more information on financial advisors:
   a. National Association of Personal Financial Advisors (NAPFA) (www.napfa.org)
   b. U.S. Department of Labor Bureau of Labor Statistics on the job descriptions, training requirements, and earnings of financial analysts (www.bls.gov/ooh/business-and-financial/financial-analysts.htm) and personal financial advisors (www.bls.gov/ooh/business-and-financial/personal-financial-advisors.htm).
   c. *Investopedia* guidelines for choosing a financial advisor (www.investopedia.com/terms/f/financial-advisor.asp).

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CHAPTER OVERVIEW

2: Basic Ideas of Finance

This chapter introduces the basic financial and accounting categories of **revenues**, **expenses**, **assets**, **liabilities**, and **net worth** as tools to understand the relationships between them as a way, in turn, of organizing financial thinking. It also introduces the concepts of **opportunity costs** and **sunk costs** as implicit but critical considerations in financial thinking.

2.1: Introduction

2.2: Income and Expenses

2.3: Assets

2.4: Debt and Equity

2.5: Income and Risk

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2.1: Introduction

There is no trick to managing personal finances. Making good financial decisions is largely a matter of understanding how the economy works, how money flows through it, and how people make financial decisions. The better your understanding, the better your ability to plan, capitalize on opportunities, and avoid disappointments. Life can never be planned entirely, of course, and the best-laid plans do go awry, but anticipating risks and protecting against them can minimize exposure to the inevitable mistakes and "the hazards and vicissitudes"[1] of life.

[1] Franklin D. Roosevelt, remarks when signing the Social Security Act, August 14, 1935. Retrieved from the Social Security Administration archives, http://www.socialsecurity.gov/history/fdrstmts.html#signing. www.ssa.gov/history/fdrstmts.html#signing.

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2.2: Income and Expenses

Learning Objectives

1. Identify and compare the sources and uses of income.
2. Define and illustrate the budget balances that result from the uses of income.
3. Outline the remedies for budget deficits and surpluses.
4. Define opportunity costs and sunk costs, and discuss their effects on financial decision-making.

Personal finance is the process of managing one's finances to support a life and a way of living. Just as a business must be financed - its buildings, equipment, use of labor and materials, and operating costs must be paid for - so must a person's possessions and living expenses. Just as a business relies on its revenues from selling goods or services to finance its costs, so a person relies on income earned from selling labor or capital to finance costs. You need to understand this financing process and the terms used to describe it. In the next chapter, you'll look at how to account for it.

Where Does Income Come From?

Income is what is earned or received in a given period. There are various terms for income because there are multiple ways to earn it. Income from employment or self-employment is wages or salary. Deposit accounts, such as savings accounts, earn interest, which can also be generated through lending. Owning stock entitles the shareholder to a dividend, if there is one. Owning a piece of a partnership or a privately held corporation entitles one to a draw.

The two fundamental ways of earning income in a market-based economy are by selling labor or selling capital. Selling labor means working, either for someone else or for yourself. Income comes in the form of a paycheck. Total compensation may include other benefits, such as retirement contributions, health insurance, or life insurance. Labor is sold in the labor market.

Selling capital means investing: taking excess cash and selling it or renting it to someone who needs **liquidity** (access to cash). Lending is renting out capital; the interest is the rent. You can lend privately by direct arrangement with a borrower, or you can lend through a public debt exchange by buying corporate, government, or government agency bonds. Investing in or buying corporate stock is an example of selling capital in exchange for a share of the company's future value.

You can invest in various other types of assets, including antiques, art, coins, land, or commodities such as soybeans, live cattle, platinum, or light crude oil. The principle is the same: investing is essentially renting capital or selling it for an asset that can be resold later, generate future income, or both. Capital is sold in the capital market and lent in the credit market - a specific part of the capital market (just like the dairy section is a specific part of the supermarket). Table 2.2.1 shows the sources of income.

Table 2.2.1 : Sources of Income

	Work	Invest	Lend
Trade	Sell Labor	Sell Capital	Rent Capital
Return/ Income	Wages or Salary	Profit or Dividend Capital Gain (Loss)	Interest
Market	Labor Market	Capital Market	Credit Market

In the labor market, the price of labor is the wage that an employer (buyer of labor) is willing to pay to the employee (seller of labor). For any given job, that price is determined by many factors. The nature of the work determines the education and skills required, and the price may also reflect other factors, such as the job's status or desirability.

In turn, the skills required and the attractiveness of the work determine the supply of labor for that particular job - the number of people who could and would want to do the job. If the supply of labor exceeds the demand, meaning there are more people available to work at a job than are needed, then employers will have more hiring choices. That labor market is a buyers' market, and the buyers can hire labor at lower prices. If fewer people are willing and able to do a job than there are jobs available, then that labor market is a seller's market, and workers can sell their labor at higher prices.

Similarly, the fewer skills required for the job, the more people will be able to do it, creating a buyer's market. The more skills required for a job, the fewer people there will be to do it, and the more leverage or advantage the seller has in negotiating a price. People pursue education to enhance their skills and, therefore, become more competitive in the labor market.

When you are starting your career, you are usually in a buyer's market (unless you have some unusual gift or talent), if only because of your lack of experience. As your career progresses, you have more (and perhaps more varied) experience and presumably more skills, and so can sell your labor in more of a seller's market. You may change careers or jobs more than once, but you would hope to do so to your advantage — that is, constantly gaining bargaining power in the labor market.

Many people love their work for many reasons other than the pay, however, and choose it for those rewards. Labor is more than a source of income; it is also a source of many intellectual, social, and other personal gratifications. Nevertheless, your labor is also a tradable commodity and has a market value. The personal rewards of your work may ultimately determine your choices, but it is essential to be aware of the market value of those choices as you make them.

Your ability to sell labor and earn income reflects your situation in the labor market. Earlier in your career, you can expect to earn less than you will as your career progresses. Most people would like to reach a point where they no longer have to sell their labor at all. They hope to retire someday and pursue other hobbies or interests. They can retire if they have alternative sources of income, such as earnings from savings and capital sales.

Capital markets exist so that buyers can buy capital. Businesses often require capital and have limited options for raising it. Sellers and lenders (investors), on the other hand, have many more choices of how to invest their excess cash in the capital and credit markets, so those markets are much more like sellers' markets. The following are examples of ways to invest in the capital and credit markets:

- Buying stocks
- Buying government or corporate bonds
- Lending a mortgage

Where Does Income Go?

Expenses are costs for items or resources that are used up or consumed in the course of daily living. Expenses recur (i.e., they occur repeatedly) because essential items such as food, housing, clothing, energy, and other necessities are used up daily.

When income is less than expenses, you have a **budget deficit** - too little cash to provide for your wants or needs. A budget deficit is not sustainable; it is not financially viable. The only choices are to eliminate the deficit by (1) increasing income, (2) reducing expenses, or (3) borrowing to make up the difference. Borrowing may seem like the easiest and quickest solution, but borrowing also increases expenses, because it creates an additional expense: interest. Unless income can also be increased, borrowing to cover a deficit will only increase it.

Better, although usually harder, choices are to increase income or decrease expenses. Table 2.2.2 shows the choices created by a budget deficit.

Table 2.2.2 : Budget Deficit

Income Less Than Expenses = Budget Deficit		
1. Reduce Expenses	= consume less	= reduce budget deficit
2. Increase Income	= sell more labor or capital	= reduce budget deficit
3. Borrow	= increase (interest) expenses	= increase budget surplus

When income for a period exceeds expenses, a **budget surplus occurs**. That situation is sustainable and remains financially viable. You could choose to decrease income by, say, working less. More likely, you would use the surplus in one of two ways: consume more or save it. If consumed, the income is gone, although presumably you enjoyed it.

If saved, however, the income can be stored, perhaps in a piggy bank or cookie jar, and used later. A more profitable way to save is to invest it in some way - deposit it in a bank account, lend it with interest, or trade it for an asset, such as stocks, bonds, or real

estate. Those ways of saving are ways of selling your excess capital in the capital markets to increase your wealth. The following are examples of savings:

1. Depositing into a savings account at a bank
2. Contributing to a retirement account
3. Purchasing a certificate of deposit (CD)
4. Purchasing a government savings bond
5. Depositing into a money market account

Table 2.2.3 shows the choices created by a budget surplus.

Table 2.2.3 : Budget Surplus

Income Greater Than Expenses = Budget Surplus		
1. Increase Expenses	= consume more	= reduce budget surplus
2. Reduce Income	= sell less labor or capital	=reduce budget surplus
3. Save and Invest	= increase income	= increase budget surplus

Opportunity Costs and Sunk Costs

In personal finance, there is always an opportunity cost. You always want to make a choice that creates more value than cost, and therefore, you always want the opportunity cost to be less than the benefit from trade. You bought the jacket instead of the boots because you decided that having the jacket would bring more benefit than the cost of not having the boots. You believed your benefit would be greater than your opportunity cost.

Opportunity costs affect not only consumption decisions but also financing decisions, such as whether to borrow or to pay cash. Borrowing has obvious costs, whereas paying with your own cash or savings seems costless. Using your cash does have an opportunity cost, however. You lose any interest you may have earned on your savings, and you lose liquidity.

When buyers and sellers make choices, they weigh opportunity costs and sometimes regret them, especially when the benefits from trade are disappointing. Regret can color future choices. Sometimes regret can keep us from recognizing **sunk costs**.

Sunk costs are costs that have already been spent; that is, whatever resources you traded are gone, and there is no way to recover them. Decisions, by definition, can be made only about the future, not about the past. A trade, when it’s over, is over and done, so recognizing that sunk costs are truly sunk can help you make better decisions.

Unlike a price tag, opportunity cost is not obvious. You tend to focus on what you are getting in the trade, not on what you are *not* getting. This tendency is a cheerful aspect of human nature, but it can be a weakness in the kind of strategic decision-making that is so essential in financial planning. Human nature may also cause you to focus too much on sunk costs, but no amount of relish or regret can change past decisions. Learning to recognize sunk costs is important in making sound financial decisions.

Summary

- It is essential to comprehend the sources (incomes) and uses (expenses) of funds, as well as the resulting budget deficit or budget surplus.
- Wages or salary are income from employment or self-employment; interest is earned by lending; a dividend is the income from owning corporate stock; and a draw is income from a partnership.
- Deficits or surpluses need to be addressed, which means making informed decisions about how to manage them.
- Increasing income, reducing expenses, and borrowing are three common ways to address budget deficits.
- Spending more, saving, and investing are three ways to deal with budget surpluses.
- Opportunity costs and sunk costs are hidden expenses that affect financial decision-making.

Exercises

1. Where does your income come from, and where does it go? Analyze your income inflow from all sources and expenditure outflow for a month, quarter, or year. After analyzing your numbers and converting them to percentages, show your results in two figures, using proportions of a dollar bill to show where your income comes from and proportions of another dollar bill to show how you spend your income. How would you like your income to change? How would you like to see your distribution of expenses change? Use your investigation to develop a rough personal budget.
2. Examine your budget and distinguish between wants and needs. How do you define a financial need? What are your fixed expenses, or costs you must pay regularly each week, month, or year? Which of your budget categories must you provide for first before satisfying others? To what extent is each of your expenses discretionary, under your control in terms of spending more or less for that item or resource? Which of your expenses could you reduce if you had to or wanted to for any reason?
3. If you had a budget deficit, what could you do about it? What would be the best solution for the long term? If you had a budget surplus, what could you do about it? What would be your best choice, and why?
4. You need a jacket, boots, and gloves, but the jacket you want will use up all the money you have available for outerwear. What is the opportunity cost of buying the jacket? What is your sunk cost if you buy the jacket? How can you modify your consumption to minimize the opportunity cost? If you buy the jacket but find that you need the boots and gloves, how could you modify your budget to compensate for your sunk cost?

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2.3: Assets

Learning Objectives

1. Identify the purposes and uses of assets.
2. Identify the types of assets.
3. Explain the role of assets in personal finance.
4. Explain how a capital gain or loss is created.

As defined earlier in this chapter, an asset is any item with economic value that can be converted to cash. Assets are resources that can be used to generate income, reduce expenses, and store value. The following are examples of tangible (material) assets:

- Car
- Savings account
- Wind-up toy collection
- Money market account
- Shares of stock
- Forty acres of farmland
- Home

Assets can be used to store wealth, generate income, and mitigate future expenses.

Assets Store Wealth

If the asset is worth more when it is resold than it was when it was bought, then you have earned a **capital gain**: The investment has not only stored wealth but also increased it. Of course, things can go the other way too: the investment can decrease in value while it is owned and be worth less when resold than when it was bought. In that case, you have a **capital loss**. The investment not only did not store wealth, but it also lost some. Table 2.3.1 shows how capital gains and losses are created.

Table 2.3.1 : Gains and Losses

Buy lower	then sell higher	Capital GAIN
Buy higher	then sell lower	Capital LOSS

The better investment asset is one that increases in value by generating a capital gain during the time it is stored.

Assets Create Income

Some assets not only store wealth but also create income. An investment in an apartment house stores wealth and creates rental income, for example. An investment in a share of stock stores wealth and may also generate dividend income. A deposit in a savings account stores wealth and creates interest income. Some investors prioritize increasing asset value, while others focus on generating income from their investments.

Assets Reduce Expenses

Some assets are used to reduce living expenses. Purchasing an asset and using it may be cheaper than arranging for an alternative. Sometimes an asset may be expected to both store wealth and reduce future expenses. Table 2.3.2 shows the roles of assets in reducing expenses, increasing income, and storing wealth.

Table 2.3.2 : Assets and the Roles of Assets

Asset	Reduce Expenses	Increase Income	Store Wealth
Car	Yes	No	No
Savings Account	No	Yes	Yes
Money Market Account	No	Yes	Yes
Home	Yes	No	Yes
Rental Property	No	Yes	Yes
Investment in Bonds	No	Yes	Yes
Investment in Stocks	No	Yes	Yes

The choice of investment assets depends on your belief in their ability to store and increase wealth, create income, or reduce expenses. Ideally, your assets will store and increase wealth while increasing income or reducing expenses. Otherwise, acquiring the asset will not be a productive use of liquidity. Additionally, in this case, the opportunity cost will be greater than the benefit from the investment, as there are many assets to choose from.

Summary

- Assets are items with economic value that can be converted to cash. You use excess liquidity or surplus cash to purchase an asset and store wealth until you resell it.
- An asset can create income, reduce expenses, and store wealth.
- To have value as an investment, an asset must either store wealth or create income (reduce expenses); ideally, assets can do both.
- Whatever the type of asset you choose, investing in assets or selling capital can be more profitable than selling labor.
- Selling an asset can result in a capital gain or capital loss.
- Selling capital means trading in the capital markets, a seller's market. You can do this only if you have a budget surplus, or an excess of income over expenses.

Exercises

1. Record your answers to the following questions in your personal finance journal. What are your assets? How do your assets store your wealth? How do your assets make income for you? How do your assets help you reduce your expenses?
2. List your assets in the order of their cash or market value (most valuable to least valuable). Then list them in terms of their degree of liquidity. Which assets do you think you might sell in the next ten years? Why? What new assets do you think you would like to acquire and why? How could you reorganize your budget to make it possible to invest in new assets?

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2.4: Debt and Equity

Learning Objectives

1. Define equity and debt.
2. Compare and contrast the benefits and costs of debt and equity.
3. Illustrate the uses of debt and equity.
4. Analyze the costs of debt and equity.

Buying capital, that is, borrowing, enables you to invest without first owning capital. By using other people's money to finance the investment, you get to use an asset before owning it free and clear, assuming you can repay it out of future earnings. Buying capital gives you equity, borrowing capital gives you debt, and both kinds of financing have costs and benefits. When you buy or borrow liquidity or cash, you become a buyer in the capital market.

The Costs of Debt and Equity

You can buy capital from other investors in exchange for an ownership share or **equity**, which represents your claim on any future gains or income. If the asset is productive, it will store wealth, generate income, or reduce expenses. The equity holder, shareholder, or owner enjoys benefits in proportion to their share of the asset. If the asset loses value, the owner bears a portion of the loss in proportion to their share of the asset. The **cost of equity** occurs when you share the benefits from the investment.

Borrowing is essentially renting someone else's money for a specified period, resulting in **debt**. During that period, rent or **interest** must be paid, which is a **cost of debt**. When that period expires, all the capital (the **principal** amount borrowed) must be paid back. The investment's earnings must be enough to cover the interest, and its growth in value must be enough to return the principal. Thus, debt is a liability, an obligation for which the borrower is liable.

In contrast, the cost of equity may need to be paid only if income or wealth increases, and even then, it can be deferred. From the buyer's point of view, purchasing liquidity through borrowing (debt) has a more immediate impact on income and expenses. Interest must be added as an expense, and repayment must be anticipated.

Table 2.4.1 shows the implications of equity and debt as the sources of capital.

Table 2.4.1 : Sources of Capital

	Equity	Debt
Trade	Buy Capital	Borrow Capital
Cost/Expense	Share Profits and Gains	Pay Interest
Market	Capital Market	Credit Market

The Uses of Debt and Equity

Debt is a means of making an investment that would otherwise be unattainable. You incur debt when you buy an asset (e.g., a house, a car, or corporate stock) that you couldn't buy without borrowing. If that asset is expected to provide sufficient benefit (i.e., increase value, generate income, or reduce expenses) to compensate for its additional costs, then the debt is worthwhile. However, if debt creates additional expense without enough additional benefit, then it is not worth it. The problem is that costs are usually known up front, but benefits are not. That adds a dimension of risk to debt, which is another factor in assessing whether it's desirable.

Debt may also be used to cover a budget deficit, or the excess of expenses over income. However, in the long run, the cost of the debt will increase expenses that are already too big, which is what created the deficit in the first place. Unless income can also be increased, debt can only aggravate a deficit.

The Value of Debt

The value of debt includes the benefits of acquiring the asset sooner rather than later, which debt financing enables. One example of the value of debt is using debt to finance an education. Education is valuable because it offers numerous benefits that can be enjoyed throughout a lifetime. One benefit is an increase in potential earnings in wages and salaries. The demand for educated or more skilled employees is generally greater than for uneducated or less-skilled employees. Education helps create a more valuable and, thus, higher-priced employee.

It makes sense to maximize your value by becoming educated as soon as possible. That way, you have as long as possible to benefit from the increased income. It even makes sense to invest in an education before you sell your labor because the opportunity cost of going to school (in this case, the "lost" wages of not working) is lowest. Without income or savings (or very little) to finance your education, typically, you borrow. Debt enables you to use the value of education to enhance your income; income will then help you pay back your debt.

The alternative would be to work, save, and then get an education, but you would be earning income less efficiently until you completed your education, and then you would have less time to earn your return. Waiting decreases the value of your education, that is, its usefulness, throughout your lifetime.

In these examples (Table 2.4.2), debt creates a cost, but it reduces expenses or increases income to offset that cost. Debt allows this to happen sooner than it otherwise could, enabling you to realize the maximum benefit from the investment. In such cases, debt is worth it.

Table 2.4.2 : Debt: Uses, Value, and Cost

Debt	Debt Used to Finance	Value	Cost Paid from
Credit Cards	Living Expenses	Convenience	Income
Auto Loan	Car	Reduce Expenses	Income
Mortgage	Home	Reduce Expenses	Income
College Loan	Education	Increase (Future) Income	Future Income

Summary

- Financing assets through equity means sharing ownership and any associated gains or losses.
- Financing assets through borrowing and creating debt means taking on a financial obligation that must be repaid.
- Both equity and debt have costs and value.
- Both equity and debt enable you to use an asset sooner than you otherwise could and therefore to reap more of its rewards.

Exercises

1. Read about the founding of Google (www.foxbusiness.com/technology/how-google-was-founded), including information about their initial public offering (www.finance.yahoo.com/news/day-market-history-google-ipo-105500069.html) in August 2004. How did the young entrepreneurs Larry Page and Sergey Brin use equity and debt to make their business successful and increase their personal wealth?
2. Record your answers to the following questions in your personal finance journal. What equity do you own? What debt do you owe? In each case, what are your equity and debt financing options? What do they cost you? How do they benefit you?
3. Watch What Everyone's Getting Wrong About Student Loans (www.youtube.com/watch?v=wzY-b2Vj9Ug) (3:45 minutes) and How to Pay for College (www.youtube.com/watch?v=L6cjyTaExCQ) (10:32 minutes). Students fear incurring debt for their education or later struggling to repay student loans.
    1. What are practical financial planning tips to take advantage of debt financing for your education?
    2. If payments on student loans become overwhelming, what should you do to avoid default?

[1] The *Investopedia* Team. If You Had Invested Right After Google's IPO. *Investopedia*, August 13, 2015. www.investopedia.com/articles/active-trading/081315/if-you-would-have-invested-right-after-googles-ipo.asp.

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2.5: Income and Risk

Learning Objectives

1. Describe how sources of income may be diversified.
2. Describe how investments in assets may be diversified.
3. Explain the use of diversification as a risk management strategy.

Personal finance is not only about getting what you want; it is also about protecting what you have. Since the way to accumulate assets is to create surplus capital by having an income larger than expenses, and since you rely on income to provide for living expenses, you also need to think about protecting your income. One way to do so is through **diversification**, or spreading the risk.

Diversification is often discussed in terms of investment decisions, but diversification of income sources works similarly and makes sense for the same reasons. If sources of income are diverse, in number and kind, and one source of income ceases to be productive, then you still have others to rely on.

Mark has a checking account, an online money market account, and a balanced portfolio of stocks. If his stock portfolio lost value, he would still have the value in his money market account.

A better way to diversify sources of income is to sell both labor *and* capital. Then you are trading in different markets, and are not totally exposed to risks in either one. In Mark's case, if all his income were to dry up, he would still have his investments, and if all his investments lost value, he would still have his paycheck and other sources of income. To diversify to that extent, you need surplus capital to trade. This brings us full circle to Adam Smith, quoted at the beginning of this chapter, who said, essentially, "It takes money to make money."

Summary

Diversifying sources of income in both the labor market and the capital markets is the best hedge against risks in any one market.

Exercises

Record your answers to the following questions in your personal finance journal:

1. How can you diversify your sources of income to spread the risk of losing income?
2. How can you diversify your investments to spread the risk of losing return on investment?

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CHAPTER OVERVIEW

3: Financial Statements

This chapter continues with the discussion of organizing financial data to help in decision making and introduces basic analytical tools that can be used to clarify the situation portrayed in financial statements.

3.1: Introduction

3.2: Accounting and Financial Statements

3.3: Comparing and Analyzing Financial Statements

3.4: Accounting Software-An Overview

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3.1: Introduction

Since the first shepherds counted their sheep, there has been accounting.

In financial planning, assessing your current situation is crucial for determining an effective financial plan. This assessment serves as the starting point for any strategy. It becomes the mark from which any progress is measured, the principal from which any return is calculated. It can determine the practical or realistic goals to have and the strategies to achieve them.

Understanding the current situation is not only a matter of measuring it, but also of putting it in perspective and context relative to your own past performance and future goals. Determine how your current position is relative to the realities in the economic world around you. Tools for understanding your current situation are your accounting and financial statements.

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3.2: Accounting and Financial Statements

Learning Objectives

1. Distinguish between accrual and cash accounting.
2. Compare and contrast the three common financial statements.
3. Identify the results shown on the income statement, balance sheet, and cash flow statement.
4. Explain the calculation and meaning of net worth.
5. Trace how a bankruptcy can occur.

The method of accounting universally used in business today is known as **accrual accounting**, in which events are accounted for even if cash does not change hands. That is, transactions are recorded at the time they occur rather than when payment is actually made or received. Anticipated or preceding payments and receipts (cash flows) are recorded as accrued or deferred. Accrual accounting is the opposite of **cash accounting**, in which transactions are recognized only when cash is exchanged.

Accrual accounting defines earnings as an economic event signified by an exchange of goods rather than by an exchange of cash. In this way, accrual accounting allows for the separation in time of the exchange of goods and the exchange of cash. A transaction can be completed over time and distance, which allows for extended and extensive trade. Another advantage of accrual accounting is that it provides a business with a more accurate picture of its current financial situation.

In personal finance, it almost always makes more sense to use cash accounting to define and account for events when cash changes hands. In personal finance, incomes and expenses are noted when cash is received or paid, or when the cash flows.

The Accounting Process

Financial decisions result in transactions, or actual trades that involve buying, selling, investing, or borrowing. The accounting process records these transactions, documenting what has been received and what has been given up to obtain it, as well as what flows in and what flows out.

In business, accounting journals and ledgers are designed to record transactions as they happen. In personal finance, a bank account record typically tracks most transactions, with statements from banks or investment accounts providing records of the remaining transactions. Periodically, transaction information is summarized in financial statements, making it readily understandable.

Bookkeeping - the process of recording what, how, and by how much a transaction affects the financial situation - is how events are recorded. Since the advent of accounting software, bookkeeping, like long division and spelling, has become somewhat obsolete, although human judgment is still required. What is more interesting and useful are the summary reports that can be produced once all this information is recorded: the income statement, cash flow statement, and balance sheet.

Income Statement

The **income statement** summarizes incomes and expenses over a period of time. In business, income is the value of what is sold, expenses are the costs incurred in earning that income, and the difference is profit. In personal finance, income is what is earned as wages or salary and as interest or dividends, and expenses are the costs of things consumed in the course of daily living: the costs of sustaining *you* while you earn income. Thus, the income statement measures what you have earned and the cost of living associated with those earnings. The difference is personal surplus, which, if accumulated as investments, becomes your wealth.

The income statement clearly shows the relative size of your income and expenses. If income is greater than expenses, there is a surplus, and that surplus can be used to save or to spend more (and create more expenses). If income is less than expenses, then there is a deficit that must be addressed. If the deficit continues, it creates debts - unpaid bills - that must eventually be paid. Over the long term, a deficit is not a viable scenario.

The income statement can also be useful for its level of detail. You can see which of your expenses consumes the greatest portion of your income or which expense has the greatest or least effect on your surplus or deficit. To reduce expenses, consider identifying which ones would have the greatest impact or free up more income if they were reduced. If you want to increase income, you can

see how much more that would buy you in terms of your expenses (Table 3.2.1). For example, consider Alice's situation per year, as shown in the following table.

Figure 3.2.1 : Alice's Situation (in Dollars)

Gross wages	$ 44,650
Income taxes and deductions	$ 8,930
Rent expense	$ 10,800
Living expenses	$ 14,400

In addition, she had car payments of $2,400 and student loan payments of $7,720. Each loan payment covers the interest expense and partial repayment of the loan. The interest is an expense representing the cost of borrowing, and thus the cost of owning the car and pursuing education. The repayment of the loan is not an expense, but rather a return of something that was borrowed. In this case, the loan payments break down as follows (Table 3.2.2).

Table 3.2.2 : Alice's Loan Payments (Annually)

	Interest	Debt Repayment
Car Loan	$ 240	$ 2,160
Student Loan	$ 4,240	$ 3,480

Breaking down Alice's living expenses in more detail and adding in her interest expenses, Alice's income statement would look like this (Table 3.2.3).

Table 3.2.3 : Alice's Income Statement for the Year 2023

Gross wages		$ 44,650
Income taxes and deductions	$ 8,930	
Disposable income		$ 35,720
Rent expense	$ 10,800	
Food	$ 3,900	
Car expenses (gas, insurance, repairs)	$ 3,600	
Clothing	$ 1,800	
Cell phone	$ 1,200	
Internet and streaming services	$ 1,200	
Entertainment, travel, etc.	$ 2,700	
Total living expenses		$ 25,200
Car loan interest	$ 240	
Student loan interest	$ 4,240	
Total interest expenses		$ 4,480
Net income		$ 6,040

Alice's **disposable income**, or income to meet expenses after taxes have been accounted for, is $35,720. Alice's net income, or net earnings or surplus, is the remaining income after all other expenses have been deducted, in this case, $6,040.

Now Alice has a much clearer view of what's going on in her financial life. She can see, for example, that living expenses take the biggest bite out of her income and that rent is the biggest single expense. If she wanted to decrease expenses, finding a cheaper place to live would make the most impact on her bottom line. It might make more sense to make many small changes (cutting back on a few expenses) rather than one large change. She could begin by cutting back on items that she feels are least necessary or that she could most easily live without. Perhaps she could do with less entertainment, clothing, or travel, for example. Whatever choices she subsequently made would be reflected in her income statement. The value of the income statement lies in presenting income and expenses in detail for a specific period.

Cash Flow Statement

The **cash flow statement** shows how much cash came in, where it came from, how much cash went out, and where it went over a period of time. This differs from the income statement because it may include cash flows that are not from income and expenses. Examples of such cash flows would be receiving repayment of money that you loaned, repaying money that you borrowed, or using money in exchanges such as buying or selling an asset.

The cash flow statement is important because it can show how well you manage liquidity, as well as your net income. Liquidity is nearness to cash, and liquidity has value. An excess of liquidity can be sold or lent, creating additional income. A lack of liquidity must be addressed by buying it or borrowing, creating additional expense.

Considering Alice's situation, she has two loan repayments that are not expenses and therefore are not included on her income statement. However, these payments reduce her liquidity, making it more difficult for her to generate excess cash. Her cash flow statement looks like this (Table 3.2.4).

Table 3.2.4 : Alice's Cash Flow Statement for the Year 2023

Cash from gross wages	$ 44,650
Cash paid for:	
Income taxes and deductions	$ 8,930
Rent expense	$ 10,800
Food	$ 3,900
Car expenses (gas, insurance, repairs)	$ 3,600
Clothing	$ 1,800
Cell phone	$ 1,200
Internet and streaming services	$ 1,200
Entertainment, travel, etc.	$ 2,700
Car loan interest	$ 240
Student loan interest	$ 4,240
Cash for repayment of car loan	$ 2,160
Cash for repayment of student loan	$ 3,480
Net cash flow	$ 400

As with the income statement, the cash flow statement is more useful if it includes subtotals for the different types of cash flows, as defined by their sources and uses. The cash flows from income and expenses are **operating cash flows**, or cash flows that are a consequence of earning income or paying for the costs of earning income. The loan repayments are **cash flows from financing** assets or investments that will increase income. In this case, cash flows from financing include repayments on the car and the education. Although Alice doesn't have any in this example, there could also be **cash flows from investing**, from buying or selling

assets. **Free cash flow** is the cash available for investment or financing decisions after accounting for operational expenses and debt obligations. It is calculated as cash flow from operations less debt repayments.

The most significant difference between the three categories of cash flows (operating, investing, or financing) is whether the cash flows are expected to recur regularly. Operating cash flows recur regularly; they are the cash flows resulting from income and expenses or consumption; therefore, they can be expected to occur in every year. Operating cash flows may vary in different periods, but they occur consistently in every period. Investing and financing cash flows, on the other hand, may or may not recur and often are unusual events. Typically, for example, you would not borrow, lend, buy, or sell assets on a yearly basis. Here is how Alice's cash flows would be classified (Table 3.2.5).

Table 3.2.5 : Alice's Cash Flow Statement for the Year 2023

Cash from gross wages	$ 44,650	
Cash paid for:		
Income taxes and deductions	$ 8,930	
Rent expense	$ 10,800	
Food	$ 3,900	
Car expenses	$ 3,600	
Clothing	$ 1,800	
Cell phone	$ 1,200	
Internet and streaming services	$ 1,200	
Entertainment, travel, etc.	$ 2,700	
Car loan interest	$ 240	
Student loan interest	$ 4,240	
Operating cash flows		$ 6,040
Cash for repayment of car loan	$ 2,160	
Cash for repayment of student loan	$ 3,480	
Financing cash flows		$ 5,640
Net cash flow		$ 400

This cash flow statement more clearly shows how liquidity is created and where liquidity could be increased. If Alice wanted to create more liquidity, it is obvious that eliminating those loan payments would be a big help: Without them, her net cash flow would increase by more than 3,900 percent.

Balance Sheet

In business or personal finance, a critical piece in assessing the current situation is the balance sheet. Often referred to as the “statement of financial condition,” the **balance sheet** is a snapshot of what you have and what you owe at a given point in time. Unlike the income or cash flow statements, it is not a record of performance over a period of time, but simply a statement of where things stand at a certain moment.

The balance sheet is a list of assets, debts or liabilities, and equity or net worth, along with their corresponding values. In business, assets are resources that can be used to create income, while debt and equity are the capital that finances those assets. Thus, the value of the assets must equal the value of the debt and the equity. In other words, the value of the business's resources must equal the value of the capital it borrowed or bought to get those resources.

$$\text{assets} = \text{liabilities} + \text{equity}$$

In business, the **basic accounting equation** is as absolute as the law of gravity. It simply must always be true, because if there are assets, they must have been financed somehow - either through debt or equity. The value of that debt and equity financing must equal or balance the value of the assets it bought. Thus, it is called the “balance” sheet because it *always* balances the debt and equity with the value of the assets.

In personal finance, assets are also things that can be sold to create liquidity. To satisfy or repay debts, liquidity is needed. Because your assets are what you use to satisfy your debts when they become due, the value of the assets should be greater than the value of your debts. That is, you should have more to work with to meet your obligations than you owe.

The difference between what you have and what you owe is your **net worth**. Net worth is the share that you own of everything that you have. It is the value of what you have *net of* (less) what you owe to others. Whatever asset value is left over after you meet your debt obligations is your own worth. It is the value of what you have that you can claim free and clear. Your net worth is essentially your financial equity or ownership in your own life. Here, too, the personal balance sheet must balance, because if

$$\text{assets} - \text{debts} = \text{net worth}$$

then it should also be

$$\text{assets} = \text{debts} + \text{net worth}$$

Alice could write a simple balance sheet to see her current financial condition. She has two assets (her car and her savings account) and she has two debts (her car and student loans) (Table 3.2.6).

Table 3.2.6 : Alice's Balance Sheet, December 31, 2023

Assets		Liabilities	
Car	$ 5,000	Car Loan	$ 2,700
Savings	$ 250	Student Loan	$ 53,000
Total	$ 5,250	Total	$ 55,700
		Net Worth	-$ 50,450

Not only does Alice's balance sheet present her with a much clearer picture of her financial situation, but it also lists a dismaying prospect: She seems to have a negative net worth. **Negative net worth** results whenever the value of debts or liabilities is greater than the assets' value (Table 3.2.7).

Table 3.2.7 : Relationship between Assets, Liabilities, and Net Worth

IF	THEN	AND
liabilities < assets	assets - liabilities > 0	net worth > 0 (net worth is positive)
liabilities > assets	assets - liabilities < 0	net worth < 0 (net worth is negative)

Negative net worth implies that the assets don't have enough value to satisfy the debts. Since debts are obligations, this would cause some concern.

Net Worth and Bankruptcy

In business, when liabilities exceed the assets available to meet them, the business has negative equity and is considered bankrupt. In that case, it may go out of business, selling all its assets and giving whatever it can to its **creditors** or lenders, who will have to settle for less than what they are owed. More often, the business continues to operate in bankruptcy, if possible, and must still repay its creditors, although perhaps under somewhat easier terms. Creditors (and the laws) allow these terms because creditors would rather receive payment in full later than receive less now or not at all.

In personal finance, personal **bankruptcy** may occur when debts exceed the value of assets. However, because creditors would rather be paid eventually than never, the person in bankruptcy is usually allowed to continue earning income in the hopes of repaying the debt later or on easier terms. Often, the bankrupt is forced to liquidate (sell) some or all of its assets. When a person files for bankruptcy in the U.S. Bankruptcy Court, they are asking the court to eliminate debt or approve a repayment plan. A bankruptcy case starts when the debtor (the person or entity filing for bankruptcy) files a petition with the court. An individual, a spouse, a corporation, or another entity can file a petition. All bankruptcy cases are handled in federal courts under rules outlined in the U.S. Bankruptcy Code.

Because debt is both a legal and an economic obligation, the laws governing bankruptcies vary from state to state in the United States and differ in other countries. The use of another's property or wealth is a serious responsibility, so debt is a solemn obligation.

However, Alice's case is not as dismal as it looks, because Alice has an “asset” not listed on her balance sheet: her education. It is not listed on her balance sheet because the value of her education, like the value of any asset, derives from its usefulness, which has not yet occurred but will happen over her lifetime. It will happen in her future, based on how she chooses to use her education to increase her income and wealth. It is difficult to assign a monetary value to her education at this time. Alice knows what she paid for her education, but, sensibly, its real value is not its cost but its potential return, or what it can help her earn as she puts it to use in the future.

Current studies indicate that a college education has economic value, as college graduates typically earn more over their lifetime than high school graduates. Recent estimates put that difference at approximately $1,000,000. [1] So, if Alice assumes that her education will be worth $1,000,000 in extra income over her lifetime, and she includes that asset value on her balance sheet, then it would look more like this (Table 3.2.8):

Table 3.2.8 : Alice's Balance Sheet (revised), December 31, 2023

Assets		Liabilities	
Car	$ 5,000	Car Loan	$ 2,700
Savings	$ 250	Student Loan	$ 53,000
Education	$ 1,000,000	Total	$ 55,700
Total	$ 1,005,250	Net Worth	$ 949,550

This looks much better, but it's not sound accounting practice to include an asset—and its value—on the balance sheet before it exists. After all, education generally pays off, but until it does, it hasn't yet, and there is a chance, however slim, that it won't for Alice. A balance sheet is a snapshot of one's financial situation at a particular point in time. At this specific time, Alice's education has value, but its amount is unknown.

However, it is easy to see that the only thing that creates negative net worth for Alice is her student loan. The student loan causes her liabilities to exceed her assets - and if that were paid off, her net worth would be positive. Given that Alice is just starting her adult earning years, her situation seems quite reasonable.

Summary

- Three commonly used financial statements are the income statement, the cash flow statement, and the balance sheet.
- Results for a period are shown on the income statement and the cash flow statement. Current point-in-time conditions are reflected on the balance sheet.

- The income statement lists income and expenses.
- The cash flow statement categorizes three types of cash flows: operating (recurring), financing (non-recurring), and investing (non-recurring).
- The balance sheet lists assets, liabilities (debts), and net worth.
- Net worth = assets − debts.
- Bankruptcy occurs when an individual or entity has a negative net worth, or when their debts exceed their assets.

? Exercises

1. Prepare a personal income statement for the past year, using the same format as Alice's income statement in this chapter. Include all relevant categories of income and expenses. What does your income statement tell you about your current financial situation? For example, where does your income come from, and where does it go? Do you have a surplus of income over expenses? If so, what are you doing with the surplus? Do you have a deficit? What can you do about that? Which of your expenses has the most significant effect on your bottom line? What is the most significant expense? Which expenses would be easiest to reduce or eliminate? How else could you reduce expenses? Realistically, how could you increase your income? How would you like your income statement for the next year to look?
2. Using the format for Alice's cash flow statement, prepare your cash flow statement for the same one-year period. Include your cash flows from all sources, in addition to your operating cash flows - the income and expenses that appear on your income statement. What, if any, were the cash flows from financing and the cash flows from investing? Which of your cash flows are recurring, and which are nonrecurring? What does your cash flow statement tell you about your current financial situation? If you wanted to increase your liquidity, what would you try to change about your cash flows?
3. Now prepare a balance sheet, again based on Alice's form. List all your assets, liabilities, and debts, and your equity from all sources. What does the balance sheet show about your financial situation at this moment in time? What is your net worth? Do you have positive or negative net worth at this time, and what does that mean? To increase your liquidity, how would your balance sheet need to change? What would be the relationship between your cash flow statement and your budget?
4. Read the *Investopedia* article Net Worth: What It Is and How to Calculate It (www.investopedia.com/terms/n/networth.asp) and determine your net worth. How does your net worth compare to that of other Americans in your age and income brackets?
5. The Small Business Administration's Personal Financial Statement (www.sba.gov/document/sba-form-413-personal-financial-statement) combines features of an income statement and a balance sheet. You would fill out a similar form if you applied for a personal or business loan at a bank or mortgage lender. Compare and contrast the SBA form with the statements you already created for this chapter's exercises.

[1] Michael T. Nietzel, "College Degrees Lead To $14.2 Trillion Gain In Career Earnings, Study Finds", *Forbes*, March 4, 2024. www.forbes.com/sites/michaeltnietzel/2024/03/01/college-degrees-lead-to-142-trillion-gain-in-career-earnings-study-finds.

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3.3: Comparing and Analyzing Financial Statements

Learning Objectives

1. Explain the use of common-size statements in financial analysis.
2. Discuss the design of each common-size statement.
3. Demonstrate how changes in the income and cash flow statements may explain changes in the balance sheet.
4. Identify the purposes and uses of ratio analysis.
5. Describe the value of comparing financial statements over time.

Financial statements are valuable summaries of financial activities because they organize information, making it easier to see and understand. Each one (the income statement, cash flow statement, and balance sheet) conveys a different aspect of the financial picture; put together, the picture is pretty complete. The three provide a summary of earnings and expenses, cash flows, and assets and debt.

Since the three statements offer different kinds of information, it is sometimes useful to examine each in the context of the others and to consider specific items within the larger context. The purpose of financial statement analysis is to create comparisons and contexts to gain a better understanding of the financial picture.

Common-Size Statements

On **common-size statements**, each item's value is listed as a percentage of another. This comparison shows the relative size and significance of items (see Table 3.3.1). On the income statement, each income and expense is listed as a percentage of the total income. This illustrates the contribution of each type of income to the total, thereby demonstrating the diversity of income sources. It also illustrates the burden of each expense on total income, showing how much income is required to support each expense.

On the cash flow statement, each cash flow can be listed as a percentage of total positive cash flows, again highlighting the relative significance and diversification of cash sources, as well as the relative size of each cash use.

On the balance sheet, each item is listed as a percentage of total assets, indicating the relative significance and diversification of assets, and highlighting the use of debt as a financing source for these assets.

Table 3.3.1 : Common Common-Size Statements

	Income Statement	Cash Flow Statement	Balance Sheet
Items as a % of	Total Income	Total Positive Cash Flows	Total Assets

Common-Size Income Statement

Alice can analyze a **common-size income statement** by examining her expenses as a percentage of her income and comparing the size of each expense to a common denominator: her total income. This shows her how much of her income is allocated to each expense proportionally (Table 3.3.2).

Table 3.3.2 : Alice's Common-Size Income Statement for the Year 2023

Gross wages		$ 44,650		100.00%
Income taxes and deductions	$ 8,930		20.00%	
Disposable income		$ 35,720		80.%
Rent expense	$ 10,800		24.19%	
Food	$ 3,900		8.73%	
Car expense	$ 3,600		8.06%	
Clothing	$ 1,800		4.03%	
Cell phone	$ 1,200		2.69%	
Internet and streaming services	$ 1,200		2.69%	
Entertainment, travel, etc.	$ 2,700		6.05%	
Total living expenses		$ 25,200		56.44%
Car loan interest	$ 240		0.54%	
Student loan interest	$ 4,240		9.50%	
Total interest expense		$ 4,480		10.03%
Net income		$ 6,040		13.53%

Seeing the common-size statement as a tree map makes the relative size of the slices even clearer (Figure 3.3.3).

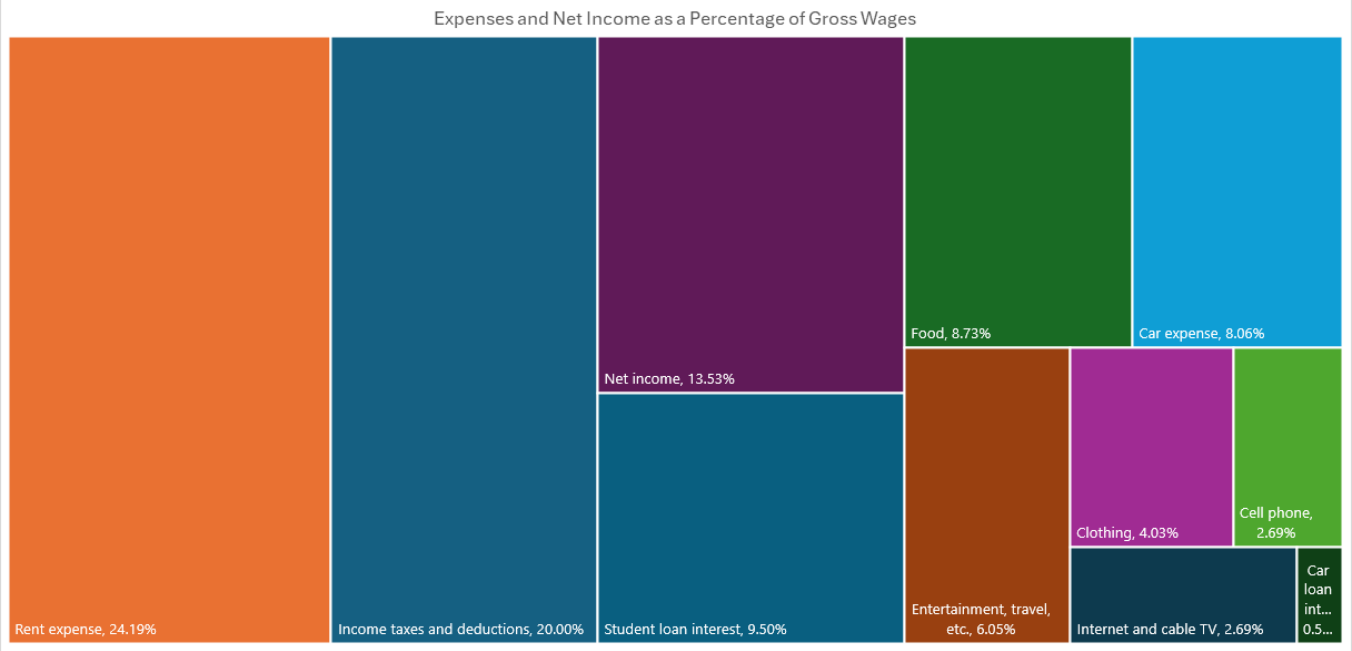


Figure 3.3.3 : Tree Map of Alice's Common-Size Income Statement for the Year 2023

The most significant portion of Alice's wages is spent on rent, followed by food, car expenses, and entertainment. Her income tax expense is a big use of her wages, but it is unavoidable and non-discretionary. Ranking expenses by size offers a fascinating insight into lifestyle choices. It is also valuable in framing financial decisions, as it highlights which expenses have the greatest impact on

income and thus on the resources available for making informed financial decisions. If Alice wanted more discretionary income to make different choices, she could easily see that reducing rent expenses would have the most impact on freeing up some of her wages for other uses.

Common-Size Cash Flow Statement

Looking at Alice's negative cash flows as percentages of her positive cash flow (on the cash flow statement), or the uses of cash as percentages of the sources of cash, creates the **common-size cash flows**. As with the income statement, this provides Alice with a clearer and more immediate view of the largest uses of her cash (Tables 3.3.4 and 3.3.6).

Table 3.3.4 : Alice's Common-Size Cash Flow Statement for the Year 2023

	Cash from gross wages	$ 44,650		100.00%
.	Cash paid for:			
.	Income taxes and deductions	$ 8,930		-20.00%
.	Rent expense	$ 10,800		-24.19%
.	Food	$ 3,900		-8.73%
.	Car expenses	$ 3,600		-8.06%
.	Clothing	$ 1,800		-4.03%
.	Cell phone	$ 1,200		-2.69%
.	Internet and streaming services	$ 1,200		-2.69%
.	Entertainment, travel, etc.	$ 2,700		-6.05%
.	Car loan interest	$ 240		-0.54%
.	Student loan interest	$ 4,240		-9.50%
.	Operating cash flows		$ 6,040	-13.53%
.	Cash for repayment of car loan	$ 2,160		-4.84%
.	Cash for repayment of student loan	$ 3,480		-7.79%
.	Financing cash flows		$ 5,640	-12.63%
.	Net cash flow		$ 400	0.00%

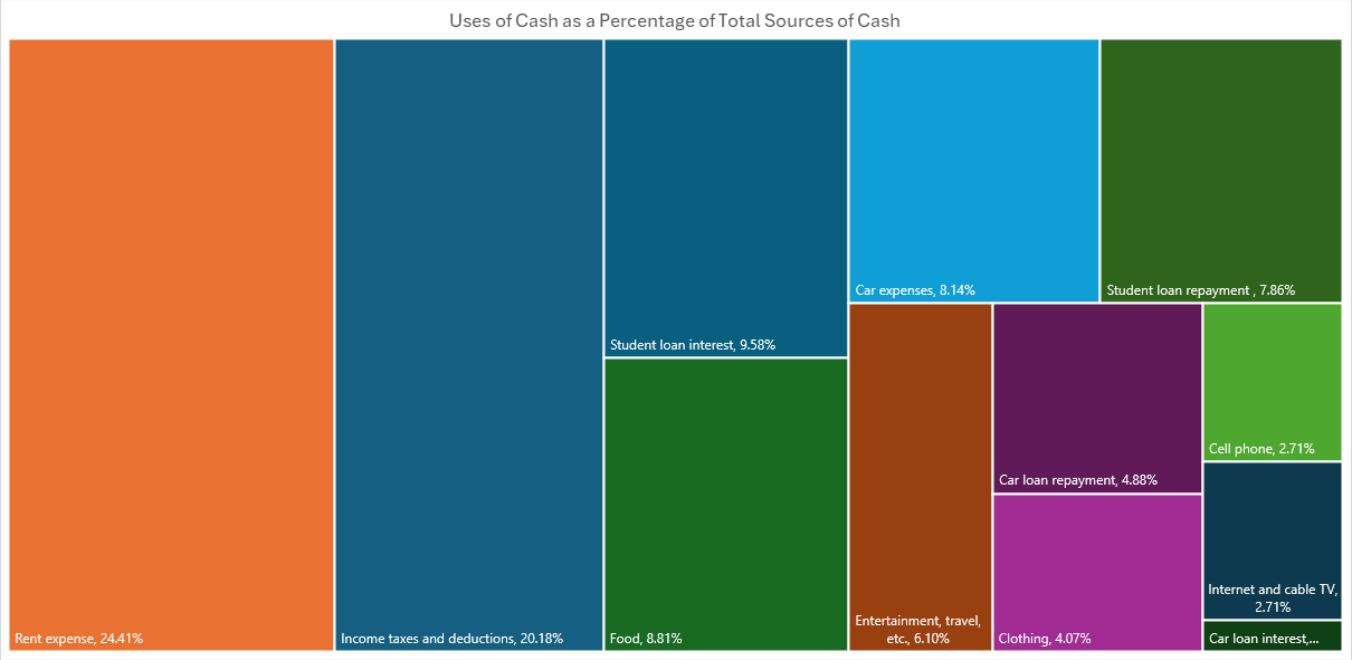


Figure 3.3.5 : Treemap of Alice's Common-Size Cash Flow Statement

Again, rent is the biggest discretionary use of cash for living expenses, but debts demand the most significant portion of cash flows. Repayments and interest together account for 30 percent of Alice's cash, which is equivalent to the amount she pays for rent and food. Eliminating those debt payments would create substantial liquidity for Alice.

Common-Size Balance Sheet

On the balance sheet, examining each item as a percentage of total assets enables the measurement of how much of the assets' value is allocated to cover each debt, or how much of the assets' value is claimed by each debt (Figure 3.3.6).

Figure 3.3.6 : Alice's Common-Size Balance Sheet, December 31, 2023

Assets			Liabilities		
Car	$ 5,000	95.00%	Car Loan	$ 2,700	51.00%
Savings	$ 250	5.00%	Student Loan	$ 53,000	1,010.00%
Total	$ 5,250	100.00%	Total	$ 55,700	1,061.00%
			Net Worth	-$ 50,450	-961.00%

This **common-size balance sheet** makes "oversized" items more apparent. For example, it is immediately apparent that Alice's student loan exceeds her asset value, resulting in a negative net worth. Diversification reduces risk, so it is advisable to diversify the sources of income and assets you can utilize to create value.

For example, Alice has only two assets, and one, her car, accounts for 95 percent of the value of her assets. If something were to happen to her car, her assets would lose 95 percent of their value. Her asset value would be less exposed to risk if she had other assets.

Likewise, both her income and her positive cash flows come from only one source, her paycheck. Because her positive net earnings and positive net cash flows depend on this one source, she is exposed to risk, which she could decrease by diversifying her sources of income. She could diversify by adding earned income, such as taking on a second job, or by creating investment income. To create investment income, however, she needs to have a surplus of liquidity, or cash, to invest.

Relating the Financial Statements

Common-size statements put the details of the financial statements in clear contrast relative to a common factor for each statement, but each financial statement is also related to the others. Each is a piece of a larger picture, and as important as it is to see each piece, it is also essential to see that larger picture. To make sound financial decisions, you need to be able to foresee the consequences of a decision and understand how it may affect the various aspects of the broader picture.

There are many other possible scenarios and transactions. Still, you can begin to see that the balance sheet at the end of a period is changed from what it was at the beginning of the period by what happens during the period, and what happens during the period is shown on the income statement and the cash flow statement.

The significance of these relationships becomes even more important when evaluating alternatives for financial decisions. When you understand how the statements are related, you can use that understanding to project the effects of your choices on different aspects of your financial reality and see the consequences of your decisions.

Ratio Analysis

Creating ratios is another way to see the numbers in relation to each other. Any ratio shows the relative size of the two items compared, just as a fraction compares the numerator to the denominator or a percentage compares a part to the whole. The percentages on the common-size statements are ratios, although they only compare items within a financial statement. Ratio analysis is used to make comparisons across statements.

The **financial ratios** you use depend on the perspective you need or the question(s) you need answered. Some of the more common ratios (and questions) are presented in the following chart (Table 3.3.8).

Table 3.3.8 : Common Personal Financial Ratios

Ratio	Calculation	Question it helps to answer
Net income margin	Net income Total income	How much income is used up by expenses?
Return on assets	Net income / Total assets	How big is the income supporting the assets?
Return on net worth	Net income Net worth	How big is income relative to net worth?
Debt to assets	Total debt Total assets	How much asset value is financed by debt? Or how much asset value is there to satisfy debt?
Total debt	Total debt Net worth	How large is debt relative to net worth?
Interest coverage	Income before interest Interest expense	How well does income cover interest expenses?
Cash flow to income	Net cash flow Net income	How much do payments for investments and financing take from income?
Cash flow to assets	Net cash flow Total assets	How much cash flow supports assets?
Free cash flow	Free cash flow Net cash flow	How much cash is left to invest after covering living expenses and debt repayments?

These ratios all get "better" or show improvement as they get bigger, with two exceptions: debt-to-assets and total debt. Those two ratios measure levels of debt, and the smaller the ratio, the less the debt. Ideally, the two debt ratios would be less than one. If your debt-to-assets ratio is greater than one, then debt is greater than assets, and you are insolvent. If the total debt ratio is greater than one, then debt is greater than net worth, and you "own" less of your assets' value than your creditors do.

Some ratios will naturally be less than one, but the bigger they are, the better. For example, net income margin will always be less than one because net income will always be less than total income (net income = total income − expenses). The larger the ratio, and the fewer expenses that are deducted from the total income, the better.

Some ratios should be greater than one, and the bigger they are, the better. For example, the interest coverage ratio should be greater than one, because you should have more income to cover interest expenses than you have interest expenses, and the more you have, the better. Table 3.3.9 suggests what to look for in the results of your ratio analyses.

Table 3.3.9 : Results of Ratio Analysis

Ratio	Calculation	Question it helps to answer	Better as it gets
Net income margin	Net income - Total income	How much income is used up by expenses?	Bigger Will be <1
Return on assets	Net income - Total assets	How big is the income supporting the assets?	Bigger
Return on net worth	Net income Net worth	How big is income relative to net worth?	Bigger
Debt to assets	Total debt Total assets	How much asset value is financed by debt? Or how much asset value is there to satisfy debt?	Smaller Should be <1
Total debt	Total debt- Net worth	How large is debt relative to net worth?	Smaller Should be <1
Interest coverage	Income before interest Interest expense	How well does income cover interest expenses?	Bigger Should be>1
Cash flow to income	Net cash flow Net income	How much do payments for investments and financing take from income?	Bigger
Cash flow to assets	Net cash flow / Total assets	How much cash flow supports assets?	Bigger
Free cash flow	Free cash flow Net cash flow	How much cash is left to invest after covering living expenses and debt repayments?	Bigger

While you may have a pretty good "feel" for your situation just by paying the bills and living your life, it so often helps to have the numbers in front of you. Here is Alice's ratio analysis for 2023 (Table 3.3.10).

Table 3.3.10 : Alice's Ratio Analysis, 2023

Ratio	Calculation	Result
Net income margin	Net income + Total assets	0.1353
Return on assets	Net income + Net worth	1.1505
Return on net worth	Total debt + Total assets	-0.1197
Debt to assets	Total debt + Net worth	10.6095
Interest coverage	Income before interest + interest expense	2.3482
Cash flow to income	Net cash flow + Net income	0.0662
Cash flow to assets	Net cash flow + Total assets	0.0762
Free cash flow	Free cash flow + Net cash flow	1.0000

The ratios that involve net worth—return-on-net-worth and total debt—are negative for Alice, because she has negative net worth, as her debts are larger than her assets. She can see how much larger her debt is than her assets by looking at her debt-to-assets ratio. Although she has a lot of debt (relative to assets and net worth), she can earn enough income to cover the cost of interest expense, as shown by the interest coverage ratio.

Alice has good earnings. Her income exceeds her assets. She can live efficiently. Her net income is a healthy 13.53 percent of her total income (net income margin), which means that her expenses are only 86.47 percent of it. Still, her cash flows are significantly lower (cash flow to income), meaning that a substantial portion of her earnings is used up in making investments or, in Alice's case, debt repayments. Her debt repayments don't leave her with much free cash flow; that is, cash flow which is not used up on living expenses or debts.

Examining the ratios, it becomes even more apparent how substantial—and yet subtle—a burden Alice's debt is. In addition to giving her a negative net worth, it prevents her from increasing her assets and creating a positive net worth, as well as potentially generating more income, by obligating her to use up her cash flows. Debt repayment keeps her from being able to invest.

Comparisons over Time

Another useful way to compare financial statements is to examine how the situation has evolved. Comparisons over time provide insights into the effects of past financial decisions and changes in circumstances. That insight can guide you in making future financial decisions, particularly in foreseeing the potential costs or benefits of a choice. Looking backward can be very helpful in looking forward.

Fast-forward ten years: Alice is now in her early thirties. Her career has progressed, and her income has grown. She has paid off her student loan and has started saving for retirement, as well as possibly a down payment on a house.

A comparison of Alice's financial statements shows the change over the decade, both in absolute dollar amounts and as a percentage (see Table 3.3.11 , Table 3.3.12 , and Table 3.3.13). In this example, the assumption is that inflation has not significantly increased during the decade.

Table 3.3.11 : Alice's Income Statements: Comparison Over Time

For the Year Ending	12/31/2023	12/31/2033	Change	% Change
Gross wages	$ 44,650	$ 74,000	$ 29,350	65.73%
Income taxes and deductions	$ 8,930	$ 18,500	$ 9,570	107.17%
Disposable income	$ 35,720	$ 55,500	$ 19,780	55.38%
Rent expense	$ 10,800	$ 18,000	$ 7,200	66.67%
Food	$ 3,900	$ 3,900		0.00%
Car expenses	$ 3,600	$ 3,600		0.00%
Clothing	$ 1,800	$ 1,800		0.00%
Cell phone	$ 1,200	$ 1,200		0.00%
Internet and streaming services	$ 1,200	$ 1,200		0.00%
Entertainment travel, etc.	$ 2,700	$ 5,200	$ 2,500	92.59%
Total living expenses	$ 25,200	$ 34,900	$ 9,700	38.49%
Car loan interest	$ 240	$ 757	$ 517	215.42%
Student loan interest	$ 4,240		-$ 4,240	-100.00%
Total interest expenses	$ 4,480	$ 757	-$ 3,723	-83.10%
Net income	$ 6,040	$ 19,843	$ 13,803	228.53%

Table 3.3.12 : Alice's Cash Flow Statements: Comparison Over Time

For the Year Ending	12/31/2023	12/31/2033	Change	% Change
Cash from gross wages	$ 44,650	$ 74,000	$ 29,350	65.73%
Cash paid for:				
Income taxes and deductions	-$ 8,930	-$ 18,500	-$ 9,570	107.17%
Rent expense	-$ 10,800	-$ 18,000	-$ 7,200	66.67%
Food	-$ 3,900	-$ 3,900		0.00%
Car expenses	-$ 3,600	-$ 3,600		0.00%
Clothing	-$ 1,800	-$ 1,800		0.00%
Cell phone	-$ 1,200	-$ 1,200		0.00%
Internet and cable TV	-$ 1,200	-$ 1,200		0.00%
Entertainment, travel, etc.	-$ 2,700	-$ 5,200	-$ 2,500	92.59%
Car loan interest	-$ 240	-$ 757	-$ 517	215.42%
Student loan interest	-$ 4,240		$ 4,240	-100.00%
Operating cash flows	-$ 6,040	$ 19,843	$ 13,803	228.53%
Cash invested in 401k		-$ 3,000	-$ 3,000	100.00%
Cash invested in car		-$ 6,300	-$ 6,300	100.00%
Investing cash flows		-$ 9,300	-$ 9,300	100.00%
Cash for repayment of car loan	-$ 2,160	-$ 4,610	-$ 2,450	113.43%
Cash for repayment of student loan	-$ 3,480			-100.00%
Financing cash flows	-$ 5,640	-$ 4,610	$ 1,030	-18.26%
Net cash flow	$ 400	$ 5,933	$ 5,533	1383.25%

Table 3.3.13 : Alice's Balance Sheets: Comparison Over Time

As of	12/31/2023	12/31/2033	Change	% Change
Assets				
Cash/checking		$ 5,000	$ 5,000	100.00%
Savings	$ 250	$ 250		0.00%
Money market		$ 2,600	$ 2,600	100.00%
Retirement 401(k)		$ 13,000	$ 13,000	100.00%
Retirement IRA		$ 7,400	$ 7,400	100.00%
Car	$ 5,000	$ 15,000	$ 10,000	200.00%
Total assets	$ 5,250	$ 43,250	$ 38,000	723.81%
Liabilities				
Car loan	$ 2,700	$ 4,610	$ 1,910	70.74%
Student loan	$ 53,000		-$ 53,000	-100.00%
Total liabilities	$ 55,700	$ 4,610	-$ 51,090	-91.72%
Net worth	-$ 50,450	$ 38,640	$ 89,090	

Starting with the income statement, Alice's income has increased. Her income tax withholding and deductions have also increased, but she still has higher disposable income (Net or take-home pay). Many of her living expenses have remained consistent; rent and entertainment have increased. Interest expense on her car loan has increased, but since she has paid off her student loan, that interest expense has been eliminated, so her total interest expense has decreased. Overall, her net income or personal surplus, which she clears after covering her living expenses, has almost doubled.

Her cash flows have also improved. Operating cash flows, like net income, have almost doubled, primarily due to the elimination of student loan interest payments. The improved cash flow allowed her to make a down payment on a new car, invest in her retirement, make the payments on her car loan, and still increase her net cash flow by a factor of ten.

Alice's balance sheet is most telling about the changes in her life, especially her now positive net worth. She has more assets. She has begun saving for retirement and has more liquidity, distributed in her checking, savings, and money market accounts. Since she has less debt, because she paid off her student loan, she now has a positive net worth.

Comparing the relative results of the common-size statements provides an even deeper view of the relative changes in Alice's situation (Table 3.3.14 , Table 3.3.15 , and Table 3.3.16).

Table 3.3.14 : Comparing Alice's Common-Size Statements for 2023 and 2033: Income Statements

For the Year Ending	12/31/2023	12/31/2033
Gross wages	100.00%	100.00%
Income taxes and deductions	20.00%	25.00%
Disposable income	80.00%	75.00%
Rent expense	24.19%	24.32%
Food	8.73%	5.27%
Car expenses	8.06%	4.86%
Clothing	4.03%	2.43%
Cell phone	2.69%	1.62%
Internet and streaming services	2.69%	1.62%
Entertainment, travel, etc.	6.05%	7.03%
Total living expenses	56.44%	47.16%
Car loan interest	0.54%	1.02%
Student loan interest	9.50%	0.00%
Total interest expenses	10.03%	1.02%
Net income	13.53%	26.81%

Table 3.3.15 : Comparing Alice's Common-Size Statements for 2023 and 2033: Cash Flow Statements

For the Year Ending	12/31/2023	12/31/2033
Cash from gross wages	100.00%	100.00%
Cash paid for:		
Income taxes and deductions	-20.00%	-25.00%
Rent expense	-24.19%	-24.32%
Food	-8.73%	-5.27%
Car expenses	-8.06%	-4.86%
Clothing	-4.03%	-2.43%
Cell phone	-2.69%	-1.62%
Internet and streaming services	-2.69%	-1.62%
Entertainment, travel, etc.	-6.05%	-7.03%
Car loan interest	-0.54%	-1.02%
Student loan interest	-9.50%	0.00%
Operating cash flows	13.53%	26.81%
Cash invested in 401(k)	0.00%	-4.05%
Cash invested in car	0.00%	-8.51%
Investing cash flows	0.00%	-12.57%
Repayment of car loan	-4.84%	-6.23%
Repayment of student loan	-7.79%	0.00%
Financing cash flows	-12.63%	-6.23%
Net cash flow	0.90%	8.02%

Figure 3.3.16 : Comparing Alice's Common-Size Statements for 2023 and 2033: Balance Sheets

As of	12/31/2023	12/31/2033
Assets		
Cash/checking	0.00%	11.56%
Savings	4.76%	0.58%
Money market	0.00%	6.01%
Retirement 401(k)	0.00%	30.06%
Retirement IRA	0.00%	17.11%
Car	95.24%	34.68%
Total Assets	100.00%	100.00%
Liabilities	0.00%	0.00%
Car loan	51.43%	10.66%
Student loan	1009.52%	0.00%
Total Liabilities	1060.95%	10.66%
Net worth	-960.95%	89.34%

Although income taxes and rent have increased as a percentage of income, living expenses have decreased, showing real progress for Alice in raising her standard of living: it now costs her less of her income to sustain herself. Interest expense has decreased substantially as a portion of income, resulting in a net income or personal profit that is not only larger, but is larger relative to income. More of her income is profit, left for other discretionary uses.

The change in operating cash flows confirms this. Although her investing activities now represent a significant use of cash, her need to use cash in financing activities, specifically debt repayment, is substantially less, resulting in a substantial increase in her net cash flow. The cash that used to have to go toward supporting debt obligations now goes toward building an asset base, some of which (her retirement) may provide income in the future.

Changes in the balance sheet reveal a more diversified and, therefore, less risky asset base. Although almost half of Alice's assets are restricted for a specific purpose, such as her retirement, she still has significantly more liquidity and a higher proportion of liquid assets. Debt has fallen from ten times the assets' value to one-tenth of it, creating positive net worth for Alice.

By analyzing over time, you can spot trends that may occur too slowly or too subtly to notice in daily life, but which may become significant over time. You would want to keep a closer eye on your finances than Alice does, however, and review your situation at least every year.

Summary

- Each financial statement shows a piece of the larger picture. Financial statement analysis puts the financial statement information into context, making it sharper in focus.
- Common-size statements show the size of each item relative to a common denominator.
- On the income statement, each income and expense is shown as a percentage of total income.
- On the cash flow statement, each cash flow is shown as a percentage of the total positive cash flow.
- On the balance sheet, each asset, liability, and net worth is shown as a percentage of total assets.
- The income and cash flow statements explain the changes in the balance sheet over time.
- Ratio analysis is a way of creating a context by comparing items from different statements.
- Comparisons made over time can demonstrate the effects of past decisions to understand the significance of future decisions better.
- Financial statements should be analyzed at least annually.

Exercises

1. Prepare common-size statements for your income statement, cash flow statement, and balance sheet. What do your common-size statements reveal about your financial situation? How will your common-size statements influence your personal financial planning?
2. Calculate your debt-to-income ratio and other ratios using online financial tools. According to the calculation, are you carrying a healthy debt load? Why, or why not? If not, what can you do to improve your situation?
3. If you increase your income and assets, and reduce your expenses and debt, your personal wealth and liquidity will grow. In your personal financial journal, outline a general plan for how you would use or allocate your growing wealth to reduce your expenses and debt further, to acquire more assets or improve your standard of living, and to increase your real or potential income further.

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3.4: Accounting Software-An Overview

Learning Objectives

1. Identify the uses of personal finance software.
2. List the common features of personal financial software.
3. Demonstrate how actual financial calculations may be accomplished using personal financial software.
4. Discuss how personal financial software can assist in your personal financial decisions.

Many software products are available to help you organize your financial information to be more useful in making financial decisions. They are designed to make the record-keeping aspects of personal finance - the collection, classification, and sorting of financial data - as easy as possible. The programs are also designed to produce summary reports (e.g., income statements, cash flow statements, and balance sheets) as well as many calculations that may be useful for various aspects of financial planning. For example, financial planning software is available for managing education and retirement savings, as well as debt and mortgage repayment, and for creating income and expense budgets.

Collecting the Data

Most software programs have been designed to resemble a checkbook, which is what some people use to keep track of their personal financial records. This type of user interface is designed to be recognizable and familiar, much like the manual record-keeping you already do.

When you enter or import your financial data into the program, the software does the bookkeeping. Most personal financial transactions happen as cash flows through a checking account, so your account statement becomes the primary source of data.

Data for other transactions, such as income from investments or changes in investment value, are usually received from periodic statements issued by investment managers, such as banks where you have savings accounts; brokers or mutual fund companies that manage investments; or employers' retirement account statements.

Most versions of personal financial software allow you to download account information directly from the source—your bank, broker, or employer—which saves you from manually entering the data into the program. Aside from providing convenience, downloading directly should eliminate human error in transferring the data.

Reporting Results and Planning Ahead

All personal financial software generates the essential summary reports—the income statement, cash flow statement, and balance sheet—that show the results of financial activity for the period. Most will also report more specific aspects of activities, such as listing all transactions for a particular income or expense.

Most will provide separate reports on activities that have some tax consequences, as users always need to be aware of their tax obligations and the tax implications of financial decisions. Some programs, especially those produced by companies that also sell tax software, allow you to export data from your financial software to your tax program, which makes tax preparation - or at least tax record keeping - easier. In some programs, you need to identify which activities are taxable and flag them accordingly. Some programs already recognize this information, while others may still require you to provide tax information.

All programs allow you to play "what if": a marvelous feature of computing power and the virtual world in general, and certainly helpful when it comes to making financial decisions. All programs include a budgeting feature that allows you to foresee or project possible scenarios and gauge your ability to live with them. This feature is particularly useful when budgeting for income and living expenses. (Budgeting is discussed more thoroughly in Chapter 5.) Most programs have features that allow you to project the results of savings plans for education or retirement. None can dictate the future, or allow you to, but they can certainly help you gain a better perspective.

Security, Benefits, and Costs

Programs are designed to be installed on a computer or smartphone, or run from a web browser. Product and service providers are very concerned with security.

As with all Internet transactions, be aware that the more data is transferred, downloaded, or exported over the Internet, the greater the risk of exposure to theft. Personal financial data theft is a serious and growing problem worldwide, and security systems work diligently to keep up with the ingenuity of hackers. The convenience gained by having your bank, brokerage, tax preparer, and so on accessible to you (and your data accessible to them) or your data accessible to you wherever you are must be weighed against the increased exposure to data theft.

Keeping digital records of your finances may be more secure than storing them in shoe boxes or files, which are exposed to risks such as fire, flood, and theft. Digital records are often easily retrievable because the software organizes them systematically for you. Space is not a practical issue with digital storage, so that records may be kept longer. As with anything digital, however, you must be diligent about backing up your data, although many programs will do that automatically or regularly prompt you to do so. Hard copy records must be disposed of periodically, and judging how long to keep them is always difficult. Throwing them in the trash may be risky because of “dumpster diving,” a well-known method of identity theft, so documents with financial information should always be shredded before disposal.

Personal financial software is typically reasonably priced, with many programs selling for under $100. Buying the software typically costs less than hiring an accountant or financial planner for an hour of expertise. While software cannot replace financial planning professionals who provide valuable judgment, it can allow you to hire them only for their judgment and not have to pay them to collect, classify, sort, and report your financial data.

Applications will not improve your financial situation, but they can enhance the organization of your financial data on a monthly and yearly basis, providing you with a much clearer view and, almost certainly, a better understanding of your situation.

Application Selection

The personal finance application ecosystem is constantly evolving with the introduction of new applications, features, and payment models. Start with an internet search for "free personal finance software" or "free personal finance app" and compare the results to your personal goals and needs.

Summary

- Personal finance software applications offer convenience and tools for collecting, categorizing, organizing, reporting, and securing financial data, enabling you to better assess your current situation.
- To help you better evaluate your choices, personal finance software provides calculations for projecting information such as the following:
  - Education savings
  - Retirement savings
  - Debt repayment
  - Mortgage repayment
  - Income and expense budgeting

Exercises

1. Explore free online resources for developing and comparing baseline personal financial statements. PCMag (www.pcmag.com) is a good resource.
2. Compare and contrast the features of popular personal financial planning software, such as Quicken, NerdWallet, and Rocket Money. In your personal finance journal, record your findings. Which tool, if any, would be your first choice, and why?
3. Read Managing Money: Six Principles of Personal Finance (www.schwab.com/learn/story/managing-money-six-principles-personal-finance) from financial services firm Charles Schwab and answer these questions:
   1. What are the six principles of personal finance described in this video?
   2. How is each principle relevant to you and your personal financial situation?
   3. Are you already following one or more of these principles?

4. If you have an hour and want to preview the rest of this text, watch The Basics of Personal Finance and Budgeting (www.youtube.com/watch?v=Ov_rEK_IGtw) (51:41 minutes) from Wayne State University. This video begins by acknowledging the impact of home mortgage redlining (www.investopedia.com/terms/r/redlining.asp) on the racial wealth gap that exists in the United States today.

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CHAPTER OVERVIEW

4: Your Own Situation

4.1: What is Money

4.2: Analyzing Your Current Financial Situation

4.3: Video- TED Wendy De La Rosa 10 Steps To Boost Your Financial Health

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4.1: What is Money

The Definition of Money

Money is most often defined as “a medium of exchange with no intrinsic value.” This essentially means that what people accept as money can be used as money. If you go back in history, you will see that people have used a number of different things as money, some that had intrinsic value (such as gold and silver), and many that had no intrinsic value of their own (such as seashells and cocoa beans). Currently, all countries around the world use money that is known as **fiat money**. From Latin, this term means, “Let it be so.” Essentially, this means that each country prints money on paper (or in some cases, plastic), and that currency is not backed by anything of intrinsic value except the full faith and credit of a country’s Central Bank.

In the past, money was backed by silver (the silver standard) or gold (the gold standard). However, that came with its own set of problems. It meant that you had to have silver or gold equivalent in value to the amount of total money you had in circulation. This made it difficult to increase the supply of money in your economy, since you had to acquire enough silver or gold to back up the additional money you wanted to circulate. So the Central Banks of the world went off the “metal standard” for their currency. The U.S. abandoned the gold standard in 1933 but allowed holders of dollar currency to convert them to gold at the fixed price of $35 per ounce, an arrangement that was eliminated in 1971. The U.S. abandoned the silver standard in 1935.

So, in a way, all paper money is fake! It is, of course, backed by “the full faith and credit” of the country that issued it, but that’s the only thing backing it. That means that unstable countries might end up with currency that cannot be used as payment for oil or food. Even if it is accepted, it is only at a greatly depreciated value. The world’s currencies fluctuate relative to each other according to the rules of demand and supply. For example, if you are trying to understand the exchange rates between the U.S. dollar and the Euro, consider how many U.S. dollars it would take to buy one Euro. If a lot of people who own dollars want to buy Euros but not an equal amount of people who own Euros want to buy dollars, the Euro will appreciate relative to the dollar.

The Barter System

Some economies in the past did not use money; instead, they used the barter system. It is a simple system. Let’s say that I have two extra bushels of corn, and I need some wheat. I will swap you my two bushels of corn for two bushels of wheat.

The problem is that the barter system depends on what is called a coincidence of wants. Now let’s say that I have three extra pigs, and I ask my neighbor ask to trade them for a cow. However, he does not have any cows he wants to trade, and he does not want any more pigs. That means I have to go searching for someone who wants to trade a cow for my pigs. Money solves this problem, because cows and pigs (and everything that is for sale) can be valued in terms of money. Instead of bartering, I can sell my pigs in the local marketplace and then use that money to buy a cow.

How Money Is Used

Money is used in several ways:

1. It is a medium of exchange. A medium of exchange is something that can be traded for goods and services. As we showed above, it solves the problem of the coincidence of wants.
2. It is a store of value. Money’s function as a store of value allows you to hold on to money and buy something in the future, and the money is still accepted. If you are going to hold onto money, you should, of course, not hide it under your pillow, but put it in a savings account and earn some interest on it. When we save money for our future retirement, it is functioning as a store of value, and we must have confidence in the money still being valuable when we retire.
3. It is a unit of account. Money functions as a universal yardstick that expresses the value of goods and services in a single measure. For example, your labor might be valued at $15 per hour and then you can take that money you earn and buy a dozen eggs at $1.98 per dozen.

The Amount of Money in the U.S. (M2)

The **Money Supply** (M2) in 2019 is $14,941,700,000,000. This is a lot of money. According to the St. Louis Federal Reserve Bank, the types of money that are counted in the M2 are:

1. Savings deposits (which include money market deposit accounts)

2. Small-denomination time deposits (less than $100,000)
3. Balances in retail money market mutual funds

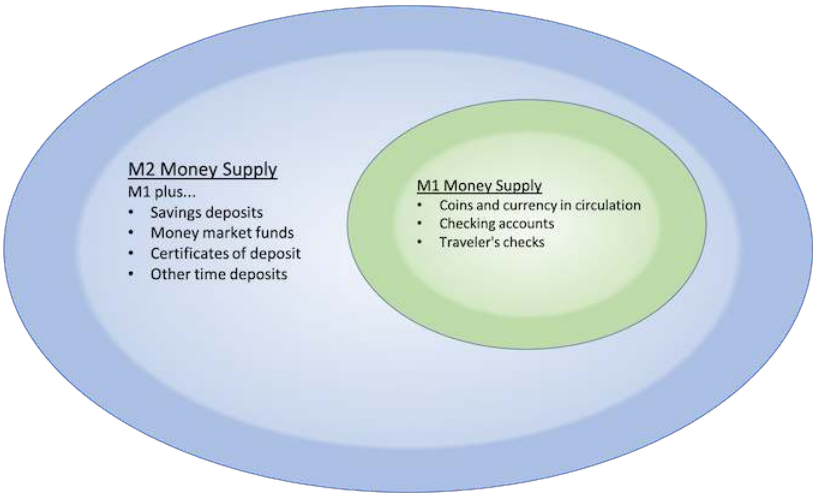


Figure 4.1.1: Measuring Money: Currency, M1, and M2 by Steven A. Greenlaw and David Shapiro has been adapted by Fred Rowland and is used under a CC BY-NC 4.0 License.

Who Owns the Money

Technically, the **monetary base** (coins and paper currency) belongs to the Central Bank of the country that created it (in our case, The Federal Reserve Bank). If you look at a U.S. dollar, you should see a few important details.

First, at the top of the banknote, it says, “Federal Reserve Note.” A note is an I.O.U. or promissory note that you will repay a loan. In essence, this paper currency is a loan from the Federal Reserve Bank to the holder of the note. It also has the signatures of the Secretary of the Treasury and the Treasurer of the United States. Since a promissory note is a legal document, it must be signed. This I.O.U. is signed. Finally, the bill also states that “This note is legal tender for all debts, public and private.” The currency may be used to pay for goods and services and to satisfy all debt. Of course, when you are paid money for your work, you get to use the money, but the actual currency is on loan from the Federal Reserve Bank.

A lot of people do not realize that not only does the Federal Reserve Bank create money, but the actual **banking system** also creates money. When you deposit your money into a bank, whether it be currency or a paycheck, the bank credits your account electronically. If you deposit $1000, you can claim it back whenever you want. This is called a **demand deposit**. The bank then might lend out the $1,000 to someone else, and now there is $2,000 in the economy’s money supply. If the person deposits that loan of $1,000 in their own bank, that second bank can then lend it out, and now there is $3,000 in the M2. Pretty sneaky, huh? In aggregate terms, of the total 2019 M2, only about 10% is currency. The rest of M2 has been created electronically by the banking system.

The Federal Reserve Bank

The Federal Reserve Bank of the United States is the Central Bank of the United States. Virtually all countries have a **Central Bank**. The main exception to this is the European Union, which created a common currency, the Euro, in 1999. The EU has 27 members and 23 of them currently use the Euro as their official currency. As a result, the EU created the European Central Bank, which functions as the Central Bank for countries using the Euro. The key function of these Central Banks is threefold:

1. It monitors the banks and other financial institutions in the country to make sure they are following its rules and are acting in a financially responsible manner. The Central Bank has great power in this area and can shut down banks, either on its own or (in the United States) through the Federal Deposit Insurance Corporation, which guarantees all the deposits at U.S. banks.
2. It controls key interest rates, such as rates for bank borrowings and, indirectly through the prime rate, commercial lines of credit for companies. It also indirectly influences longer term rates such as car loans and mortgages.
3. It also controls the money supply.

These activities all together are called **monetary policy**. The Federal Reserve Bank (or “the Fed”) is made up of three key entities:

1. The *Federal Reserve Board of Governors*. The seven governors are appointed by the President of the United States and serve for fourteen years each. Their terms are staggered so that one governor's term expires every two years. This arrangement prevents one President from controlling the Fed through their appointments. The Chair of the Federal Reserve Board of Governors is also appointed every four years by the President.
2. The *Federal Reserve Banks*. There are twelve Federal Reserve Banks in the United States and these are effectively local offices of the Fed. The United States is divided into twelve Federal Reserve Districts, with a Federal Reserve Bank monitoring the commercial banks in each district and each Federal Reserve Bank is headed by a President.

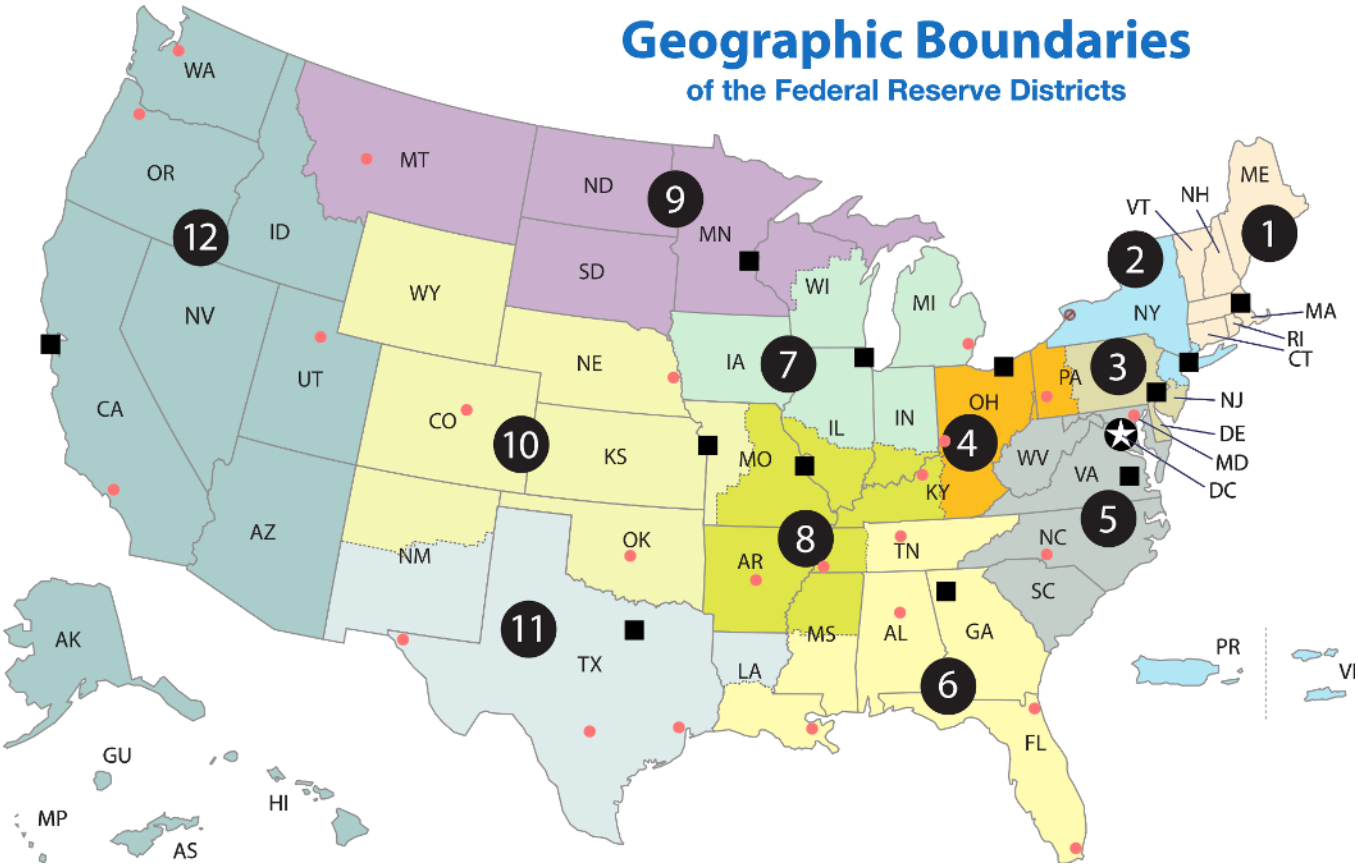


Figure 4.1.2: Federal Reserve Districts Map – Banks & Branches by ChrisnHouston is used under a CC BY-SA 3.0 License.

3. The *Open Market Committee*. The Open Market Committee dictates monetary policy. It has twelve members and is composed of the seven members of the Board of Governors, the President of the New York District Federal Reserve Bank , and four additional Presidents of the District Federal Reserve Banks, each of whom serves on a rotating basis for one year. The Open Market Committee meets every six weeks to decide on monetary policy. In addition to the function and structure of the Fed, we also need to understand the mandate of the Fed. According to the various laws creating and underpinning the Federal Reserve Bank, it has a dual mandate:

- To maintain low and predictable rates of inflation
- To maintain maximum levels of employment that are sustainable.

The Fed meets these mandates by controlling the amount of money in the economy. This indirectly influences the amount of goods and services bought in the economy.

The total amount of goods and services made and purchased in any economy in a specific time period (usually a year) is called the **Gross Domestic Product** (GDP) of an economy. If we look back over the last forty years of the U.S. economy, the empirical evidence tells us that the ratio of the GDP purchased each year to the M2 is pretty constant. Specifically, it is a ratio of approximately 2 to 1.

Note

\dfrac{\text { Nominal GDP }}{\mathrm{M} 2}=\dfrac{$ 2}{$ 1}

The technical term for this ratio is the **Velocity of Circulation**. The relatively constant Velocity of Circulation has three important implications for Monetary Policy. First, this constant 2 to 1 ratio means that every dollar of money in the economy buys two dollars of GDP over the course of a year. Second, it also means that if the Fed wants to influence the growth of GDP, it needs to create $1 of Money for every $2 of GDP it wants to stimulate. Third, the growth rate of M2 needs to be equal to the growth rate of GDP or the lack of money will slow down the growth of GDP. The relatively constant ratio of GDP to M2 is an important assumption of the Quantity Theory of Money, as espoused by the Monetarist economists. **Monetarism** is a school of thought in monetary economics that emphasizes the role of governments in controlling the amount of money in circulation. Monetarist theory asserts that variations in the money supply have major influences on national output in the short run and on price levels over longer periods (Wikipedia).

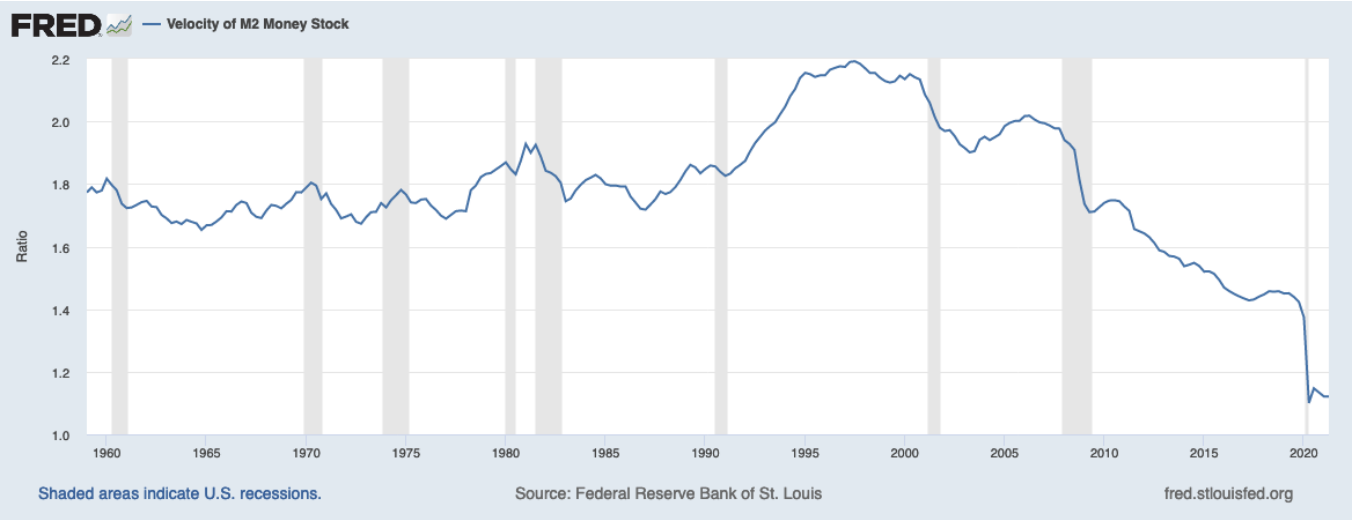


Figure 4.1.3: Federal Reserve Bank of St. Louis, Velocity of M2 Money Stock [M2V], retrieved from FRED, Federal Reserve Bank of St. Louis; September 30, 2021.

The standard bearer of Monetarism was Nobel Laureate Milton Friedman of the University of Chicago. Unfortunately, although the ratio of GDP to M2 was fairly constant in the 1960s and 1970s when Friedman was doing his Nobel Prize winning research, it is no longer true (see graph below). This discrepancy now calls into question the validity of Monetarism.

Firms need employees to make things and provide services, and we can get pretty specific about how many people will be employed based on additional GDP purchases. In 2018, if we take the total GDP and divide it by the number of employed people, we get this result:

$$\frac{\text{2018 Nominal GDP}}{\text{2018 Employed Workers}} = \text{Output per Worker (2018)}$$
$$\frac{\$20.5 \text{ Trillion}}{155{,}760{,}000 \text{ Workers}} = \$131,600 \text{ Output per Worker}$$

Thus we see that for every $131,600 in GDP purchased throughout the course of the year, the economy needs to hire on average one additional worker. This is how the Federal Reserve Bank influences employment.

As for inflation, the Fed influences this by maintaining the growth of M2. Simply put, inflation is caused by too much money trying to buy fewer goods and services, thus raising prices. This can be expressed in the Inflation Equation from the economic Quantity Theory of Money:

Rate of Inflation =
Rate of Growth of Money Supply - Rate of Growth of Real GDP

Although this does not hold exactly for every year, it is true over the long run (ten years or more), and we see that the actual data support this relationship. An important way to interpret this equation (for our purposes) is that if the money supply is growing more

quickly than the supply of goods and services available to purchase, then prices will rise. As we said, this general rise in the prices in an economy is called inflation. Therefore, we see that the Fed can influence employment by increasing the money supply or reduce the rate of inflation by decreasing the money supply. Unfortunately, these dual mandates are sometimes in conflict, and when they are, the Fed will always choose controlling inflation overachieving maximum employment. In the past, the Fed has sometimes put the economy into a recession in order to control inflation.

The Fed is very interested in controlling expectations in the marketplace, and it has been very clear about its targets for maximum employment and low and stable prices. The Fed is trying to achieve the natural rate of unemployment. The determination of this rate is an empirical question, not a theoretical one. The natural rate of unemployment is the rate which if we go below it wages generally rise (wage inflation), and this then causes general inflation in the economy. The Fed used to think the natural rate of inflation was 4.5%, but at the end 2019, the unemployment rate is 3.7% without seeing any significant inflation in the economy.

As to the ideal inflation rate, the Fed set a target of a 2% general rise in prices over the course of a year. We might call this target **Goldilocks inflation**, as the Fed does not want the rate of inflation to be much higher or much lower than this. Higher inflation can feed on itself (through inflation expectations), while lower inflation can cause consumers to hold off their spending. I should note that the Fed targets core inflation, which is the rise in GDP prices, and it eliminates food and energy prices from the calculation, as they are too volatile.

In order to control the money supply and therefore short term interest rates, the Fed conducts **Open Market Operations**. If unemployment is too high, the Fed buys Treasury Bonds from the banks, thereby increasing their Reserves (the banks' money that has not yet been lent out). This increases the money supply and lowers interest rates, stimulating the economy through the availability of cheaper borrowing rates for all loans. If inflation is too high the Fed sells Treasury Bonds to the banks, thereby decreasing their Reserves. This decreases the money supply and increases interest rates and slows down the economy due to more expensive borrowing rates.

Nominal Money and Real Money

This subtitle might confuse you. What is the difference between nominal and real money? Further, what is the distinction between nominal and real wages? Simply put, **nominal value** is money's face value. If you have a hundred-dollar bill, its nominal value is $100. On the other hand, its **real value** is what it can purchase. Let's say you hold that $100 bill for a year, and in that year, prices of the things you normally buy rise by 10% (as measured by the Consumer Price Index, or CPI). Your $100 bill is now worth 10% less or $90 in real money. This is why high inflation is so pernicious; it erodes the value of your money. High inflation hurts poor people the most, because the things that usually inflate—food and energy—occupy a large portion of their budget. High inflation also hurts retired people on a fixed pension for the same reason. (As a side note, social security payments are increased every year according to the rise in the CPI, but many corporate pensions are not).

Nominal wages are the face value of the wages you receive, and similar to our discussion of real money above, real wages are what your wages can purchase. High inflation erodes the value of your wages, and this has a deep impact on your day-to-day life. Pew Research shows that real wages have been flat for the last 30 years or so, noting that despite the strong labor market, wage growth has lagged expectations. In fact, despite some ups and downs over the past several decades, today's real average wage (that is, the wage after accounting for inflation) has about the same purchasing power it did 40 years ago. And what wage gains there have been have mostly flowed to the highest-paid tier of workers (2018).

These relatively flat real wages have exacerbated both the income distribution and wealth distribution in the United States. The top 10% of income earners have gained an increasing share of total income, and this has also contributed to the top 10% owning an increasing share of the wealth in the United States.

Finally, it is worth noting that employers consider real wages in their hiring decisions. This is true both in economic theory and in their real-world decisions. An increase in wages above the CPI actually causes a drop in labor demand and vice versa. The fact that real wages have been stagnant for many years is good for employers but bad for workers.

Foreign Exchange Rates

As part of your financial education in a global economy, you should understand global exchange rates. When importers bring foreign goods into the United States, they will put them up for sale at U.S. dollar prices. However, the manufacturer in the foreign

country wants to be paid in the local currency. As you see below, supply and demand affect the value of one currency in terms of another, and this influences the price of an imported good in the United States.

Here is an example:

Table 4.1.1. Foreign Exchange Rate Toyota Example

Price of Toyota in Japan Price of Toyota in the U.S.	Exchange Rate	Price of Toyota in the U.S.
1,000,000 Yen	100 Yen/ U.S. $	$10,000 U.S.
1,000,000 Yen	90 Yen/ U.S. $	$11,111 U.S
1,000,000 Yen	110 Yen/ U.S. $	$9,090 U.S.

Think of the exchange rate as the price of the foreign currency. Thus when the U.S. dollar can purchase 100 Yen, the 1,000,000 Yen price translates to 10,000 in U.S. dollars. If the U.S. dollar depreciates to 90 Yen/ U.S. dollar, the Toyota costs more in the U.S. If the U.S. dollar appreciates to 110 Yen/ U.S. dollar, the Toyota costs less in the U.S.

The bottom line is that a stronger U.S. dollar makes imports into the United States cheaper and incentivizes U.S. consumers to buy more imports. The contrary is also true: a weaker U.S. dollar makes foreign goods more expensive and discourages imports. Similarly, a weaker U.S. dollar makes U.S. exports cheaper and encourages foreign consumers to buy our goods. U.S. Presidents and Treasury Secretaries always say that they want a strong U.S. dollar, but secretly, they really do not. Overall, a weaker dollar is good for the U.S. economy.

The basic law of supply and demand causes fluctuations in the valuations of currencies relative to one another. Even with these fluctuations, there are a number of reasons someone who holds a foreign currency would want to trade them for U.S. dollars:

- To buy U.S. Exports. U.S. companies who are exporting goods and services to a foreign company want to be paid in U.S. dollars, so foreign importers must exchange their currency for U.S. dollars.
- *To invest in U.S. Investments, such as the U.S. Stock Market, the U.S. Bond Market, U.S. Real Estate, or to buy a U.S. company*. Investors from every country in the world invest in the U.S. Stock and Bond Markets. They are considered one of the most reliable investment markets in the world. Since the stocks and bonds in these markets must be paid for in U.S. dollars, anyone buying U.S. stocks or bonds (or U.S. Real Estate or U.S. companies) must exchange their currency for U.S. dollars.
- *Speculation on the volatility in the value of currencies (or "hot money")*. Currency values fluctuate every day relative to each other. Usually, these daily fluctuations are small. However, over a year or longer, there can be significant changes in the relative value of currencies, caused by supply and demand for particular currencies. For example, if an investor expects the U.S. dollar to appreciate 10% over time against the Japanese Yen, they can buy and hold dollars until the they rise against the Yen. Then, after converting the dollars back to Yen, the investor will earn 10% (minus any transaction costs).

For a real world example, the U.S. dollar appreciated 4.3% in 2018 and continued to appreciate in 2019 (measured against a basket of foreign currencies) due to an influx of foreign money into U.S. investments. Foreign stock and bond markets were not doing as well as their U.S. counterparts at the time, so foreign investors had to trade their currency for U.S. dollars in order to invest in American markets. The demand for U.S. dollars caused it to rise and as a consequence, foreign imports became cheaper, and the U.S. brought in more imports.

It's all pretty complicated, but that's the real world. Since 2019, the U.S. dollar has stopped its appreciation (after a brief jump during the Pandemic Recession), as seen in the graph below:

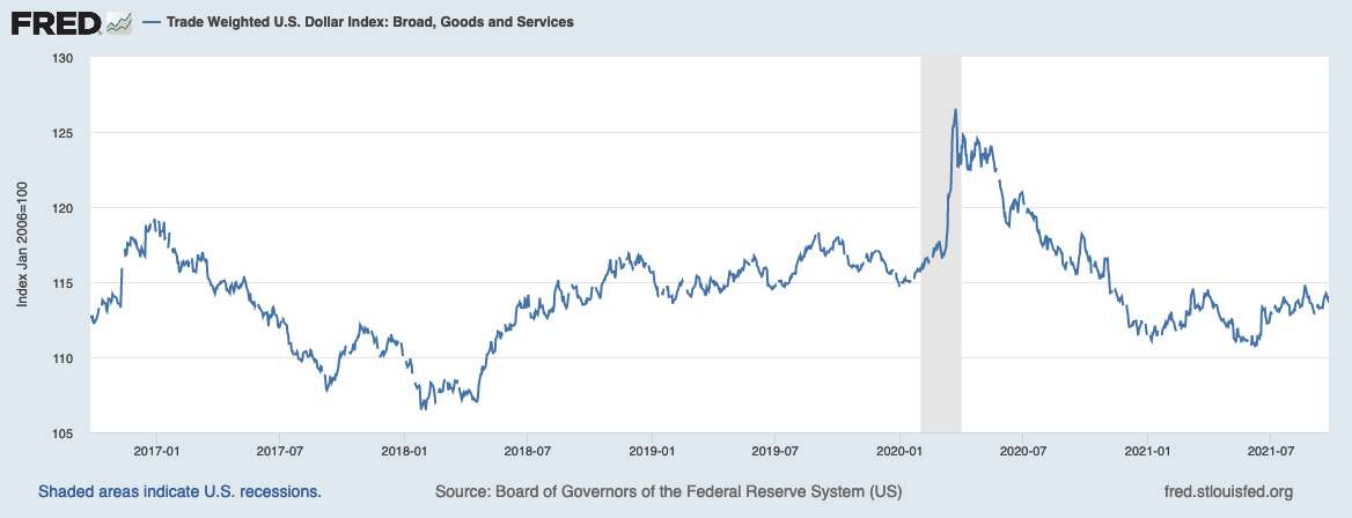


Figure 4.1.3: Board of Governors of the Federal Reserve System (US), Trade Weighted U.S. dollar Index: Broad, Goods and Services [DTWEXBGS], retrieved from FRED, Federal Reserve Bank of St. Louis; September 29, 2021.

The U.S. dollar is also the preferred currency for several Central Banks, and it is the preferred international currency. As a result, the U.S. dollar is involved in over 90% of over $4 trillion dollars' worth of foreign exchange trades every day.

How We Get Addicted to Money

In *The Protestant Work Ethic and the Spirit of Capitalism* , sociologist Max Weber points out that there has been a predisposition to amassing material things since this country's founding (1930). Puritans, the original colonizers were Calvinists, and as such, they believed in predestination. In this tradition, God already knows who is going to end up in heaven or hell; however, for Puritans, this also meant that those destined for heaven would also be blessed with material prosperity in this life. The Puritans then worked hard to attain material wealth but also led ascetic lifestyles—no drinking, no dancing, and no enjoyment of their wealth. As Weber points out, all of this was so that these forefathers of the American Dream could assure themselves that they were truly one of the chosen.

American materialism still exists in our society's **materialistic value orientation** (MVO), as defined by Kasser and Kanner:

> *From our perspective, an MVO involves the belief that it is important to pursue the culturally sanctioned goals of attaining financial success, having nice possessions, having the right image (produced, in large part through consumer goods) and having a high status (defined mostly by the size of one's pocketbook and the scope of one's possessions (2004).*

Further, Kasser and Kanner focus on two questions:

1. What causes people to care about and to accept materialistic values and to "buy into" high consumption behavior?

   MVO develops in individuals through two pathways:

   - From personal experiences and environments that deny peoples' basic psychological needs of safety, relatedness and love, and competence and autonomy
   - From exposure to social models that encourage materialistic values – parents who are excessively materialistic or by heavy exposure to the advertisements and influences of our materialistic culture or by schooling (Kasser & Kanner, 2004)

2. What are the personal, social and ecological consequences of an individual's or a society's having a strong MVO?

   According to Kasser and Kanner, personal well-being declines as materialism becomes more centralized in someone's value system. Further, they show that an MVO encourages behaviors that damage interpersonal and community relations and destroy the ecological health of the planet.

Many psychologists, economists, and neuroscientists have presented research that shows how easily money can become addictive (Layard, 2005, Peterson, 2007). The human brain constantly engages in what is called “hedonic adaptation.” When we reach a higher level of income, we initially derive satisfaction from it. However, very soon, we adapt mentally and emotionally to that higher level and need even more money to achieve the same level of happiness. Through the same mechanisms by which we can succumb to drugs, alcohol or gambling, people can become addicted to money.

Current psychological theories characterize money as both a tool (a function of money as what it can be exchanged for) and as a drug (a maladaptive function of money as an interest in the money itself) (Lea and Webley 2006). Essentially, this posits that people not only value money for its instrumentality—that is, how it enables people to achieve goals—but for itself— that is, for the totally false sense of control, security, and power that it gives (Vohs et al. 2006). Conversely, Price et al. (2002) have shown that physical and mental illness after financial strain due to job loss is triggered by reduced feelings of personal control.

Unfortunately, even with enormous amounts of money, the wealthy are no happier than the less wealthy. In fact, they are actually more prone to depression and psychopathology (Kasser & Kanner, 2004, p. 129). Adults who engage in conspicuous consumption are largely trying to compensate for our unique human awareness of mortality and the pursuit of self-worth and meaning that this engenders or, simply put, existential anxiety, or the fear of going out of existence (Kasser & Kanner, 2004, p.128). National and time-series studies attest to the fact that large amounts of wealth have little or no effect on happiness. Real purchasing power has more than doubled in the United States, France, and Japan over the last fifty years, but life satisfaction has not changed at all (Seligman, 2002, p. 153; Layard, 2005).

I believe that people with a MVO are at risk for anxiety, psychological problems, family dysfunctions, health problems, and personal financial problems. The evidence for this is voluminous (Kasser and Kanner 2004). These attitudes cause real damage and are then major contributors to social problems that undermine the fabric of our society. MVO even contributes to world discord, as the exportation of American materialism emphasizes the gulf between the haves and the have-nots around the globe.

Cryptocurrencies

For economists, Bitcoin and other cryptocurrencies are an interesting experiment, but they are not yet ready to be adopted by banks and financial institutions as a way of doing business. The extreme volatility of Bitcoin (see chart below) and other cryptocurrencies make them an extremely poor store of value (one of the main functions of money) though they might be an adequate medium of exchange. Further, if you look at the history of the Bitcoin, you will see that there have been a number of scandals and thefts. Bitcoin’s defenders say these problems are just the “growing pains” of a whole new type of currency and system. To this I say, that is fine, but let me know when it is grown up and adopted by (and guaranteed by) major financial institutions in the United States. My advice is to stay away from these cryptocurrencies for now.

The graph below certainly looks enticing. If you had bought one Bitcoin on January 8, 2015, at a price of $288.99, you would have had your investment grow to $19,650 dollars by December 16, 2017, a return of 67 times your original investment, 3,350% per year for each of the two years you held it. But how could you have known that? At the same time, if you had bought one share of Amazon stock on January 1, 2015 at $320, you would have had your investment grow to $3,225 on August 6, 2020, a return of 10 times your original investment, an equivalent to 200% annual return on your investment for each of the five years you held it. The fundamental difference here is that Amazon makes something. It provides goods and services to customers, it has a cash flow, and it has revenue and net income on which you can calculate **Return on Investment** (the universal way we value companies and the price of their stocks). Buying Bitcoin is almost like buying collectibles, like an A-Rod rookie baseball card or a pair of original Air Jordans. Will these collectibles increase in value? Maybe yes or maybe no. Do you remember the Beanie Baby collecting craze? Did those increase in value?



Figure 4.1.4: Bitcoin Stock Price by Fred Rowland is used under a CC BY-NC 4.0 License. Source: Cointelegraph data (11/22/2020).



Figure 4.1.5: Amazon Stock Price by Fred Rowland is used under a CC BY-NC 4.0 License. Source: Yahoo Finance data (11/30/2020).

"Risk follows reward" is an immutable law of Wall Street; if you are seeking higher than average returns, you must go after riskier investments. You might have been lucky enough to invest in Bitcoin in 2015, but you might have bought it in 2017, at the height of its speculative run. You also could have bought shares in an S&P mutual fund at the Vanguard Mutual Fund Company, and your return from January 2, 2015 to August 6, 2020, would have been + 63% over five and a half years for an annual return of 11.5%, with much less risk than Bitcoin (and the start-up, Amazon).

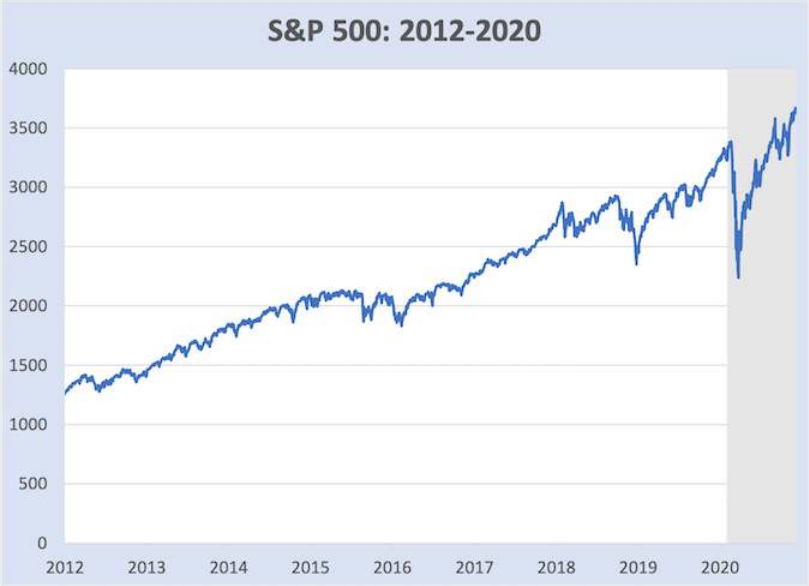


Figure 4.1.6: S&P 500 by Fred Rowland is used under a CC BY-NC 4.0 License. Source: Yahoo Finance data (12/3/2020).

A Cashless Society

Unquestionably, we are moving more and more toward a cashless society. In a cashless society (in the U.S.) it's possible only drug dealers and firms paying their employees "under the table" will be using cash. Think about all the transactions you use debit or credit cards for each month. Like me, you might also be paying your bills electronically through your financial institution. And, as I mentioned earlier, only about 10% of M2 is actually currency; its circulation creates the rest of M2 in the worldwide banking system. Debit cards could easily replace this currency.

Hyperinflation In Zimbabwe

As I said before, the Quantity Theory of Money states that the growth rate in the money supply will equal the growth rate in the prices of goods and services in an economy (inflation rate) minus the growth rate in real Gross Domestic Product. Rearranging this equation, we have:

Rate of Inflation =
Rate of Growth of Money Supply - Rate of Growth of Real GDP

This is called the inflation equation. As we said above, although this relation does not hold for every year, it is accurate over the long run, a fact supported by the empirical evidence. To paraphrase the Nobel Prize winning economist, Milton Friedman, inflation is always and everywhere a money supply problem (1970).

As a thought experiment, imagine an economy with a certain (fixed) money supply. You need money to buy goods and services created within that economy (the GDP). Now let's imagine that over time the money supply grows 10% greater (rate of growth = 10%) but the goods and services do not change at all (rate of growth= 0%). Therefore, the prices paid for the fixed amount of goods and services will be bid up by 10% (rate of inflation=10%).

For example, consider Robert Mugabe, the strongman dictator who ruled Zimbabwe for over 30 years. From 2007 to 2010, he created seismic shifts in his country's monetary policy. Since he needed more money to run the government, to pay the military, and to buy imports, he simply ordered the Central Bank of Zimbabwe to print more money. Unfortunately, he printed so much money compared to the supply of goods and services that the rate of inflation in 2008 was over one billion percent (1,000,000,000%). As things became more expensive, the Central Bank had to print currency notes in larger and larger denominations so the residents would not have to carry money around in wheelbarrows to pay for food at the market.

In addition, Mugabe instituted poorly executed land reforms that did not help, but the root cause of the hyperinflation was printing too much money.

In 2009, so many people had lost confidence in the Zimbabwe dollar that the government had to allow the U.S. dollar and other foreign currencies to be used for payments. They also stopped printing the Zimbabwe dollar, which caused the inflation rate to drop precipitously. Even so, in 2010, it still cost 100 Billion Zimbabwe dollars to buy lunch. Eventually, the inflation rate in Zimbabwe was tamed (relatively, at least), and as of June 2019, the official inflation rate was 97.8% annually.

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4.2: Analyzing Your Current Financial Situation

Your Parents' Advice

Some students may have received advice from their parents or other adults ranging from how to ride a bike to which fork to use at a formal dinner. However, many parents are reluctant to talk to their children about financial management. And if you got financial advice, it might be wrong, as so much has changed since they had to make the important financial decisions you are currently facing. Julia Carpenter, in the Wall Street Journal article "Your Parents' Financial Advice is (Kind of) Wrong," points out what is right and wrong about your parents' advice:

> *The rules have changed…Americans entering the workforce in the decade since the financial crisis face a starkly different landscape than their parents did at the same age. They often have far higher student loan debt. Housing eats up a bigger chunk of each paycheck. And young households have lower incomes and fewer assets than previous generations did at the same ages (2019).*

Given these new conditions, Carpenter feels we need new rules. Below, I have listed these rules along with my commentary.

Educational Debt is Not Necessarily Good Debt

In 2018, the average starting salary of a college graduate was about $60,000, while the average salary for a high school graduate was $28,000. On average, students complete their undergraduate degrees in five years; however, at more than a third of U.S. colleges, only half of the students will earn their degree in eight years. Those who do not finish end up with debt but not with the higher income they were hoping for. Further, four in ten college graduates are in jobs which do not require a college degree (New York Federal Reserve Bank, 2018).

If you plan to go to graduate school, remember that if your starting salary after the degree equals the debt incur then it is probably a good investment. You want to be able to pay your living expenses and still have enough left over to pay off your loans in about ten years. If you think about it, "buying" an education after high school is really an investment and you should think about the kind of return you will be getting on that investment.

Do Not Assume You Should Buy a Home

Owning a house is still part of the American Dream, but it might not make financial sense for you. For example, you might work in a city with a hot housing market. You might not be able to afford a down payment, or you could wind up depleting your entire savings. On top of that, if you do not expect to stay in a city for more than three years, you will likely not get back all the transaction costs (fees, title insurance, etc.) of purchasing a house. Do not buy a house just because you think you should.

The Best Place for Financial Growth

You should compare your salary (or potential salary, based on the average for your field) to a city's cost of living. Many people think it would be cool to live in New York City or San Francisco, but the cost of living is so high that your salary has to be proportionate. Otherwise, you can find yourself commuting an hour or more from the only affordable living accommodations in the area. Some cities like Chicago, Philadelphia, Austin, and Portland, although costly, have more affordable housing than San Francisco and good starting salaries. If, for example, you compare the salaries of high-tech workers and the cost of living in San Francisco to those in these cities, you will find you are financially better off living in the city with the lower cost of living. Cities around the U.S. are trying to attract tech companies and, although San Francisco had a higher percentage of high-tech jobs as a proportion of overall jobs, there are good high-tech jobs in the many cities.

As a result of the Pandemic, remote work has increased substantially. The U.S. Census Bureau recently released its annual 2021 American Community Survey a survey of household behavior (September, 2022). According to the Census Bureau, between 2019 and 2021, the number of people primarily working from home tripled from 5.7% (roughly 9 million people) to 17.9% (27.6 million people).

However, remote work is not evenly distributed around the country. In metropolitan areas, 19% of employees worked from home (with Washington, D.C. at 48% remote workers and Silicon Valley at 35% remote workers as outliers). Outside metro areas, only

9% of employees were working from home in 2021.

The opportunity for remote work is a factor to consider when seeking a position. It has its advantages, including working flexible hours and saving on commuting time. It also has its disadvantages, including the loss of comradery of office work and not being visible to your superior to take advantage of bonding and advice.

Not All the Old Rules Are Dead

Your parents might have followed this old rule: be frugal until you save up enough for the down payment on a house. Unfortunately, with student debt and the higher cost of housing, it does not work to do simple things like pack your own lunch or hold off on a vacation. It's part of the American Dream that couples rent for a while, save up for a house, and then, when they are ready to have children, buy a house in a good school district. If they cannot do this, they might feel a sense of disappointment or failure. However, that should not cause you to throw up your hands and not work on saving for your future. There are still important goals for you to save for. First, although young people tend to live in cities, there are almost always suburbs that are more affordable.

Under the **gravity model of real estate**, the center of gravity is downtown where there are a lot of jobs. Then, unless there are physical constraints such as mountains or a coastline, housing construction proceeds over the years in concentric rings around center city. In general, the closer the housing is to the center, the more expensive it is. Housing that is farther out is then cheaper, but it could entail a longer commute. However, in many cities, young people are creating a new trend of moving into affordable suburban housing, and others have started looking for a job in smaller cities with good salaries and a reasonable cost of living.

Outside of housing, you will need to save for a number of things. You should an emergency fund of, ideally, at least six months' salary in case you lose your job and begin contributing to your retirement as early as possible. If you intend to have children and expect them to attend college, you should begin putting aside money for their college expenses. Put these savings into an account where the money will compound to a significant amount by the time you need it. Having these savings will reduce your financial anxiety and improve your well-being.

Ten Rules for Financial Freedom

In 2019, Susan Hube wrote for the financial journal Barron's saying:

> *The true measure of financial success isn't how much money you make—it's how much you keep. That's a function of how well you're able to save money, protect it, and invest it over the long term. Sadly, most Americans are lousy at this(Hube, 2019).*

Two-thirds of Americans would have trouble coming up with $1,000 cash (not credit) to pay for an unexpected medical bill or emergency. Even more disturbing, seventy-five percent are not saving enough or investing correctly for their future retirement requirements. While there are a number of external factors that exacerbate this problem—stagnant salaries, expensive healthcare and education and rising housing costs—there is a deeper issue: a lack of financial literacy.

Parents are reluctant to talk to their children about money, and high schools and colleges lack financial literacy courses. Individuals are increasingly left on their own to decide how much to save and where to invest their savings. To help, Hube laid out ten rules for financial freedom that I present here, along with my commentary.

Set goals.

The first step is to set goals: short-term. medium-term, and long-term. For example, a short-term goal could be to save up six-months' salary as an emergency fund. A medium-term goal might be to save up for a down payment on a house. Finally, a long-term goal would be to save for retirement.

The sooner you set your goals, the sooner you will begin trying to achieve them. Goals motivate us, and when you have your goals to think about, you will likely squirrel away the extra cash.

Know what you have got and what you need.

Always keep this question in mind: "Do I need this thing or do I just want it?" It is hard to resist something you really want, like a new pair of shoes or a new kind of tool. However, you should it is not a good idea to buy something just because it gives you a jolt

of pleasure.

For example, my neighbor had a garage sale recently. Since my wife helped organize the sale, we got a preview on what was being sold. I saw three electric guitars, and I really wanted one. Luckily, my wife said, “You already have a guitar. You don’t need another one!” I must admit, it was hard to distract myself from that guitar, but the next day, I knew she was right.

Look at your monthly after-tax income (disposable income), and add up all your expenses for the month. If your expenses exceed your income or if you are not saving any money monthly, you have to cut expenses. Finally, if you are buying things that you do not need or do not use (such as a gym membership or a particular streaming service), drop it and bank the money.

Save systematically.

Pay into your savings, the same way you pay your electric bill: monthly and automatically. Assuming you have joined a credit union for your banking needs, (See Chapter 10, Banks and Financial Institutions.) arrange for automatic bill payment and have a specific amount transferred into your savings account every month. Ideally, you will be saving 10% of your disposable income each month. However, this is impossible to do in your first or second job. Start out with 5% of your take-home pay and slowly ramp it up to 10%.

Begin saving early to take advantage of the compounding of interest. In simple terms, this means if you put $1,000 in a savings account, and in year one you earn 10% interest, this means you will have $1,100 at the end of the first year. If you leave the $1,100 in the account and continue to earn 10% interest, you will not only earn interest on the original principle of $1,000 but you will also earn interest on your year one interest. Thus, at the end of year two, you will have $1,210 in your account.

There are websites such as www.bankrate.com that give you compound interest calculators to estimate the value of your principle over time, but the Rule of Seventy can also calculate your money’s growth. Take the number 70 and divide into it the interest you earn. Assuming compounding of interest, the result is the number of years it will take for your money to double. Using our example above, if you are earning 10% per year your money will double in seven years. (A 10% return is not an unrealistic goal. As you will see in Chapter 15, The Vanguard Group has shown that, going back to 1926, a mutual fund containing a very broad portfolio of U.S. stocks (i.e., the stocks in the S&P 500 Index) has earned 10% per year).

Invest in your retirement plan.

If your employer provides a retirement plan, for example, a 401(k), and matches your contribution to it, always contribute the maximum your employer will match. If you really think about this, you are earning 100% return on your money; the employer is doubling the money you contribute. You should even give up your lunch or other non-essential expenditures to contribute the maximum.

Employers often have 401(k) plans where they will match your contribution up to 4% of your gross salary. These plans have taken the place of the traditional guaranteed pensions and have shifted the burden of managing each worker’s retirement fund from the employer to the worker. However, if you put your retirement contributions in a mutual fund of all stocks with a good manager such as Vanguard, you can earn the 10% annually. The value of a 410(k) plan is that the money you contribute and the money your employer matches are tax-deferred (but not tax-free). That is, you are not taxed on these contributions nor on the annual return (presumably 10% annually) until you withdraw money for your retirement. If your employer does not offer a retirement plan or if you are self-employed, you can create either an Individual Retirement Account (IRA) or a Roth Individual Retirement Account (Roth IRA) and still earn the same returns. As of 2019, you can contribute up to a maximum of $19,000 into a 401(k) and $6,000 or $7,000 into a Roth IRA.

Invest for growth.

Until you are within a couple of years of retirement, you should invest your retirement funds and other extra income for growth, which means investing in stocks. Although stock prices have more volatility than bonds, they return double what bonds do over time. You will need to be able to stomach that volatility in order to get the higher return. In Wall Street terms, a bull market is a market in which prices are going higher, while a bear market is a market in which prices are going lower. This archaic language comes from the fact that a bear hits downward with its paws while a bull gores upward with its horns. See Chapters 14 and 15 for more detail on the joys and risks of investing in the stock market.

Avoid bad debt.

Debt used for investing in something, such as a house, your education, or your car is good debt. Credit cards are bad debt—debt for consumption purposes. If you buy something with a credit card, pay it off at the end of month. Credit cards charge anywhere from 9% to 25% per month, depending on your credit score. If you pay only the minimum each month, you can end up paying double the original amount you borrowed. If you really need to pay for something on a credit card, such as car repairs or a new computer for school or work, use the credit card that charges the lowest interest rate and then use another credit card for your other purchase and pay it off every month.

Do not overpay for anything.

Do not overpay on fees or commissions for investing in stocks and do not overpay on your taxes. I talk about each of these issues in the chapters on investing and on taxes. Financial advisers usually charge 1% of your assets annually to tell you what stocks to buy. None of the actively managed portfolios or mutual funds has consistently exceeded the return on the S&P 500. Index funds or Exchange Traded Funds will hold all the stocks in the S&P 500 or similar indexes and will charge less than ¼% of your assets annually and still return 10% per year on average. Furthermore, do not overpay on other big purchases, such as televisions and appliances. Shop around.

Protect yourself.

The ideal goal is to build up a fund worth six months' expenses. This is a very difficult goal to accomplish, so when you are young try to save at least one month's rent for starters. Why do all the experts pick six months as the ideal amount in this emergency fund.? This is because it takes about six months to find a new job if you are laid off. You can go on your job search without falling apart emotionally. Also, buy renters insurance (It's very cheap) and, if you own a house, a decent house policy with a reasonably low deductible.

You may have an accident and be unable to work. Many employers pay for a minimum amount of disability insurance that will pay you 60% of your salary if you are disabled long term. If you own a home and have a family, you should consider buying some long-term disability insurance as a supplement to your employer's. It is pretty inexpensive. As to life insurance, do not buy a whole life policy. Whole life insurance is a rip-off. If your life is financially complicated with a house and family, buy term life insurance. It is much cheaper than whole life insurance.

Keep your investing simple.

As I said above, keep your investments simple. Do not chase fads, such as cryptocurrency or 3D printing companies. Invest in an Index Fund that has the S&P 500 stocks in it, and you will pay low fees and earn on average 10% per year. Also, a mutual fund with the S&P 500 stocks in it will have Google, Apple, Facebook, and any other significant stock worth holding, so you can still ride the high-tech wave with your mutual fund.

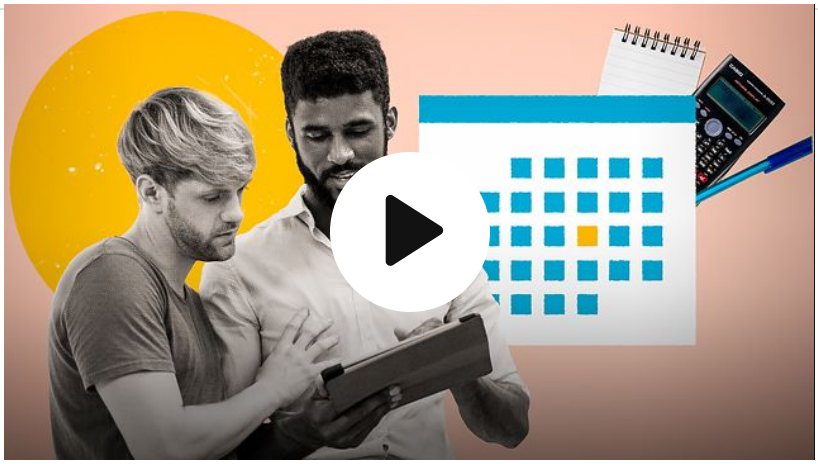
Seek unbiased advice.

I strongly advise you to go to Vanguard and invest in one of their index funds. Vanguard is owned by the customers who invest in its mutual funds, so it is essentially a non-profit. There are no stockholders, so they can keep their fees low. Jack Bogle, the founder of Vanguard, invented Index Funds (passively managed funds that track a stock market index like the S&P 500) because he saw that actively managed mutual funds were not beating the S&P 500 returns and were charging a fee of 1% of assets.

Finally, do not buy individual stocks from a stockbroker, and do not buy mutual funds that charge you a commission to get into them. You cannot pick the consistent winner stocks and the brokers who charge you a commission to get into a fund often sell you the investment that gains them the highest commission, not the investment that fits your needs.

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4.3: Video- TED Wendy De La Rosa 10 Steps To Boost Your Financial Health



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CHAPTER OVERVIEW

5: Financial Plans- Budgets

This chapter demonstrates how organized financial data can be used to create a plan, monitor progress, and adjust personal financial goals.

5.1: Introduction to Budgets
5.2: The Budget Process
5.3: Creating the Comprehensive Budget
5.4: The Cash Budget and Other Specialized Budgets
5.5: Budget Variances
5.6: Budgets, Financial Statements and Financial Decisions
5.7: Alternate Perspective
5.7.1: Personal Budgeting
5.7.1.1: Making a Budget
5.7.1.2: Creating Your Budget
5.7.1.3: Understanding College Costs
5.7.1.4: Saving and Investing
5.7.2: Budgets and Saving
5.7.3: Video- Can't Stick to a Budget? Try these tweaks Instead

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5.1: Introduction to Budgets

Seeing the value of reaching a goal is often much easier than finding a way to achieve it. People frequently resolve to improve themselves or their lives in some way. But while they are not lacking sincerity, determination, or effort, they nevertheless fall short for want of a plan, a map, a picture of why and how to get from here to there.

Pro forma financial statements provide a look at the potential results of financial decisions. They can also be used as a tool to plan for specific results. When projected in the form of a **budget**, figures become not only an estimated result but also an actual strategy or plan, a map illustrating a path to achieve a goal. Later, when you compare actual results to the original plan, you can see how shortfalls or successes can point to future strategies.

Budgets are typically created with a specific goal in mind: to reduce living expenses, increase savings, or save for a specific purpose, such as education or retirement. While the need to do such things may be brought into sharper focus by the financial statements, the budget provides an actual plan for doing so. It is more a document of action than of reflection.

As an action statement, a budget is meant to be dynamic, a reconciliation of “facts on the ground” and “wishes.” While financial statements are summaries of historic reality, that is, of all that has already happened and is “sunk,” budgets reflect the current realities that define the next choices. A budget should never be merely followed but should constantly be revised to reflect new information.

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5.2: The Budget Process

Learning Objectives

1. Trace the budget process.
2. Discuss the relationships between goals and behaviors.
3. Demonstrate the importance of conservatism in the budget process.
4. Show the importance of timing in the budget process.

The budget process is an infinite loop similar to the larger financial planning process. It involves

- defining goals and gathering data
- forming expectations and reconciling goals and data
- creating the budget
- monitoring actual outcomes and analyzing variances
- adjusting budget, expectations, or goals
- redefining goals

A review of your financial statements or your current financial condition (as well as your own ideas about how you are and could be living) should indicate immediate and longer-term goals. It may also highlight new options. For example, an immediate goal may be to lower housing expenses. In the short term, you could look for an apartment with lower rent; however, in the long run, purchasing a home may be more advantageous. This long-term goal may suggest the need to establish a savings plan for a down payment.

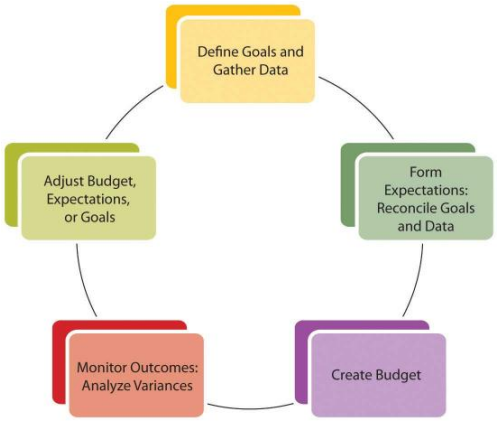


Figure 5.2.1 : The Budget Process

The process of creating a budget can be instructive. Creating a budget involves projecting realistic behavior. Your assumptions may come from your actual past behavior based on accurate records that you have gathered. If you have been using personal finance software, it has been keeping those records for you; if not, a thorough review of your bank account and investment statements will reveal that information. Financial statements are useful summaries of the information you need to create a budget.

After formulating realistic expectations based on past behavior and current circumstances, you still must reconcile your future behavior with your original expectations. For example, you may recognize that greater sacrifices need to be made, that you must change your behavior, or even that your goals are unattainable and should be more realistic, perhaps based on less desirable choices. On the other hand, this can be a process of happy discovery: Goals may be closer or require less sacrifice than you may have thought.

Whether it results in sobering dismay or ambitious joy, the budget process is one of reconciling your financial realities to your financial dreams. How you finance your life determines how you can live your life. Budgeting is a process of mapping out a life strategy. You may find it difficult to separate the emotional and financial aspects of your goals, but the more successfully you can do so, the more likely you will reach your goals.

A budget is a projection of how things should work out, but there is always some uncertainty. If the actual results are better than expected, and incomes are higher or expenses lower, expectations can be adjusted upward as a welcome accommodation to good fortune. On the other hand, if actual results are worse than expected, if incomes are lower or expenses are higher, future budgets—and current living choices—may need to be adjusted to accommodate that situation. Those new choices are less than preferred, or you would have chosen them in your original plan.

To avoid unwelcome surprises, it is advisable to be **conservative** in your expectations, thereby maximizing the likelihood that your actual results will exceed expectations. Thus, when estimating, you should always underestimate the income items and potential gains, and overestimate the expense items and potential losses.

You will also need to determine a time period and frequency for your budget process, such as annually, monthly, or weekly. The timing will depend on the level of financial activity you have and the degree of discipline or guidance you want your budget to provide. You should assess your progress at least once a year. In general, you want to keep a manageable amount of data for any one period, so the more financial activity you have, the shorter your budget period should be.

Summary

- A budget is a process that mirrors the financial planning process.
- The process of creating a budget can suggest goals, behaviors, and limitations.
- For the budget to succeed, goals and behaviors must be reconciled.
- Budgets should be prepared conservatively, so
  - Overestimate costs.
  - Underestimate earnings.
- The appropriate time period is
  - Short enough to limit the amount of information.
  - Long enough to capture meaningful information.

Exercises

1. In your financial planning journal, begin your budgeting process by reviewing your short-term and long-term goals. What will it take to achieve those goals? What limitations and opportunities do you have for meeting them? Then gather your financial data and choose a time period and frequency for checking your progress.
2. Watch Building a Better Financial Future: Developing A Realistic Budget (www.youtube.com/watch?v=voNDemdJTi4) (2:04 minutes). Why is a budget so important in personal financial planning? What kinds of problems can you resolve by manipulating your personal budget? What types of goals can you attain through changes to your personal budget?
3. Watch and reflect on Why we make bad financial choices -- even when we know better (www.youtube.com/watch?v=caGlzR9F2zI) (3:36 minutes). Add notes in your personal finance journal reflecting on what you heard and learned.

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5.3: Creating the Comprehensive Budget

Learning Objectives

1. Describe the components of the comprehensive budget and their purposes.
2. Describe the components of an operating budget.
3. Discuss the sources of recurring income and expenses.
4. Identify the factors in the operating budgeting process.
5. Identify the factors in the capital budgeting process.

Gathering data and creating a budget, with some goals already in mind, are the initial steps in the process. Understanding the format or shape of the budget will help guide you to the kind of information you need. A **comprehensive budget**, that is, a budget covering all aspects of financial life, will include projections of recurring incomes and expenses, as well as nonrecurring expenditures. (Nonrecurring income or "windfalls" should not be counted on or "budgeted for," conservatively.) Recurring incomes would be earnings from wages, interest, or dividends. Recurring expenditures may include living expenses, loan repayments, and regular savings or investment deposits. Nonrecurring expenditures may include capital improvements, such as a new roof for your house, or the purchase of durable items, like a refrigerator or a car. These are purchases that would not be made on a regular basis. A comprehensive budget diagram is shown in Figure 5.3.1 .

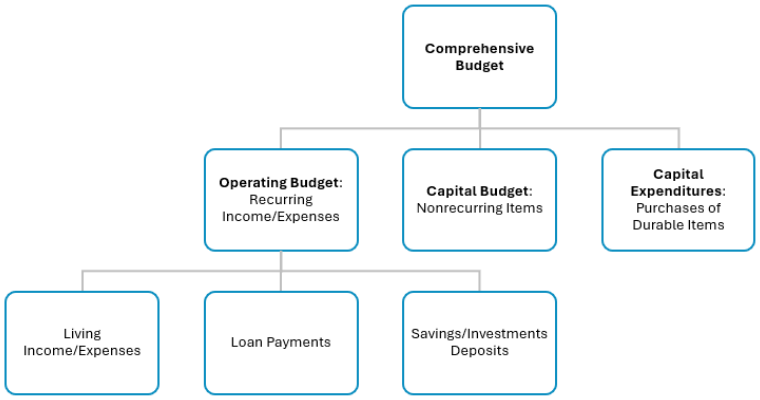


Figure 5.3.1 : Comprehensive Budget Diagram

Another distinction in recognizing recurring and nonrecurring items is the time frame for each. Recurring items require repeated attention and are therefore considered in the short term, whereas items on the capital budget may allow for long-term planning because they occur less frequently. The different time horizons for planning recurring and nonrecurring items may allow for various strategies to achieve those distinct goals.

A comprehensive budget is a combination of an **operating budget, which** focuses on short-term goals involving recurring items, and a **capital budget,** which addresses long-term goals involving nonrecurring items.

Operating Budget: Recurring Incomes and Expenditures

Recurring incomes and expenditures are usually the easiest to determine and project, as they occur consistently and have an immediate impact on your everyday life. An income statement shows income and expenses; a cash flow statement shows actual cash inflows and outflows. Recurring incomes and expenditures are planned in the context of short-term lifestyle goals or preferences.

Consider a time period that is large enough to capture relevant data. Some incomes and expenditures recur reliably but only periodically or seasonally. For example, you may pay the premium on your auto insurance policy twice per year. It is a recurring expense, but it only occurs in two months of the year, so you would need to examine expenditures over a sufficient number of months to notice it. Additionally, your heating or cooling expenses may fluctuate seasonally, resulting in higher utility expenses in some months than in others.

The time period you choose for a budget should be long enough to categorize intermittent items as recurring and nonrecurring items as unusual, yet short enough to follow and manage choices within the period. For personal budgets, a month is the most common budget period to use, since most living expenses are paid at least monthly. However, it is best to use at least one full year's worth of data to obtain a reasonable monthly average and to identify seasonal and periodic trends as they occur.

Some items may recur, but not reliably. The frequency, amount, or both may be uncertain. Taking a conservative approach, you should include the maximum possible amount of uncertain expenses in your budget. If income occurs regularly but the amount is uncertain, conservatively include the minimum amount that is expected. If income happens irregularly, it may be better to leave it out of your budget - and your plans - since you can't "count" on it.

Consider the following example: Mark works as a school counselor, tutors on the side, does house painting in the summer, and buys and sells sports memorabilia online. In 2016, he bought an older house with a $200,000 fixed-rate mortgage at 5.75 percent. Each year, he deposits $1,000 into his retirement account and makes home improvements. He used a car loan to buy his car. Whatever cash is left after he has paid his bills is saved in a money market account that earns 3 percent interest. At the end of 2023, Mark is attempting to draft a budget for 2024. Since he bought the house, he has been keeping pretty good financial records, as shown in Table 5.3.2 .

Mark has five sources of income - some more constant, some more reliable, and some more seasonal. His counseling job provides a steady, year-round paycheck. House painting is a seasonal, although fairly reliable, source of income; however, in 2022, Mark fell from a ladder and was unable to paint for two months. Tutoring is a seasonal source of income, and since the school hired an additional counselor in 2021, his income has decreased. Memorabilia trading is a year-round but unpredictable source of income. In 2023, he made some very lucrative trades, but almost none in 2021. Interest income depends on the balance in the money market account. He would include his counseling, painting, and interest incomes in his budget, but should be conservative about including his tutoring or trading incomes.

Mark's expenses are reliable and easily predictable, with a few exceptions. His 2022 accident increased his medical expenses for that year. Both gas costs for the car and heating expenses vary with the weather and the highly volatile price of oil; in 2021, those expenses were unusually high. Property tax increased in 2023, but is unlikely to do so again for several years.

Table 5.3.2 : Mark's Financial Data, 2019 - 2023

	2019	2020 Actual	2021 Actual	2022 Actual	2023 Actual
Incomes					
Wages		$ 32,000	$ 33,500	$ 35,000	$ 36,500
Tutoring		$ 3,000	$ 400	$ 5,000	$ 500
Memorabilia Sales		$ 2,500	$ 950	$ 2,650	$ 5,300
House Painting		$ 10,000	$ 11,000	$ 4,500	$ 10,250
Interest Income		$ 180	$ 192	$ 173	$ 146
Total Income		$ 47,680	$ 49,642	$ 47,323	$ 52,696
Payroll/Income Taxes		$ 8,000	$ 8,375	$ 8,750	$ 9,125
Disposable Income		$ 39,680	$ 41,267	$ 38,573	$ 43,571
Living Expenses					
Groceries		$ 3,120	$ 3,120	$ 3,120	$ 3,120
Car-Fuel		$ 1,688	$ 1,875	$ 2,813	$ 1,500
Car-Services, etc.		$ 350	$ 350	$ 320	$ 350
Car-Insurance		$ 800	$ 800	$ 800	$ 800
Electricity		$ 780	$ 780	$ 780	$ 780
Phone/Internet		$ 1,500	$ 1,188	$ 1,188	$ 1,068
Heat		$ 1,240	$ 1,200	$ 1,990	$ 1,125
Health Insurance		$ 320	$ 335	$ 350	$ 365
Medical		$ 50	$ 50	$ 1,200	$ 50
Dental		$ 200	$ 200	$ 200	$ 200
Travel/Entertainment		$ 3,000	$ 3,000	$ 3,000	$ 3,000
Car Loan Payment		$ 3,600	$ 5,400	$ 5,400	$ 5,400
Mortgage Interest		$ 11,433	$ 11,281	$ 11,120	$ 10,950
Property Tax		$ 3,450	$ 3,450	$ 3,450	$ 4,350
Total Living Expenses		$ 31,530	$ 33,029	$ 35,761	$ 33,058
Income after Living Expenses		$ 8,150	$ 8,238	$ 2,813	$ 10,514
Interest Expense					
Capital Expenditures/ Investment					
Mortgage Principal		$ 2,573	$ 2,725	$ 2,886	$ 3,056

	2019	2020 Actual	2021 Actual	2022 Actual	2023 Actual
Free Cash Flow		$ 5,577	$ 5,513	-$ 73	$ 7,458
Retirement Account Deposit		$ 1,000	$ 1,000	$ 1,000	$ 1,000
Home Improvement		$ 4,357	$ 5,327	$ 0	$ 4,146
Savings Deposit (withdrawal)		$ 220	-$ 814	-$ 1,073	$ 2,312
Draw on (pay off) Line of Credit					
Net Cash Flow		$ 0	$ 0	$ 0	$ 0
Line of Credit					
Money Market Account Balance	$ 6,000	$ 6,400	$ 5,778	$ 4,878	$ 7,336

Using New Information and "Micro" Factors

Along with your known financial history, you should also include any new information that may change your expectations. As with any forecast, the more information you can include in your projections, the more accurate the forecast will be.

Mark knows that the hiring of a new counselor has significantly cut into his tutoring income and will likely continue to do so. He will get a modest raise in his wages, but has been notified that the co-pays and deductibles on his medical and dental insurance will increase in 2024. He has just traded in his car and gotten a new loan for a used car.

The personal or micro characteristics of your situation influence your expectations, especially if they are expected to change. Personal factors such as family structure, health, career choice, and age significantly influence financial choices and goals. If any of those factors is expected to change, your financial situation will probably change as well, and that expectation should be included in your budget projections.

For example, if you expect to increase or decrease the size of your family or household, that will affect your consumption of goods and services. If you anticipate a change in job or career, it will likely affect your income from wages. A change in health may result in working more or less and thus changing income from wages. There are many ways that personal circumstances can change, and these changes can alter your financial expectations, choices, and goals. All these projected changes need to be included in the budget process.

Using Economics and "Macro" Factors

Macro factors affecting your budget stem from the broader economic context, so understanding how incomes and expenses are generated is useful in forming accurate estimates. Incomes are created when labor or capital (liquidity or assets) is sold. The amount of income created depends on the quantity sold and the price.

The price of labor depends on the relative balance of supply and demand for labor, as reflected in unemployment rates. The price of liquidity depends on the relative supply and demand for capital reflected in interest rates. In turn, unemployment rates and interest rates are influenced by the complex and dynamic economy.

The economy tends to behave cyclically. If the economy is in a period of contraction or recession, demand for labor is lower, competition among workers is higher, and wages are unlikely to rise. As unemployment rises, especially if you are working in an industry that is cyclically contracting with the economy, wages may become unreliable or increasingly risky if there is a risk of losing your job. Interest rates are generally more volatile and difficult to predict, but they tend to fall during periods of contraction and rise during periods of expansion. A budget period is usually short, so economic factors will not vary widely enough to affect projections over that brief period. Still, those economic factors should inform your estimates of potential income.

Expenses are incurred when a quantity of goods or services is consumed at a specific price. That price depends on the relative supply and demand for those goods and services, as well as the broader context of price levels in the economy. Inflation decreases the value of our currency, thereby reducing the purchasing power of goods and services. Again, as a rule, the budget period should be short enough so that changes in purchasing power do not significantly affect the budget; still, these changes should not be ignored. Price levels are much quicker to change than wage levels, so it is quite possible to have a rise in prices before an increase in wages, which decreases the real purchasing power of your paycheck.

If you have a variable rate loan - that is, a loan for which the interest rate may be adjusted periodically - you are susceptible to interest rate volatility. You should be aware of that particular macro factor when creating your budget.

Macroeconomic factors are challenging to predict, as they reflect complex scenarios; however, news about current and expected economic conditions is readily available in the media every day. A good financial planner will also track the economic indicators and forecasts. You will have a fairly concrete idea of where the economy is in its cycle and how that affects you simply by seeing how your paycheck covers your living expenses (e.g., filling up your car with gas or shopping for groceries). Figure 5.3.3 shows the relationship between personal history, microeconomic factors, and macroeconomic factors.

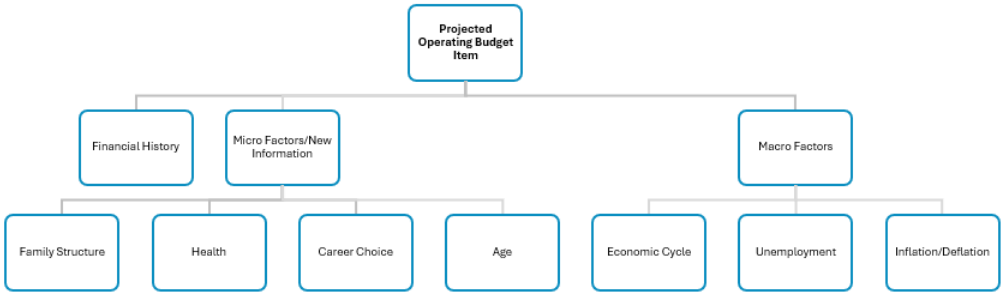


Figure 5.3.3 : Factors for Determining a Projected Operating Budget Item

Using his history, current information, and understanding of current and expected macroeconomic factors, Mark has compiled the budget shown in Table 5.3.4 .

To project his income, Mark relied on his most recent information to estimate his wages and tutoring income. He used the minimum income from the past four years for memorabilia sales, which is conservative and reasonable given its volatility. His painting income is less volatile, so his estimate is an average, excluding the unusual year of his accident. Interest income is based on his current money market account balance, which is adjusted for an expected drop in interest rates.

Mark expects his expenses to remain the same as they were in 2019, since his costs and consumption are not expected to change. However, he has adjusted his medical and dental insurance and his car loan payments based on his new knowledge (Table 5.3.4).

The price of gas and heating oil has been extraordinarily volatile during this period (2019-2023), affecting Mark's gas and heating expenses. Therefore, he bases his estimates on his expected consumption and the current price. He knows he drives an average of about 15,000 miles per year and that his car gets about 20 miles per gallon. He estimates his gas expense for 2024 by guessing that since oil price levels are about where they were in 2021, gas will cost, on average, what it did then, which was $2.50 per gallon. He will buy, on average, 750 gallons per year (15,000 miles ÷ 20 mpg), so his total expense will be $1,875. Mark also knows that he uses 500 gallons of heating oil each year. Estimating heating oil prices at 2021 levels, his cost will be about the same as it was then, or $1,200.

Mark knows that the more knowledge and information he can bring to bear, the more accurate and useful his estimates are likely to be.

Table 5.3.4 : Mark's 2024 Budget

	2019	2020 Actual	2021 Actual	2022 Actual	2023 Actual	2024 Budget
Incomes						
Wages		$ 32,000	$ 33,500	$ 35,000	$ 36,500	$ 38,000
Tutoring		$ 3,000	$ 400	$ 5,000	$ 500	$ 0
Memorabilia Sales		$ 2,500	$ 950	$ 2,650	$ 5,300	$ 950
House Painting		$ 10,000	$ 11,000	$ 4,500	$ 10,250	$ 10,417
Interest Income		$ 180	$ 192	$ 173	$ 146	$ 49
Total Income		$ 47,680	$ 49,642	$ 47,323	$ 52,696	$ 49,416
Payroll/Income Taxes		$ 8,000	$ 8,375	$ 8,750	$ 9,125	$ 9,500
Disposable Income		$ 39,680	$ 41,267	$ 38,573	$ 43,571	$ 39,916
Living Expenses						
Groceries		$ 3,120	$ 3,120	$ 3,120	$ 3,120	$ 3,120
Car-Fuel		$ 1,688	$ 1,875	$ 2,813	$ 1,500	$ 1,875
Car-Services, etc.		$ 350	$ 350	$ 320	$ 350	$ 350
Car-Insurance		$ 800	$ 800	$ 800	$ 800	$ 800
Electricity		$ 780	$ 780	$ 780	$ 780	$ 780
Phone/Internet		$ 1,500	$ 1,188	$ 1,188	$ 1,068	$ 1,068
Heat		$ 1,240	$ 1,200	$ 1,990	$ 1,125	$ 1,200
Health Insurance		$ 320	$ 335	$ 350	$ 365	$ 760
Medical		$ 50	$ 50	$ 1,200	$ 50	$ 50
Dental		$ 200	$ 200	$ 200	$ 200	$ 500
Travel/Entertainment		$ 3,000	$ 3,000	$ 3,000	$ 3,000	$ 3,000
Car Loan Payment		$ 3,600	$ 5,400	$ 5,400	$ 5,400	$ 5,988
Mortgage Interest		$ 11,433	$ 11,281	$ 11,120	$ 10,950	$ 10,769
Property Tax		$ 3,450	$ 3,450	$ 3,450	$ 4,350	$ 4,350
Total Living Expenses		$ 31,530	$ 33,029	$ 35,761	$ 33,058	$ 34,610
Income after Living Expenses		$ 8,150	$ 8,238	$ 2,813	$ 10,514	$ 5,305
Interest Expense						$ 321
Capital						

	2019	2020 Actual	2021 Actual	2022 Actual	2023 Actual	2024 Budget
Expenditures/Investment						
Mortgage Principal		$ 2,573	$ 2,725	$ 2,886	$ 3,056	$ 3,226
Free Cash Flow		$ 5,577	$ 5,513	-$ 73	$ 7,458	$ 1,748
Retirement Account Deposit		$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 1,000
Home Improvement		$ 4,357	$ 5,327	$ 0	$ 4,146	$ 15,000
Savings Deposit (withdrawal)		$ 220	-$ 814	-$ 1,073	$ 2,312	-$ 7,385
Draw on (pay off) Line of Credit						$ 6,870
Net Cash Flow		$ 0	$ 0	$ 0	$ 0	$ 3
Line of Credit						$ 6,870
Money Market Account Balance	$ 6,000	$ 6,400	$ 5,778	$ 4,878	$ 7,336	$ 0

Capital Budget: Capital Expenditures and Investments

The income, or **free cash flow**, that remains after paying living expenses and debt obligations is cash available for capital expenditures or investment. Capital expenditures are usually part of a long-term plan for building an asset base. Investment may also be part of a longer-term plan to build an asset base or to achieve a specific goal, such as financing education or retirement.

Long-term strategies are based on expected changes to the micro factors that shape goals. For example, you want to save for retirement because you anticipate aging and not being as willing or able to sell labor. Expanding or shrinking the family structure may create new savings goals or a change in housing needs, indicating a shift in the asset base (e.g., buying or selling a house).

Some changes will eliminate a specific goal. A child finishing college, for example, ends the need for education savings. Some changes will emphasize the necessity of a goal, such as a decline in health that underscores the need to save for retirement. As personal factors change, you should reassess your longer-term goals and the capital expenditures associated with those goals, because long-term goals and thus capital expenditures may also change in response.

While many personal factors are relatively predictable over the long term (e.g., you will get older, not younger), the macroeconomic factors that will occur simultaneously are much harder to predict. Will the economy be expanding or contracting when you retire? Will there be inflation or deflation? The further (in time) you are from your goals, the harder it is to predict those factors and the less relevant they are to your budgeting concerns. As you approach your goals, macro factors become increasingly influential in assessing your progress toward them. This was discussed in detail in Chapter 4.

Since long-term strategies unfold over time, you should utilize the relationship between time and value to calculate capital expenditures and track progress toward long-term goals. Long-term goals are often best achieved through a progression of steady and even steps; for example, a savings goal is typically reached by a series of regular and consistent deposits. You can also determine if your goal is too modest or too ambitious and should be adjusted in terms of the time required to reach it or the rate at which you achieve it.

Capital expenditures may be a one-time investment, like a new roof. A capital expenditure may also be a step toward a long-term goal, like an annual savings deposit. That goal should be assessed with each budget, and that "step" or capital expenditure should be reviewed. Figure 5.3.5 shows the relationship of factors used to determine the capital budget.

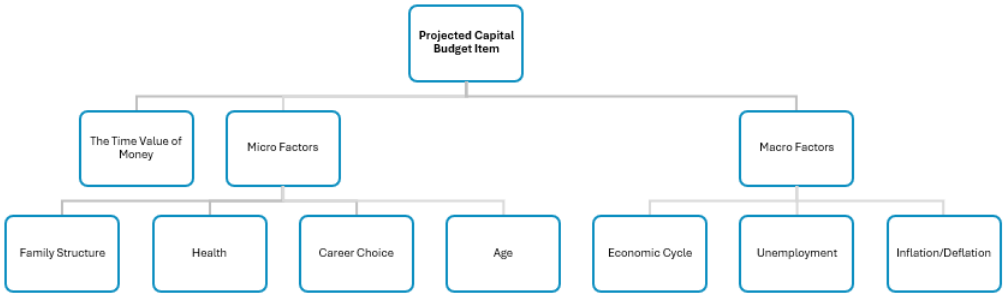


Figure 5.3.5 : Factors for Determining the Projected Capital Budget Item

Mark's 2024 budget (shown in Table 5.3.4) projects a decline in income and disposable income, along with an increase in living expenses, resulting in less free cash flow for capital expenditures or investments. He knows that his house needs a new roof (estimated cost: $15,000) and was hoping to have it done in 2024. However, that capital expenditure would create a negative net cash flow, even if he also uses the savings from his money market account. Mark's budget shows that both his short-term lifestyle preferences (projected income and expenses) and progress toward his longer-term goals (property improvement and savings) cannot be achieved without some changes and choices. What should those changes and choices be?

Summary

- A comprehensive budget consists of an operating budget and a capital budget
- The operating budget accounts for recurring incomes and expenses
- Recurring incomes result from selling labor and/or liquidity
- Recurring expenses result from the consumption of goods and/or services
- Recurring incomes and expenses
  - satisfy short-term, lifestyle goals
  - create free cash flow for capital expenditures
- The capital budget accounts for capital expenditures or nonrecurring items
- Capital expenditures are usually part of a longer-term plan or goal
- Projecting recurring incomes and expenses involves using
  - financial history
  - new information and microeconomic factors
  - macroeconomic factors
- Different methods may be used to project different incomes and expenses depending on the probability, volatility, and predictability of quantity and price
- Projecting capital expenditures involves using the following:
  - New information and microeconomic factors
  - Macroeconomic factors are harder to predict for a longer period, and are therefore less relevant
  - The relationships described by the time value of money

Exercises

1. Using Mark's budget sheet as a guide, adapt the budget categories and amounts to reflect your personal financial realities and projections. Develop an operating budget and a capital budget, distinguishing recurring incomes and expenses from nonrecurring capital expenditures. On what basis will you make projections about your future income and expenses?
2. How does your budget sheet relate to your income statement, your cash flow statement, and your balance sheet? How will you use this history to develop a budget to reach your short-term and long-term goals?

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5.4: The Cash Budget and Other Specialized Budgets

Learning Objectives

1. Discuss the use of a cash budget as a tool for effective cash management.
2. Explain the value of the cash budget in clarifying risks and opportunities.
3. Explain the purpose of a specialized budget, including a tax budget.
4. Demonstrate the importance of including specialized budgets in the comprehensive budget.

The Cash Budget

When cash flows are not periodic, meaning they are influenced by seasonality or a frequency different from the budgetary period, a closer examination of cash flow management can be beneficial. Although cash flows may be sufficient to cover expenses for the entire year, there may still be timing differences. For example, cash flows from income may be less frequent than cash flows for expenses. Cash flows may be seasonal, whereas expenses tend to be more regular. Most expenses must be paid monthly, and if some income cash flows occur less frequently or only seasonally, there is a risk of running out of cash in a particular month. For cash flows, timing is everything.

A good management tool is the cash budget, which is a detailed breakdown of budget items by month. Irregular cash flows can be allocated to specific months when they are expected to occur, allowing you to see the effects of cash flow timing more clearly. Mark's cash budget for 2024 is in the spreadsheet shown in Table 5.4.1 .

Table 5.4.1 : Mark's Cash Budget

	2024 January	2024 February	2024 March	2024 April	2024 May	2024 June	2024 July	2024 August	2024 September	2024 October	2024 November	2024 December
Incomes												
Wages	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167
Tutoring	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Memorabilia Sales	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79
House Painting						$ 3,472	$ 3,472	$ 3,472				
Interest Income	$ 4	$ 25	$ 36	$ 45	$ 57	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Total Income	$ 4,118	$ 3,271	$ 3,281	$ 3,291	$ 3,303	$ 6,718	$ 6,718	$ 6,718	$ 3,246	$ 3,246	$ 3,246	$ 3,246
Payroll/Income Taxes	$ 792	$ 792	$ 792	$ 792	$ 792	$ 792	$ 792	$ 792	$ 792	$ 792	$ 792	$ 792
Disposable Income	$ 4,910	$ 4,062	$ 4,073	$ 4,083	$ 4,094	$ 7,510	$ 7,510	$ 7,510	$ 4,038	$ 4,038	$ 4,038	$ 4,038
Living Expenses												
Groceries	$ 260	$ 260	$ 260	$ 260	$ 260	$ 260	$ 260	$ 260	$ 260	$ 260	$ 260	$ 260
Car-Fuel	$ 156	$ 156	$ 156	$ 156	$ 156	$ 156	$ 156	$ 156	$ 156	$ 156	$ 156	$ 156
Car-Services, etc.	$ 29	$ 29	$ 29	$ 29	$ 29	$ 29	$ 29	$ 29	$ 29	$ 29	$ 29	$ 29
Car-Insurance		-$ 400						-$ 400				
Electricity	$ 65	$ 65	$ 65	$ 65	$ 65	$ 65	$ 65	$ 65	$ 65	$ 65	$ 65	$ 65
Phone/Cable/Internet	$ 89	$ 89	$ 89	$ 89	$ 89	$ 89	$ 89	$ 89	$ 89	$ 89	$ 89	$ 89
Heat	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100
Health Insurance	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63
Medical	$ 4	$ 4	$ 4	$ 4	$ 4	$ 4	$ 4	$ 4	$ 4	$ 4	$ 4	$ 4
Dental	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42
Travel/Entertainment	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250
Car Loan	$ 499	$ 499	$ 499	$ 499	$ 499	$ 499	$ 499	$ 499	$ 499	$ 499	$ 499	$ 499

	2024 January	2024 February	2024 March	2024 April	2024 May	2024 June	2024 July	2024 August	2024 September	2024 October	2024 November	2024 December
Payment												
Mortgage Interest	$ 897	$ 897	$ 897	$ 897	$ 897	$ 897	$ 897	$ 897	$ 897	$ 897	$ 897	$ 897
Property Tax										-$ 4,350		
Total Living Expenses	$ 2,455	$ 2,055	$ 2,455	$ 2,455	$ 2,455	$ 2,455	$ 2,455	$ 2,055	$ 2,455	-$ 1,895	$ 2,455	$ 2,455
Income after Living Expenses	$ 7,365	$ 6,117	$ 6,528	$ 6,538	$ 6,549	$ 9,965	$ 9,965	$ 9,565	$ 6,493	$ 2,143	$ 6,493	$ 6,493
Interest Expense						-$ 49	-$ 27	-$ 7	-$ 9	-$ 40	-$ 43	-$ 46
Capital Expenditures/Investment												
Mortgage Principal	$ 270	$ 270	$ 270	$ 270	$ 270	$ 270	$ 270	$ 270	$ 270	$ 270	$ 270	$ 270
Free Cash Flow	$ 7,634	$ 6,387	$ 5,798	$ 6,808	$ 6,819	$ 10,186	$ 10,208	$ 9,827	$ 6,754	$ 2,372	$ 6,719	$ 6,716
IRA Deposit			-$ 1,000									
Retirement Account Deposit					-$ 15,000							
Home Improvement	$ 7,634	$ 6,387	$ 5,798	$ 6,808	-$ 34,126							
Savings Deposit (withdrawal)					$ 10,525	-$ 3,250	-$ 3,275	-$ 2,890	$ 180	$ 4,765	$ 415	$ 417
Draw on (pay off) Line of Credit												
Net Cash Flow	$ 0	$ 0	$ 0	$ 0	$ 36,470	$ 6,936	$ 6,933	$ 6,937	$ 6,934	$ 7,137	$ 7,134	$ 7,133

	2024 January	2024 February	2024 March	2024 April	2024 May	2024 June	2024 July	2024 August	2024 September	2024 October	2024 November	2024 December
Line of Credit			$ 27,216		$ 10,525	$ 7,275	$ 4,000	$ 1,110	$ 1,290	$ 6,055	$ 6,470	$ 6,887
Money Market Account Balance	$ 14,971	$ 21,383		$ 34,069	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0

Mark's original annual budget (Table 5.4.1) indicates that although his income is sufficient to cover his living expenses, it does not generate enough cash to support his capital expenditures, specifically, to repair the roof. His cash flow would fall short by about $6,870, even after he uses the cash from his savings (the money market account). If he must make the capital expenditure this year, he can finance it with a **line of credit**—a loan where money can be borrowed as needed, up to a limit, and repaid as desired, with interest paid only on the outstanding balance. Using the line of credit, Mark would create an extra $321 of interest expense for the year.

The alternative cash budget (Table 5.4.2) shows a more detailed and slightly different story. Because of Mark's seasonal income, if he has the roof fixed in May, he will need to borrow $10,525 in May (before he has income from painting). Then he can pay that balance down until October, when he will need to extend it again to pay his property tax. By the end of the year, his outstanding debt will be slightly more than initially shown, with an ending balance of $6,887. However, his total interest expense will be slightly lower - only $221 - as the loan balance (and therefore the interest expense) will be lower in some of the months he has the loan.

The cash (monthly) budget shows a different story than the annual budget because of the seasonal nature of Mark's income. Since he plans to make capital expenditures before earning income from painting, he has to borrow more—and assume more risk—than indicated initially.

The cash budget may reveal risks, but it also highlights remedies that may not be immediately apparent. In Mark's case, it is clear that the capital expenditure cannot be financed without some external source of capital, most likely a line of credit. He would have to pay interest on that loan, creating an additional expense. That expense would be proportional to the amount borrowed and the duration for which it is borrowed. In his original plan, the capital expenditure was scheduled for May, and Mark would have had to borrow approximately $10,525, paying interest for the next seven months of the year. However, delaying the capital expenditure until October would cost him less, because he would have to borrow less and would be paying interest for fewer months. An alternative cash budget illustrating this scenario is shown in Table 5.4.2 .

Table 5.4.2 : Mark's Alternative Cash Budget

	2024 January	2024 February	2024 March	2024 April	2024 May	2024 June	2024 July	2024 August	2024 September	2024 October	2024 November	2024 December
Incomes												
Wages	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167
Tutoring	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Memorabilia Sales	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79
House Painting						$ 3,472	$ 3,472	$ 3,472				
Interest Income	$ 12	$ 12	$ 10	$ 8	$ 8	$ 8	$ 13	$ 19	$ 24	$ 0	$ 0	$ 0
Total Income	$ 3,258	$ 3,257	$ 3,256	$ 3,254	$ 3,254	$ 6,726	$ 6,731	$ 6,737	$ 3,269	$ 3,246	$ 3,246	$ 3,246
Payroll/Income Taxes	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792
Disposable Income	$ 2,466	$ 2,466	$ 2,465	$ 2,462	$ 2,462	$ 5,934	$ 5,940	$ 5,945	$ 2,578	$ 2,454	$ 2,454	$ 2,454
Living Expenses												
Groceries	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260
Car-Fuel	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156
Car-Services, etc.	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29
Car-Insurance		-$ 400						-$ 400				
Electricity	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65
Phone/Cable/Internet	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89
Heat	-$ 200	-$ 200	-$ 200							-$ 200	-$ 200	-$ 200
Health Insurance	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63
Medical	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4
Dental	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42
Travel/Entertainment	-$ 250	-$ 250	-$ 250	-$ 250	-$ 250	-$ 250	-$ 250	-$ 250	-$ 250	-$ 250	-$ 250	-$ 250
Car Loan	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499

	2024 January	2024 February	2024 March	2024 April	2024 May	2024 June	2024 July	2024 August	2024 September	2024 October	2024 November	2024 December
Payment												
Mortgage Interest	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897
Property Tax										-$ 4,350		
Total Living Expenses	-$ 2,555	-$ 2,955	-$ 2,555	-$ 2,355	-$ 2,355	-$ 2,355	-$ 2,355	-$ 2,755	-$ 2,355	-$ 6,905	-$ 2,555	-$ 2,555
Income after Living Expenses	$ 89	$ 489	$ 90	$ 107	$ 107	$ 3,579	$ 3,585	$ 3,190	$ 123	-$ 4,451	-$ 101	-$ 101
Interest Expense						$ 0	$ 0	$ 0	$ 0	-$ 38	-$ 41	-$ 44
Capital Expenditures/Investment												
Mortgage Principal	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270
Free Cash Flow	-$ 358	-$ 759	-$ 360	-$ 162	-$ 163	$ 3,309	$ 3,315	$ 2,920	-$ 147	-$ 4,759	-$ 412	-$ 414
IRA Deposit			-$ 1,000									
Retirement Account Deposit										-$ 15,000		
Home Improvement	-$ 358	-$ 759	-$ 1,360	-$ 162	-$ 163	$ 3,309	$ 3,315	$ 2,920	-$ 147	-$ 14,029		
Savings Deposit (withdrawal)										$ 5,730	$ 412	$ 415
Draw on (pay off) Line of Credit												
Net Cash Flow	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 1
Line of					$ 0	$ 0	$ 0	$ 0	$ 0	$ 5,730	$ 6,142	$ 6,557

	2024 January	2024 February	2024 March	2024 April	2024 May	2024 June	2024 July	2024 August	2024 September	2024 October	2024 November	2024 December
Credit												
Money Market Account Balance	$ 6,978	$ 6,230	$ 4,881	$ 4,726	$ 4,571	$ 7,886	$ 11,214	$ 14,153	$ 14,029	$ 0	$ 0	$ 0

Delaying the capital expenditure until October would also allow the money market account to build value, as Mark's seasonal income would be deposited during the summer, which would finance more of the capital expenditure. He could borrow less, ending the year about $6,557 short, and his interest expense would be only $123 because he has borrowed less and because he can wait until October to borrow, thus paying interest for only three months of the year.

Timing matters for cash flows not only because you need to get cash before you spend it, but also because time affects value. It is always better to have liquidity sooner and hang onto it longer. A cash budget provides a much more detailed look at these timing issues, and the risks and opportunities of cash management that you may otherwise have missed.

Other Specialized Budgets

A cash flow budget is a budget that projects a specific aspect of your finances, that is, the cash flows. Other types of **specialized budgets** focus on a specific financial aspect or goal. A specialized budget is ultimately included in the comprehensive budget, as it is a part of total financial activity. It typically focuses on a specific activity in greater detail, such as the impact of owning and maintaining a particular asset or pursuing a specific activity. You create a budget for that asset or that activity by segregating its income and expenses from your comprehensive budget. It is possible to make such a focused budget only if you can identify and separate its financial activity from the rest of your financial life. If so, you may want to track an activity separately that is directly related to a specific goal.

For example, suppose you decide to take up weekend backpacking as a recreational activity. You will try it for two years and then decide whether to continue. Aside from assessing the enjoyment it gives you, you also want to evaluate its impact on your finances. Typically, weekend backpacking requires specialized equipment and clothing, travel to a hiking trail access or campground, and perhaps lodging and meals: capital investment (in the equipment) and then recurring expenses. You may want to create a separate budget for your backpacking investment and expenses to assess the value of this new recreational activity.

One common type of specialized budget is a **tax budget**, which includes activities, such as incomes, expenses, gains, and losses, that have direct tax consequences. A tax budget can be useful in planning for or anticipating an event that will have significant tax consequences, such as income from self-employment; the sale of long-term or short-term assets such as a stock, business, or real estate; or a gift of significant wealth or the settling of an estate.

While it can be valuable to isolate and identify the effects of a specific activity or the progress toward a specific goal, that activity or that goal is ultimately just a part of your larger financial picture. Specialized budgets should remain an integral part of your comprehensive financial planning.

Summary

- The cash flow budget is an alternative format used as a cash management tool that provides
  - more detailed information about the timing and amounts of cash flows
  - a clearer view of risks and opportunities
- Specialized budgets focus on a specific asset or activity
- A tax budget is commonly used to track taxable activities
- Eventually, specialized budgets need to be included in the comprehensive budget to have a complete perspective

Exercises

1. When is a cash flow budget a useful alternative to a comprehensive budget?
2. Create a specialized budget and a tax budget from your comprehensive budget.

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5.5: Budget Variances

Learning Objectives

1. Define and discuss budget variances.
2. Identify the importance of budget-monitoring activities.
3. Analyze budget variances to understand their causes, including possible changes in micro or macro factors.
4. Analyze budget variances to identify potential remedies and assess their feasibility.

A **budget variance** occurs when the actual results of your financial activity differ from your budgeted projections. Since your expectations were based on knowledge from your financial history, micro- and macroeconomic factors, and new information, any variance is likely due to either an inaccurate estimate or a change in one or more of those factors that was unexpected. If your estimate was inaccurate—perhaps you had overlooked or ignored a factor—knowing that can help you improve. If one or more of those factors have changed unexpectedly, then identifying the cause of the variance creates new information to help assess your situation. At the very least, variances will alert you to the need for adjustments to your budget and to the appropriate choices.

Once you have created a budget, your financial life continues. As actual data replace projections, you must monitor the budget compared to your actual activities so that you will notice any serious variances or deviations from the expected outcomes detailed in the budget. Your analysis and understanding of variances constitute new information for adjusting your current behavior, preparing the next budget, or perhaps realistically reassessing your behavior or original goals.

The sooner you notice a budget variance, the sooner you can analyze it and, if necessary, adjust for it. The sooner you correct the variance, the less it costs. For example, perhaps you have had a little trouble living within your means, so you have created a budget to help you do so. You have worked out a plan so that total expenses are equal to total income. In your original budget, you expected to incur a certain expense for gas, which you calculated based on your mileage and the current price of gas. You are following your budget and going along just fine. Suddenly, the price of gas goes way up, and so does this monthly expense. That means you'll have to

- spend less on other expenses to keep your total expenses within your budget
- lower your gas expense by driving less, and/or
- increase your income to accommodate this higher expense

In the short term, monitoring your gas expense alerts you to a need to change your financial behavior by driving less, spending less on other things, or earning more. In the long run, if you find this increased expense intolerable, you will make different choices to avoid it. Perhaps you would consider buying a more fuel-efficient or electric car, or adjust your lifestyle to require less driving. The number and feasibility of your choices will depend on your desire for that particular budget item. But if you hadn't been paying attention and had not been monitoring your budget against the real outcomes as they occurred, you would not have been aware that any change was needed. You would have found yourself with a surprising budget deficit.

It bears repeating that once you have identified a significant budget variance, you must analyze its cause so that you can address it effectively.

Income comes from the sale of labor (wages) or liquidity (interest or dividends). If income deviates from its projection, it is because

- a different quantity of labor or liquidity was sold at the expected price (e.g., you had fewer house painting contracts than usual but kept your rates the same)
- the expected quantity of labor or liquidity was sold at a different price (e.g., you had the usual number of contracts but earned less from them), or
- a different quantity of labor or liquidity was sold at a different price (e.g., you had fewer contracts and charged less to be more competitive)

Expenses result from consuming goods or services at a price. If an expense deviates from its projected outcome, it is because

- a different quantity was consumed at the expected price (e.g., you did not use as much gas)

- an expected quantity was consumed at a different price (e.g., you used as much gas, but the price of gas fell), or
- a different quantity was consumed at a different price (e.g., you used less gas and bought it for less)

Isolating the cause of a variance is useful because different causes will dictate different remedies or opportunities. For example, if your gas expense has increased, is it because you are driving more miles or because the price of gas has gone up? You can't control the price of gas, but you can control the miles you drive. Isolating the cause allows you to identify realistic choices. In this case, if the variance is too costly, you will need to address it by somehow driving fewer miles or arranging for less expensive transportation.

If your income falls, is it because your hourly wage has fallen or because you are working fewer hours? If your wage has fallen, you need to try to increase it either by negotiating with your employer or by seeking a new job at a higher wage. Your success will depend on the demand in the labor market and on your value as a labor supplier.

If you are working fewer hours, it may be because your employer is offering you less work or because you have chosen to work fewer hours. If the problem is with your employer, you may need to renegotiate your position or find a new one. However, suppose your employer is reducing labor demand due to decreased market demand. In that case, that may be attributed to an industry or economic cycle, which could impact your ability to make that change.

If it is your choice of hours that has caused the variance, perhaps that is due to personal factors, such as aging or the need for more care and attention for your dependents. Some personal factors can be resolved to allow you to work more, but others cannot be controlled. If you are able, you might simply choose to work more.

Identifying *why* you are deviating from your budget is crucial in determining remedies and choices. Putting those causes in the context of the micro- and macroeconomic factors that affect your situation will help identify feasible choices. Figure 5.5.1 shows these factors.

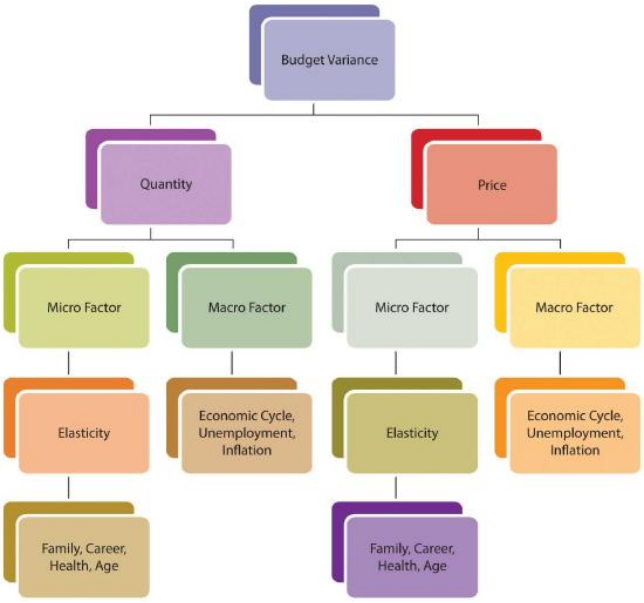


Figure 5.5.1 : The Factors of a Budget Variance

After three months, Mark decides to review his budget variances to ensure he's on track. His actual results for January - March 2024 are detailed in Table 5.5.2 .

Table 5.5.2 : Mark's Actual Income and Expenditures, January - March 2024

	2024 January Actual	2024 February Actual	2024 March Actual
Incomes			
Wages	$ 3,167	$ 3,167	$ 3,167
Tutoring	$ 400	$ 400	$ 400
Memorabilia Sales	$ 450	$ 450	$ 450
House Painting			
Interest Income	$ 31	$ 34	$ 34
Total Income	$ 4,047	$ 3,960	$ 4,801
Payroll/Income Taxes	-$ 792	-$ 792	-$ 792
Disposable Income	$ 3,256	$ 3,169	$ 4,009
Living Expenses			
Groceries	-$ 260	-$ 260	-$ 260
Car-Fuel	-$ 156	-$ 156	-$ 156
Car-Services, etc.	-$ 29	-$ 29	-$ 29
Car-Insurance		-$ 400	
Electricity	-$ 65	-$ 65	-$ 65
Phone/Internet	-$ 89	-$ 89	-$ 89
Heat	-$ 200	-$ 200	-$ 200
Health Insurance	-$ 63	-$ 63	-$ 63
Medical	-$ 4	-$ 4	-$ 4
Dental	-$ 42	-$ 42	-$ 42
Travel/Entertainment	$ 0	$ 0	$ 0
Car Loan Payment	-$ 499	-$ 499	-$ 499
Mortgage Interest	-$ 897	-$ 897	-$ 897
Property Tax			
Total Living Expenses	-$ 2,305	-$ 2,305	-$ 2,305
Income after Living Expenses	$ 951	$ 464	$ 1,704
Interest Expense			
Capital Expenditures/Investment			
Mortgage Principal	-$ 270	-$ 270	-$ 270
Free Cash Flow	$ 681	$ 194	$ 1,435
Retirement Account Deposit			-$ 1,000
Home Improvement			

	2024 January Actual	2024 February Actual	2024 March Actual
Savings Deposit (withdrawal)	$ 681	$ 194	$ 435
Draw on (pay off) Line of Credit			
Net Cash Flow	$ 0	$ 0	$ 0
Line of Credit			
Money Market Account Balance	$ 8,048	$ 8,275	$ 8,774

How will Mark analyze the budget variances he finds? In Mark's case, the income variances are positive. He has picked up a couple of tutoring clients who have committed to lessons through the end of the school year in June; this new information can be used to adjust income. His memorabilia business has performed well; although sales volume has not increased, the memorabilia market appears to be up, and prices are better than expected. The memorabilia business is cyclical; economic expansion and increases in disposable incomes enhance that market. However, given the volatility of prices in that market and the fact that there has been no increase in sales volume (Mark is not doing more business, just more lucrative business), Mark will not make any adjustments going forward. Interest rates have risen. Mark can use that macroeconomic news to adjust his expected interest income.

His expenses are as expected. The only variance is the result of Mark's decision to cut his travel and entertainment budget for this year (i.e., giving up his vacation) to offset the costs of the roof. He is planning that capital expenditure for October, which (as seen in the previous section) will actually make it cheaper to do. His adjusted cash budget is shown in Table 5.5.3 .

Table 5.5.3 : Mark's Adjusted Cash Budget for 2024

	2024 January Actual	2024 February Actual	2024 March Actual	2024 April	2024 May	2024 June	2024 July	2024 August	2024 September	2024 October	2024 November	2024 December
Incomes												
Wages	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167	$ 3,167
Tutoring	$ 400	$ 400	$ 400	$ 400	$ 400	$ 400	$ 33	$ 33	$ 33	$ 33	$ 33	$ 33
Memorabilia Sales	$ 450	$ 360	$ 1,200	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79
House Painting						$ 3,472	$ 3,472	$ 3,472				
Interest Income	$ 31	$ 34	$ 34	$ 15	$ 15	$ 16	$ 23	$ 29	$ 34	$ 0	$ 2	$ 2
Total Income	$ 4,047	$ 3,960	$ 4,801	$ 3,660	$ 3,661	$ 7,134	$ 6,741	$ 6,747	$ 3,280	$ 3,246	$ 3,248	$ 3,248
Payroll/Income Taxes	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792	-$ 792
Disposable Income	$ 3,256	$ 3,169	$ 4,009	$ 2,869	$ 2,870	$ 6,343	$ 5,949	$ 5,955	$ 2,488	$ 2,454	$ 2,456	$ 2,456
Living Expenses												
Groceries	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260	-$ 260
Car-Fuel	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156	-$ 156
Car-Services, etc.	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29	-$ 29
Car-Insurance		$ 400						-$ 400				
Electricity	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65	-$ 65
Phone/ Internet	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89	-$ 89
Heat	-$ 200	-$ 200	-$ 200							-$ 200	-$ 200	-$ 200
Health Insurance	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63	-$ 63
Medical	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4	-$ 4
Dental	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42	-$ 42
Travel/Entertainment	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Car Loan	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499	-$ 499

	2024 January Actual	2024 February Actual	2024 March Actual	2024 April	2024 May	2024 June	2024 July	2024 August	2024 September	2024 October	2024 November	2024 December
Payment												
Mortgage Interest	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897	-$ 897
Property Tax										-$ 4,350		
Total Living Expenses	-$ 2,305	-$ 2,705	-$ 2,305	-$ 2,105	-$ 2,105	-$ 2,105	-$ 2,105	-$ 2,505	-$ 2,105	-$ 6,655	-$ 2,305	-$ 2,305
Income after Living Expenses	$ 951	$ 464	$ 1,704	$ 764	$ 765	$ 4,238	$ 3,844	$ 3,450	$ 383	-$ 4,201	$ 151	$ 151
Interest Expense						$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Capital Expenditures/Investment												
Mortgage Principal	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270	-$ 270
Free Cash Flow	$ 681	$ 194	$ 1,435	$ 494	$ 495	$ 3,968	$ 3,575	$ 3,181	$ 114	-$ 4,471	-$ 119	-$ 119
IRA Deposit			-$ 1,000									
Home Improvement										-$ 15,000		
Savings Deposit (withdrawal)	$ 681	$ 194	$ 435	$ 494	$ 495	$ 3,968	$ 3,575	$ 3,181	$ 114	-$ 19,471	-$ 119	-$ 119
Draw on (pay off) Line of Credit										$ 0		
Net Cash Flow	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Line of Credit					$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Money Market	$ 8,047	$ 8,275	$ 8,744	$ 9,253	$ 9,763	$ 13,747	$ 17,345	$ 20,554	$ 20,702	$ 1,231	$ 1,114	$ 998

	2024 January Actual	2024 February Actual	2024 March Actual	2024 April	2024 May	2024 June	2024 July	2024 August	2024 September	2024 October	2024 November	2024 December
Account Balance												

With these adjustments, Mark can avoid new debt and still support the capital expenditure of the new roof. The increased income that Mark can expect, combined with his decreased expenses (if he can maintain his resolve), can finance the project and still leave him with a bit of savings in his money market account.

This situation bears continued monitoring, however. Some improvements are attributable to Mark's efforts (cutting back on entertainment expenses, giving up his vacation, getting new tutoring clients). However, Mark has also benefited from macroeconomic factors that have shifted to his advantage (rising interest rates and rising memorabilia prices), and those factors could change again to his disadvantage. He has tried to be conservative about making adjustments from now on. Still, he should continue to keep a close eye on the situation, especially as he approaches the relatively large capital expenditure in October.

Sometimes a variance cannot be "corrected" or is due to a micro- or macroeconomic factor beyond your control. In that case, you must adjust your expectations to reality. You may need to modify expected outcomes or even your ultimate goals.

Variances are also measures of the accuracy of your projections. What you learn from them can enhance your estimates and budgeting abilities. The unexpected can always occur, but the better you can anticipate what to expect, the more accurate and useful your budget process can be.

Summary

- Recognizing and analyzing variances between actual results and budget expectations
  - identifies potential problems
  - identifies potential remedies
- The more frequently the budget is monitored, generally
  - the sooner adjustments may be made
  - the less costly adjustments are to make
- Budget variances for incomes and expenses should be analyzed to see if they are caused by a difference in
  - actual quantity
  - actual price
  - both actual quantity and actual price
- Variances also need to be analyzed in the context of micro and macro factors that may change

Exercises

You are working fewer hours, which is reducing your income from employment and causing a budget variance. If the choice is yours, what are some microeconomic factors that could be causing this outcome? If the choice is your employer's, what are some macroeconomic factors that could be sources of the variance? What are your choices for increasing income? Alternatively, what might you change in your financial behavior, budget, or goals to improve outcomes?

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5.6: Budgets, Financial Statements and Financial Decisions

Learning Objectives

1. Describe the budget process as a financial planning tool.
2. Discuss the relationships between financial statements and budgets.
3. Demonstrate the use of budgets in assessing choices.
4. Identify factors that affect the value of choices.

Whatever type of budget you create, the budget process is a key aspect of personal financial planning, a tool that helps you make better financial decisions. Other tools include financial statements, assessments of risk and the time value of money, macroeconomic indicators, and microeconomic or personal factors. The usefulness of these tools lies in their ability to provide a clearer view of “what is” and “what is possible.” It puts your current situation and your choices into a larger context, giving you a better way to think about where you are, where you’d like to be, and how to go from here to there.

Mark must decide whether to proceed with the new roof. Assuming the house needs a new roof, his decision is only about his choice of financing. An analysis of Mark’s budget variances has shown that he can actually pay for the roof with the savings in his money market account. This means his goal is more attainable (and less costly) than in his original budget. This favorable outcome is due to his efforts to increase income and reduce expenses, as well as to macroeconomic changes that have been to his advantage. Consequently, Mark can make progress toward his long-term goal of building his asset base. He can continue saving for retirement with deposits into his retirement account and continue improving his property by installing a new roof on his house.

Because Mark is financing the roof with the savings from his money market account, he can avoid new debt and thus additional interest expense. He will lose the interest income from his money market account (which is insignificant as it represents only 0.09 percent of his total income). Still, the increases from his tutoring and sales income will offset the loss. Mark’s income statement will be virtually unaffected by the roof. His cash flow statement will show unchanged operating cash flow, a significant capital expenditure, and the use of savings.

Mark can finance this increase in asset value (his new roof) with another asset, his money market account. His balance sheet will not change substantially - value will shift from one asset to another - but the money market account earns income, which the house does not, although there may be a gain in value when the house is sold in the future.

Currently, that interest income is insignificant; however, given the prevailing trend of rising interest rates, the opportunity cost of forgoing interest income could be substantial in the future if the account balance were allowed to grow.

Moreover, Mark will be moving value from a highly liquid money market account to a less liquid house, thereby decreasing his overall liquidity. Looking ahead, this loss of liquidity could create another opportunity cost: It could narrow his options. Mark’s liquidity will be significantly depleted by the time the roofing expense is incurred, so future capital expenditures may need to be financed with debt. If interest rates continue to rise, it will make financing future capital expenditures more expensive and may cause Mark to delay or even cancel those expenditures.

However, Mark also has a very reliable source of liquidity in his earnings. His paycheck can offset this loss. If he can continue to generate free cash flow to add to his savings, he can restore his money market account and his liquidity. Mark has no dependents, so he can assume the risk of depleting his liquidity now and relying on his income to restore it later.

The opportunity cost of losing liquidity and interest income will be less than the cost of new debt and new interest expense. That is because interest rates on loans are always higher than interest rates earned on savings. Banks always charge more than they pay for liquidity. The added risk and obligation of new debt could also create opportunity costs, making it more challenging to finance future capital expenditures. Therefore, funding capital expenditure with an asset rather than a liability is less costly both immediately and in the future, as it creates fewer obligations, more opportunities, less opportunity cost, and lower risk.

The budget and financial statements enable Mark to project the effects of this financial decision within the broader context of his current financial situation and ultimate financial goals. His understanding of opportunity costs, liquidity, the time value of money, and personal and macroeconomic factors also helps him evaluate his choices and their consequences. Mark can use this decision and its results to inform his next decisions.

Financial planning is a continuous process of making financial decisions. Financial statements and budgets can summarize the current situation and project the outcomes of choices. Financial statement analysis and budget variance analysis assess the effects of choices. Personal factors, economic factors, and the relationships of time, risk, and value affect outcomes.

Summary

- Financial planning is a continuous process of making financial decisions
- Financial statements are ways of summarizing the current situation
- Budgets are ways of projecting the outcomes of choices
- Financial statement analysis and budget variance analysis are ways of assessing the effects of choices
- Personal factors, economic factors, and the relationships of time, risk, and value affect choices, as their dynamics affect outcomes

Exercises

Analyze Mark's budget as a financial planning tool for making decisions in the following situations. In each case, how will other financial planning tools affect Mark's decisions? For each case, create a new budget showing the projected effects of Mark's decisions.

1. Mark injures himself on the cross-trainer, and the doctor recommends a course of physical therapy.
2. A neighbor and coworker suggest that he and Mark commute to work together.
3. The roofers inform Mark that his chimney needs to be repaired.
4. Mark wants to give up tutoring and put more time into his memorabilia business.
5. Mark wants to marry and start a family, and needs to know when would be a good time.

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SECTION OVERVIEW

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5.7.1: Personal Budgeting

5.7.1.1: Making a Budget

5.7.1.2: Creating Your Budget

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5.7.2: Budgets and Saving

5.7.3: Video- Can't Stick to a Budget? Try these tweaks Instead

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SECTION OVERVIEW

5.7.1: Personal Budgeting

5.7.1.1: Making a Budget

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5.7.1.1: Making a Budget

What It Is

What is a budget?

A budget is a plan you write down to decide how you will spend your money each month.

A budget helps you make sure you will have enough money every month. Without a budget, you might run out of money before your next paycheck.

A budget shows you:

- how much money you make
- how you spend your money

Why do I want a budget?

A budget helps you decide:

- what you must spend your money on
- if you can spend less money on some things and more money on other things

For example, your budget might show that you spend $100 on clothes every month. You might decide you can spend $50 on clothes. You can use the rest of the money to pay bills or to save for something else.

For Example

A link to an interactive elements can be found at the bottom of this page.

Why should I try to save money?

You might need money for an emergency. You also might need to buy something more expensive, like a car. Saving money might help you buy a car, put a security deposit on an apartment, or pay for something else expensive.

What To Know

How do I start a budget?

Start a budget by gathering your bills and pay stubs. Think about how you spend money, besides paying your bills. For example, do you buy a cup of coffee every day? After a month, that coffee money could add up to an expense you might write down.

When you have your bills and pay stubs:

- write down your expenses. An expense is money you spend
- write down how much money you make. This is called income
- subtract your expenses from how much money you make

If the number is less than zero, you are spending more money than you make. Look for things in your budget you can change. Maybe something you do not need, or a way to spend less.

Use this Budget Worksheet to help you.

What if I don't get paid every month?

Some people do not get paid every month. If you expect things to be like they were last year, do this:

- add all the money you earned last year
- divide that number by 12. This is about how much money you will have for each month

For Example

Last year my paychecks added up to $30,000.
$30,000 ÷ 12 = $2,500

I had about $2,500 each month.

How can I use my budget?

A budget is something you use every month. A written budget will help you:

- see where you spend money
- see where you can save
- make a plan for how to spend and save your money

Your budget can help you save money for the future. You can make savings one of your expenses. You might find ways to spend less money. Then you can put money into savings every month – maybe into a bank or credit union.

Why should I save money?

It can be hard to save money. It is very hard when your expenses go up and your income does not. Here are some reasons to try to save money even when it is not easy.

- **Emergencies** – Saving small amounts of money now might help you later. Everyone has expenses they do not expect.
- **Expensive things** – Sometimes, we have to pay for expensive things – like a car, a trip, or a security deposit on an apartment. You will have more choices if you have money to pay for those expensive things.
- **Your goals** – You might want to pay for college classes. Maybe you need to visit family in another country. You can plan for these goals and save money. Then you might not have to use a credit card or borrow money to pay.

How else can I save money?

You can try these ways to help save money:

- For one month, write down everything you spend. Small expenses, like a cup of coffee, can add up to a lot of money. When you know where you are spending your money, you can decide what you might **not** want to buy.
- Pay with your credit card only if you can pay the full amount when the bill comes. That way, you do not pay interest on what you owe.
- Pay your bills when they are due. That way, you will not owe late fees or other charges.
- Keep the money you are saving separate from the money you spend.
- Consider opening a savings account in a bank or credit union. Read more about opening a bank account.
- If you keep cash at home, keep the money you are saving separate from your spending money. Keep all your cash someplace safe.

For Example

What I did **not** buy this month:

Music downloads	$5.00
Shirt	$30.00
Movie ticket	$10.00
Top off gas tank	$15.00
Cups of coffee	$12.00
What I saved this month:	$72.00

What To Do

A budget is a plan that shows you how you can spend your money every month. Making a budget can help you make sure you do not run out of money each month. A budget also will help you save money for your goals or for emergencies.

How do I make a budget?

Write down your expenses. Expenses are what you spend money on. Expenses include:

Bills:

- bills that are the same each month, like rent
- bills that might change each month, like utilities
- bills you pay once or twice a year, like car insurance

Other expenses, **like**:

- food
- gas
- entertainment
- clothes
- school supplies
- money for family
- unplanned expenses, like car repairs or medical bills
- credit card bills

You might have bills that change every month. Look at what you paid for the same month last year. You might need $200 for your gas bill in January, but $30 in July.

Write down how much money you make. This includes your paychecks and any other money you get, like child support.

Subtract your expenses from how much money you make. This number should be more than zero. If it is less than zero, you are spending more money than you make. Look at your budget to see what you do not need or what you could spend less on.

How do I use my budget?

You can use your budget every month:

- At the beginning of the month, make a plan for how you will spend your money that month. Write what you think you will earn and spend.
- Write down what you spend. Try to do this every day.
- At the end of the month, see if you spent what you planned.
- Use the information to help you plan the next month's budget.

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5.7.1.2: Creating Your Budget

Creating a *budget* may sound complicated, but all you need to do to get started is set aside some time and get organized—the benefits will make the effort worthwhile. The following steps will help you set up your budget and manage your finances by helping you track your income and expenses.

Determine a Time Span for Your Budget
Choose a Tool to Help You Manage Your Budget
Review Your Monthly Income
Identify and Categorize Your Expenses
Save for Emergencies
Balance Your Budget
Maintain and Update Your Budget

Determine a Time Span for Your Budget

You can create your budget for a month, *academic year*, or calendar year. If you are currently attending college or career school, you may want to consider creating a monthly budget for an academic term, such as your fall semester. Keep in mind that your income may vary from month to month, and not all of your expenses will be the same each month. Larger expenses (such as car insurance and books) and seasonal expenses (such as a trip home at the holidays or a higher electricity bill in summer when the air conditioning is on) need to be incorporated into your budget.

Choose a Tool to Help You Manage Your Budget

To create a budget, you'll want to use a tool for tracking your income and expenses. You can use pen and paper, a simple automated spreadsheet, or a budgeting app. Many banks offer budgeting tools, so see what works best for you.

The Financial Awareness Counseling Tool (FACT) is a free interactive tool that can help you manage your finances. FACT covers topics ranging from managing your budget to avoiding *default*. Plus, you can access your loan information and receive personalized feedback to help you better understand your financial obligations.

Review Your Monthly Income

First, estimate how much money you will have coming in each month. Here are some tips for assessing your income:

- Your income may come from sources such as your pay from work, financial contributions from family members, or financial aid (scholarships, grants, *work-study*, and loans).
- If you're working while in school, review your records to determine how much your take-home pay is each month. If you earn most of your money over the summer, you may want to estimate your yearly income then divide it by 12.
- Include income from any financial aid credit balance refunds—money that may be left over for other expenses after your financial aid is applied toward tuition and fees.

Monthly Income Tracking Example

Income Source	Monthly Income
Income from work	$1,200
Tax refund ($360 total divided by 12)	$30
Estimated financial aid credit balance refund ($2,100 total divided by 12)*	$175
Monthly support from parents and/or family member	$250
Other income	
Total Monthly Income	**$1,655**

*Note: If you are getting ready to attend school, you'll want to estimate your federal aid credit balance by taking your estimated financial aid and subtracting your expected tuition and fees. If you have not yet received an aid offer from your school, you can use *FAFSA4caster* to get an early estimate of your eligibility for *federal student aid*.

Identify and Categorize Your Expenses

To estimate your monthly expenses, you'll want to start by recording everything you spend money on in a month. This may be a bit time-consuming but will definitely be worthwhile in helping you understand where your money is going and how to better manage it. After that, gather your bank records and credit card statements that will show you other expenditures that may be automatically paid.

If you are currently attending college or career school or getting ready to go, you'll also need to estimate your college costs. In addition to tuition and fees (unless covered by financial aid), you'll want to make sure to include books and supplies, equipment and room materials, and travel expenses. Find details on what's included in the cost of college and tips on how to reduce college costs.

If you are still researching your school options, keep in mind that college and career school costs can vary significantly from school to school. We have resources to help you estimate and compare school costs.

Once you've identified your expenses, you should group them into two categories—fixed expenses and variable expenses.

- Fixed expenses stay about the same each month and include items such as rent or mortgage payments, car payments, and insurance. These obligations are generally nonnegotiable until you realize that you are spending too much money on rent and take steps to find a cheaper place! When creating a monthly budget, divide the amount due by the number of months the bill covers. For example, take your yearly $1,200 insurance bill that's paid in two $600 installments six months apart, and divide it by 12 to know you need to set aside $100 per month.
- Variable expenses are those that are flexible or controllable and can vary from month to month. Examples of variable expenses include groceries, clothing, eating out, and entertainment. You'll want to examine these expenses to make sure they stay under control and don't bust your budget at the end of the month.

Monthly Expenses Tracking Example

Fixed Expenses	**Projected Cost**
Rent or dorm fee	$500
Books	$70
Electricity	$35
Gas and water	$22
Cable and Internet	$50
Car insurance ($600 divided by 12 months)	$50
Parking fee ($84 divided by 12)	$7
Car maintenance and repairs ($480 divided by 12 months)	$40
Cell phone (basic charges)	$60
Car loan payment	$125
Money set aside for savings	$50
Total Fixed Expenses	**$1,009**

Fixed Expenses	Projected Cost
Variable Expenses	**Projected Cost**
Groceries	$250
Dining out	$50
Entertainment (example: concerts)	$50
Music downloads	$20
Movies (theater and downloads)	$48
Medical (including prescriptions)	$40
Hair and nails	$40
Clothing	$50
Laundry and dry cleaning	$10
Health club	$40
Credit card monthly payment	$25
Public transportation	$25
Gas for car	$60
Total Variable Expenses	**$708**
Total Expenses	**$1,717**

Save for Emergencies

Include “Savings” as a fixed expense in your monthly budget. Pay yourself first every month! Your savings can be used as an emergency fund to help you deal with unexpected expenses. The ideal amount of an emergency fund typically covers three to six months of your expenses.

Balance Your Budget

Now that you’ve identified your sources of income and expenses, you’ll want to compare the two to balance your budget. To do so, you simply subtract your expenses from your income.

Total Monthly Income	$1,655
Minus Total Expenses	$1,717
= + / – Difference	($62)

If you have a positive balance, then your income is greater than your expenses. In other words, you’re earning more money than you’re spending. If you have a positive balance, you shouldn’t start looking at new ways to spend your money. Instead, focus on putting the extra money toward your savings to cover your emergency fund or to support future goals such as buying a car. Also, if you have a positive balance but you’ve borrowed student loan funds, pay back some of your loans and consider borrowing less in the future.

If you have a negative balance, then you are spending more money than you have. You’ll want to balance your budget and make sure your expenses don’t exceed your income. Balancing your budget may include monitoring your variable expenses, reducing your expenses, and/or finding ways to increase your income. Spending less can be a lot easier than earning more. Consider eating out less frequently and making your own lunch. Rent books rather than buying them, or buy books to download to your computer.

Use a shopping list when grocery shopping, and buy only what you need. Ask yourself before buying anything, “Do I really need this?”

Get budgeting tips to keep in mind as you create and maintain your budget.

Maintain and Update Your Budget

Now that you’ve created your budget, you’ll want to make sure it remains a living document and you update it over time. Here are some smart practices to keep in mind:

- **Review your budget on a monthly basis.** Regular review and maintenance of your budget will keep you on top of things and may help you avoid being blindsided by something unexpected.
- **Forgive yourself for small spending mistakes and get back on track.** Most people overspend because they buy things on impulse. The next time you’re tempted to make an impulse buy, ask yourself the following questions:
  - What do I need this for?
  - Can I afford this item?
  - If I buy this item now, will I still be happy that I bought it a month from now?
  - Do I need to save this money for a financial goal?
  - Will this item go on sale? Should I wait to buy it?
  - Does it matter if I buy brand-name or can I get by with generic?

If you take a moment to think about what you’re buying, you’re more likely to make a choice that fits your budgeting goals.

Quick Links

- Budgeting
- Budgeting Tips

Glossary

Budget

A financial plan that helps you track your money, make informed spending decisions, and plan for your financial goals.

Academic Year

This is the amount of the academic work you must complete each year, and the time period in which you are expected to complete it, as defined by your school. For example, your school’s academic y…

Default

Failure to repay a loan according to the terms agreed to in the promissory note. For most federal student loans, you will default if you have not made a payment in more than 270 days. You may …

Work-Study

A federal student aid program that provides part-time employment while you are enrolled in school to help pay your education expenses.

Federal Student Aid

Financial aid from the federal government to help you pay for education expenses at an eligible college or career school. Grants, loans and work-study are types of federal student aid. You must com…

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5.7.1.3: Understanding College Costs

The cost of college can include a variety of items including some you might not expect. By understanding college costs, you can compare schools and explore options for how to lower your costs.

What is included in the cost of college?
How can I lower the cost of college?
How can I compare the costs of colleges?

What is included in the cost of college?

College costs include more than tuition and *room and board*. Here are common costs:

Item	Description
Tuition	The cost of taking courses. Course costs vary by school.
Room and board	Lodging and food costs vary by school.
Books and school supplies	Books can be expensive. School supplies include • book bags; • notebooks; • pens and pencils; • paper and computer paper; and • desk accessories such as folders, trays, and pen holders.
Fees	Fees depend upon your school. Examples include activity fees and parking decal fees. Schools can provide a list of fees.
Equipment and room materials	This category might include • a computer and printer; • reading lamps; • a microwave and refrigerator; and • sheets, towels, etc.
Travel and miscellaneous expenses	• If you commute to school, include transportation costs. • If you live on campus, include travel during school breaks. • You may also want to include clothing and mobile phone costs.

Make sure colleges and career schools give you a clear statement of their tuition and fees.

How can I lower the cost of college?

Here are some suggestions on how you might be able to lower the cost of college. For many of these suggestions, you'll want to follow up with the colleges or career schools you are interested in to get additional details.

- Set a *budget* and stick to it! Having a budget will help you compare anticipated college or career school expenses against your potential available income and financial aid. You also can use a budget to compare costs between different schools. Learn about budgeting.
- College or career school costs can vary significantly and there are many schools with affordable tuition and generous financial assistance. Make sure to research all schools that may meet your academic and financial needs. To find colleges or career schools, use our college search tool, *College Navigator*.

- You may be able to get school credit based on your knowledge or life experiences, and you can manage your course work to reduce costs.
  - Ask your school whether it's possible to "test out of" any classes. If you don't take a class, you may not have to pay for the credits.
  - Some colleges give credit for life experiences, thereby reducing the number of credits needed for graduation.
  - Most schools charge a set price for a specific number of credits taken in a semester. If academically possible, take the maximum number of credits allowed. This strategy reduces the amount of time needed to graduate.
  - Some schools offer combined degree programs or three-year programs that allow you to take all of the courses needed for graduation in three years, instead of four, thereby eliminating one year's educational expenses.
- Colleges and career schools may offer discounts on tuition if
  - you are a child of an alumnus or alumna (i.e., if your parent went to the school);
  - more than one family member is enrolled at the school;
  - you are a student government leader or the editor of the college newspaper or yearbook;
  - you are an older student;
  - your family's main wage earner is unemployed; or
  - you or a member of your family works at the school.
- Housing costs can add up. Here are some tips for reducing your housing costs:
  - If you go to a college or career school near home, consider living with your parents or other family.
  - If you live off-campus, consider sharing a house or apartment with multiple housemates to cut down the cost of rent, and carpool to save on gas and parking.
  - Most colleges and universities sponsor resident advisor programs that offer reduced tuition or reduced room and board costs if you work in a residence hall.
- You may be eligible for health care benefits including the following:
  - Most young adults can stay on their parents' family plan until they turn 26, even if they are married or still living with their parents.
  - If you have been uninsured because of a pre-existing condition, you may be eligible to join the Pre-Existing Condition Insurance Plan.
  - If you are in a new insurance plan, insurance companies cannot charge you a deductible or copays for recommended or preventive services such as flu shots or other immunizations.
- You can work part-time to pay part of your costs. Be sure your work and school schedules don't conflict and that you have enough time for studying. Here are a couple of options:
  - The Federal Work-Study Program provides an opportunity to earn money while going to school. Ask schools if they participate in the program.
  - Cooperative education programs allow students to alternate between working full-time and studying full-time.
  - Most schools have placement offices that help students find employment and personnel offices that hire students to work on campus.
- Taking small steps can add up. For example, you can lower the cost of textbooks if you buy used books or rent textbooks (if you won't need the books once you finish the class).

A credit card can help you build a credit history, if you use it wisely. But use it for emergencies only and don't spend more than you can afford to pay. If you decide to get a credit card, make sure you understand the terms.

How can I compare the costs of colleges?

You can find information about whether the cost of a college is low, medium, or high by using the *College Scorecard*. Keep in mind that a higher-priced school might have more financial aid available to help you pay for your education, so take a look at the school's net price if you want an idea of how much it might cost you after financial aid is taken into account.

Quick Links

- Applying to Schools
- Taking Required Tests
- Types of Aid
- Things to Consider
-

Glossary

Room and Board

An allowance for the cost of housing and food while attending college or career school.

Budget

A financial plan that helps you track your money, make informed spending decisions, and plan for your financial goals.

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5.7.1.4: Saving and Investing

Find popular topics about saving and investing.

What's on This Page

- Manage Finances and Save Money
- Steps to Make a Budget
- Saving for Retirement
- Savings Bonds
- Treasury Securities
- Trusts
- Things to Consider Before You Invest
- Tools to Research Investments
- Choose a Financial Professional
- Pyramid Schemes

Manage Finances and Save Money

To help you manage your money and reach your saving goals:

Create a Budget

A budget is your plan for how you will spend money over a set period of time. It shows how much money you make and how you spend your money. Creating a budget can help you:

- Pay your bills on time.
- Save for unplanned expenses in the future.
- Prepare for retirement.

Download a budget spreadsheet that you can use to create your own to manage your monthly income and expenses.

Consider Ways to Save

Saving money involves looking for deals and buying the quality items you need at the best price. You can save money by comparison shopping, comparing the prices and quality of products you plan to buy. MyMoney.gov offers ways to manage your spending and build your savings accounts to achieve your saving goals.

Invest in Long Term Goals

Investing is a way to make money grow, by buying shares of stocks, mutual funds, bonds, or real estate. When you invest, there is risk that you could lose the money you invest; in general the greater the earnings you can make, the greater the risk. You can save for long term goals, such as retirement (PDF, Download Adobe Reader) and college education, by investing. Learn how to savefor emergencies, short term and long term goals, and become an informed investor.

Steps to Make a Budget

See this video to learn how to make a budget and plan your finances.

A link to an interactive elements can be found at the bottom of this page.

Show the Video Transcript

Saving for Retirement

As you approach retirement, there are many things to think about. Experts advise that you will need about 80 percent of your pre-retirement income to continue your current quality of life. The exact amount depends on your individual needs. Some important factors to consider include:

- At what age do you plan to retire?

- Can you participate in an employer's retirement savings plan, such as a 401(k) plan, or a traditional pension plan?
- Will your spouse or partner retire when you do?
- Where do you plan to live when you retire? Will you downsize, rent, or own your home?
- Do you expect to work part-time?
- Will you have the same medical insurance you had while working? Will your coverage change?
- Do you want to travel or pursue a new hobby that might be costly?

Resources to Help You Prepare for Retirement

To help you plan for retirement:

- Find practical tips for building retirement savings in the Top 10 Ways to Prepare for Retirement(PDF, Download Adobe Reader).
- Use a retirement calculator to find out the best age to claim your Social Security benefits.
- myRA can help you start saving for retirement when you don't have access to an employer-sponsored plan or lack other options to save.
- Find out the trade-offs between taking your pension in a monthly payment or in a lump sum(PDF, Download Adobe Reader).
- Social Security pays benefits that are on average equal to about 40 percent of your pre-retirement earnings. You may be able to estimate your benefits.
- Learn how you can boost your retirement savings at Investor.gov.
- If you have a financial advisor, talk to him or her about your plans.

Savings Bonds

U.S. savings bonds are one of the safest types of investments because they are endorsed by the federal government and, therefore, are virtually risk free.

Visit TreasuryDirect, a website from the U.S. Department of the Treasury, to learn about savings bonds, treasury bonds, and securities: how to buy and redeem your investments, what to do in the event of the death of an owner, and much more. TreasuryDirect is your one-stop shopping site for government securities where you can find information about the wide range of savings options, including EE/E, HH/H, and I savings bonds.

Manage and determine the value of savings bonds using these tools:

- Savings Bond Calculator
- Savings Bond Wizard
- Redemption Tables

You can give savings bonds for many occasions, such as birthdays, weddings, and graduations. Learn how to give savings bonds as gifts.

Treasury Securities

Treasury securities are debts issued by the federal government's Bureau of Fiscal Service. When you buy a treasury security, you are lending money to the federal government for a set amount of time. In return the government promises to pay you back the entire amount, also known as the face value, when the security matures.

There are several types of treasury securities:

- Treasury Bills—Short term securities that mature between a few days and 52 weeks.
- Treasury Notes—Medium term securities that mature between one and 10 years.
- Treasury Bonds—Long term securities, with a 30 year term that pays interest every six months, until the bond matures.
- Treasury Inflation-Protected Securities (TIPS)—Securities with principle values that adjust based on inflation, but with fixed interest rates for five, 10, or 30 year maturities.
- Savings Bonds—Securities that offer a fixed interest rate over a fixed period of time.
- Floating Rate Notes (FRNs)—Securities with variable interest rates, so that as bank interest rates increase or decrease, the interest rates on the FRNs change in the same direction.

You can purchase treasury securities for yourself or as gifts. You can purchase them in several ways:

- Banks, brokers, and other financial institutions through the Commercial Book-Entry System.
- Online through Treasury Direct
- Payroll savings plans
- Public auctions

Trusts

A trust (or trust fund) is a legal entity that allows a person (the grantor, donor, or settlor) to transfer assets to another person or organization (the trustee). Once the grantor establishes the trust, the trustee controls and manages the assets for the grantor or for another beneficiary—someone who will ultimately benefit from the trust. To help you decide if a trust is right for you, first consult a licensed attorney experienced with estate planning and trust matters.

Reasons to Set Up a Trust

Some common reasons for setting up a trust include:

- Providing for minor children or family members who are inexperienced or unable to handle financial matters
- Arranging for management of personal assets, if you become unable to handle them yourself
- Avoiding probate and immediately transferring assets to beneficiaries upon death
- Reducing estate taxes and providing liquid assets to help pay for them
- The terms of a will are public while the terms of a trust are not, so privacy makes a trust an appealing option.

Types of Trusts

Trusts can be living (inter vivos) or after-death (testamentary). A living trust is one that a grantor sets up while still alive and an after-death trust is usually established by a will after one's death. Living trusts can be irrevocable (can't be changed) or revocable (can be changed), although revocable trusts don't get the same tax shelter benefits as irrevocable ones do.

The most common type of trust is the revocable living trust. If there's a specific purpose in mind for the trust, dozens of different options exist (charitable trusts, bypass trusts, spendthrift trusts, and life insurance trusts). Two types of trusts can help pay for long-term care services:

- **Charitable Remainder Trusts** – This trust allows you to use your own assets to pay for long-term care services while contributing to a charity of your choice and reducing your tax burden at the same time. You can set up the trust so that you receive payments from the trust to pay for long-term care services while you are alive.
- **Medicaid Disability Trusts** – These trusts are limited to persons with disabilities who are under age 65 and qualify for public benefits. Parents, grandparents, and legal guardians often set up these trusts to benefit people with disabilities and a non-profit organization manages the assets. This is the only kind of trust that is exempt from rules regarding trusts and Medicaid eligibility.

Trust Scams and Fraud

If someone approaches you to set up a trust, be careful. Before signing any papers to create a living trust, will, or other kind of trust, make sure to explore all options and shop around to compare services. Some other tips to avoid trust scams and fraud include:

- Avoid high-pressure sales tactics and high-speed sales pitches.
- Stay away from salespeople who give the impression that specific organizations and recognized brands back or sell the trust.
- Research and get information about local probate laws from the Clerk or Register of Wills.
- If someone tries to sell a living trust to you, ask if they are an attorney. Some states restrict the sale of living trusts to licensed attorneys.
- If you buy a trust in your home or in another location that is not the seller's permanent place of business, remember you have the right to take advantage of the Cooling Off Rule and cancel the transaction within three business days.

Things to Consider Before You Invest

Do you have a financial goal in mind, such as saving for retirement, paying for college, or buying a new house? If so, then you may decide to invest your money to earn enough to fund your goals. Before you invest, make sure you have answers to all of these questions:

- **How quickly can you get your money back?** Stocks, bonds, and shares in mutual funds usually can be sold at any time, but there is no guarantee that you will get back all the money you invested. Other investments, such as limited partnerships, certificates of deposit (CDs), or IRAs, often restrict your ability to cash out your holdings.
- **What can you expect to earn on your money?** While bonds generally promise a fixed return, earnings on most other securities go up and down with market changes. Keep in mind, just because an investment has done well in the past, there is no guarantee it will do well in the future.
- **What type of earnings can you expect?** Will you get income in the form of interest, dividends, or rent? Some investments, such as stocks and real estate, have the potential for earnings and growth in value. What is the potential for earnings over time?
- **How much risk is involved?** With any investment, there is always the risk that you will not get your money back or the earnings promised. There is usually a trade-off between risk and reward–the higher the potential return, the greater the risk. While the U.S. government backs U.S. Treasury securities, it does not protect against loss on any other investments.
- **Are your investments diversified?** Some investments perform better than others in certain situations. For example, when interest rates go up, bond prices tend to go down. One industry may struggle while another prospers. Putting your money in a variety of investment options can reduce your risk.
- **Are there any tax advantages to a particular investment?** U.S. savings bonds are exempt from state and local taxes. Municipal bonds are exempt from federal income tax and, sometimes, state income tax as well. Tax-deferred investments for special goals, such as paying for college and retirement, are available that let you postpone or even avoid paying income taxes.

More Information on Investing

To learn more about investing, refer to these resources:

- You can find useful tips on investing at Investor.gov, a website from the Securities and Exchange Commission (SEC).
- For all of your investment-related questions, contact the SEC's Office of Investor Education and Advocacy.
- To get help preparing to invest, consult the Financial Industry Regulatory Authority (FINRA).

Tools to Research Investments

To help you make informed decisions when investing and avoid investment fraud, there are a variety of research tools available:

- Find investor news and alerts and a guide to investment products at Investor.gov, a website from the Securities and Exchange Commission (SEC).
- The SEC requires public companies to disclose financial and other information to help you make sound decisions. You can view the text of these files on EDGAR.
- The Financial Industry Regulatory Authority (FINRA) has up-to-date market data and information for a wide range of stocks, bonds, mutual funds, and other securities.
- If you are considering investing in collectible coins, refer to the U.S. Mint. Before you purchase coins or coin-related products, research the seller with a government agency, such as your state consumer protection office or the Federal Trade Commission (FTC).

Choose a Financial Professional

A financial professional can have multiple titles and be authorized to provide various services, including investment, financial planning, and insurance products. When researching a financial professional, find out what the titles and licenses mean, as well as the educational, work experience, and ethical requirements. Keep in mind that a professional title is not the same as a license. The Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and state regulators do not grant or endorse any professional titles.

When choosing a broker or investment adviser, research the person's education and professional history as well as the firm the person works for. Make sure you have answers to all of these questions:

- For more information on choosing a financial professional, refer to these resources:
  -

Pyramid Schemes

A pyramid scheme, also known as Ponzi scheme, is an illegal form of multilevel marketing. In these scams, your ability to earn profits is based on the number of new participants you recruit, instead of the amount of products or services you sell. Sometimes there actually aren't any real products that are being sold. These types of schemes are common with investment and independent direct selling opportunities.

These schemes rely on the income from new participants in order to pay fake "profits" to people that have been part of the scheme for longer amounts of time. However, the scheme falls apart when there aren't enough new recruits to pay into the system, so the earlier participants no longer receive earnings.

Tips to Avoid Being a Victim

Take steps to protect yourself from being a victim of a pyramid scheme:

- Be wary of "opportunities" to invest your money in franchises or investments that require you to bring in more investors to increase your profit, or recoup your initial investment.
- Be wary if the company sells non-tangible products or technical services, rather than physical items.
- Independently verify the legitimacy of any franchise or investment with the Better Business Bureau, your state Attorney General, or any licensing agencies.
- Be skeptical of success stories and testimonials of fantastic earnings.

File a Complaint

If you are aware of a pyramid scheme or have been the victim of one, file a complaint with your state consumer protection office, state Attorney General, or the Better Business Bureau (BBB). If the pyramid scheme involved securities, you should also file a complaint with your state's securities administrator, or the Securities and Exchange Commission.

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5.7.2: Budgets and Saving

Savings Among Americans

Personal and household savings are important, both for you and for the economy. For you, savings creates a buffer for unexpected expenses and can also be used to finance a down payment on a house or to help pay for college. You can deposit your savings in a financial institution or buy a mutual fund that invests in the stock and bond markets. In other words, your savings becomes an investment; that is, it is money that you put into a financial institution or instrument for which you receive a return in the form of interest or dividends.

$$\text{Savings} = \text{Investment}$$

For the economy as a whole, these savings create economic growth. Firms borrow money (your deposits) from financial institutions or sell shares to your mutual funds and then use that money to expand their businesses. Before we go further, though, we should break down some of these terms. First of all, it's important to understand that personal savings is equal to income minus personal outlays (or consumption) and taxes:

Personal Savings =
Gross Personal Income - Government Taxes - Consumption

Then, the Personal Savings Ratefor any economy is defined as this ratio:

$$\text{Personal Savings Rate} = \frac{\text{Personal Savings}}{\text{Income}}$$

Disposable personal income(DPI), mentioned above, is your take home pay:

$$\text{Personal Savings Rate} = \frac{\text{Personal Savings}}{\text{Income}}$$

From another perspective, savings can be viewed as the portion of personal income that is used either to provide funds to capital markets or to invest in real assets such as residences.

What happened to the U.S. savings rate in the recent Pandemic Recession is quite unusual, to say the least. As you look at the graph below, you will see that from 2000 to 2020, the Personal Savings Rate averaged about 5% to 7% of Disposable Income. However, as the Pandemic Recession began (in February 2020) the Personal Savings Rate skyrocketed.

- In February 2020, the U.S. Personal Savings Rate was 8.3%.
- In March 2020, the U.S. Personal Savings Rate was 12.8%.
- In April 2020, the U.S. Personal Savings Rate was 33.5%.
- In May 2020, the U.S. Personal Savings Rate was 22.4%.
- In June 2020, the U.S. Personal Savings Rate was 19.0%.

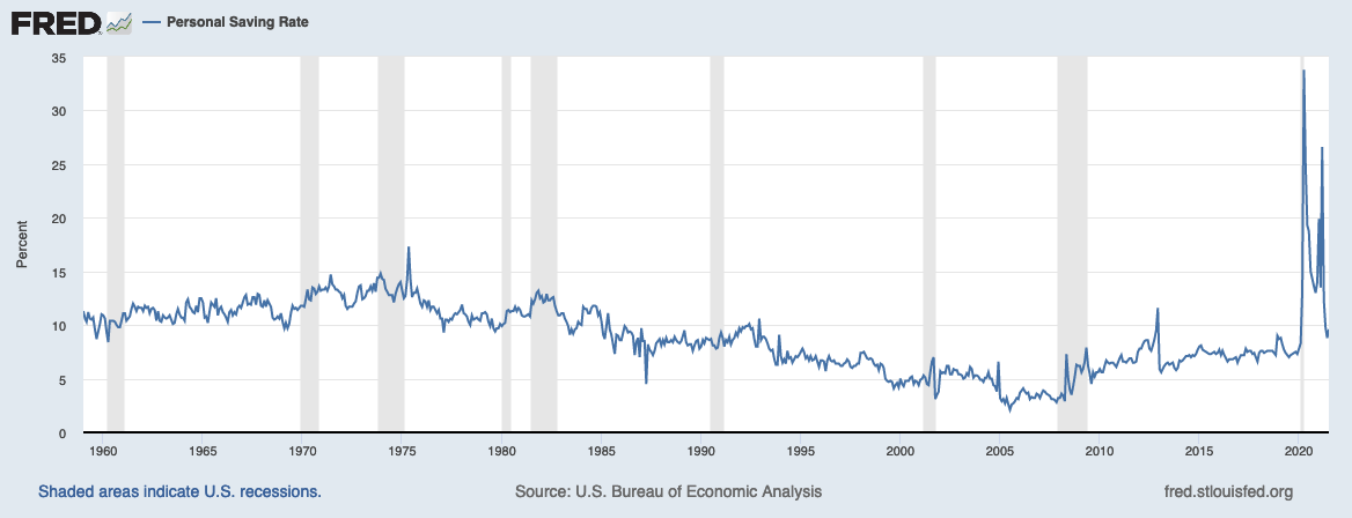


Figure 5.7.2.1: U.S. Bureau of Economic Analysis, Personal Saving Rate [PSAVERT], retrieved from FRED, Federal Reserve Bank of St. Louis; September 30, 2021.

If you look at the gray bars, which indicate recessions, you can see that the Personal Savings Rate does increase somewhat. This is due to consumer sentiment or, as John Maynard Keynes called it, "animal spirits." During a recession, the sentiment is fear. Even so, the magnitude of the Personal Savings Rate during the Pandemic Recession is unprecedented.

As stated before, the absolute amount of personal savings is the difference between income minus taxes and spending. The graph below shows this difference in absolute dollars from 2014 up to June 2020. From April to July 2020, personal income jumped dramatically from the $600 supplemental unemployment compensation and other relief payments provided by the CARES Act. However, because of fear, consumers decreased their spending. On top of this, in many states, restaurants, bars, hotels and all non-essential retail stores were shuttered in April, curtailing consumer spending and further increasing pessimistic sentiment.

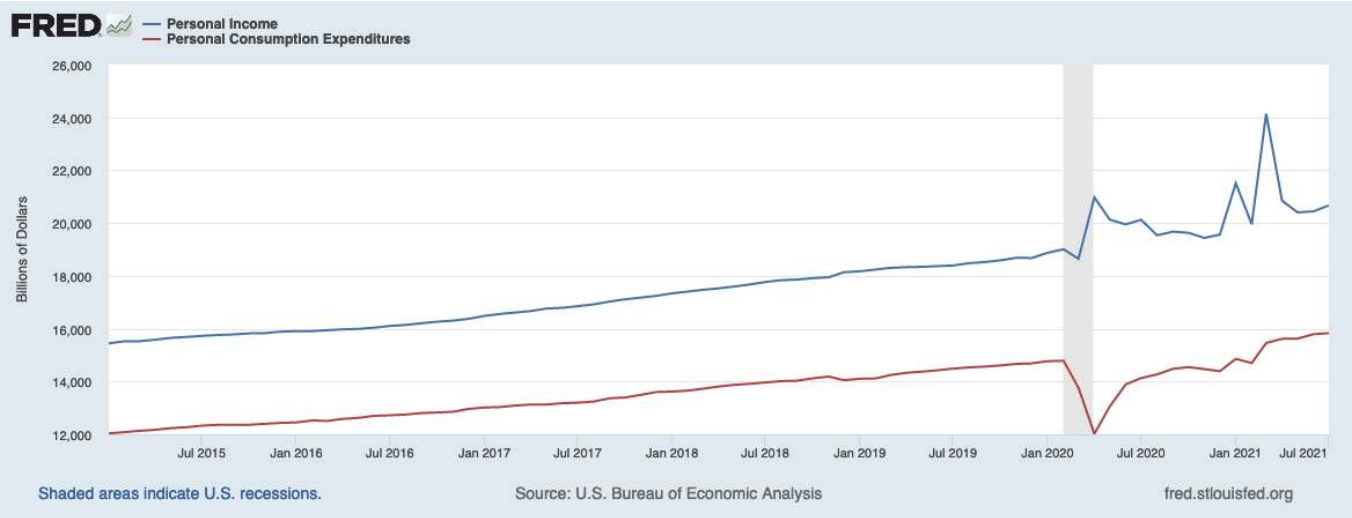


Figure 5.7.2.2: U.S. Bureau of Economic Analysis, Personal Income [PI] and Personal Consumption Expenditures [PCE], retrieved from FRED, Federal Reserve Bank of St. Louis; September 30, 2021.

As this graph shows, even though personal income increased in 2020, spending still decreased, highlighting just how important consumer sentiment is to the economy. If consumers are worried about the economic future, they will put off their expenditures to whatever extent they can. During the Pandemic Recession, restaurants, bars, vacation venues and services took the biggest hit. In comparison, the 2008 Great Recession saw large durable goods expenditures (appliances, automobiles, clothing) decrease by 8%, but spending on restaurants and services stayed relatively the same. According to a recent Gallup Poll, consumer satisfaction in the U.S. has fallen, and this could curtail future spending. However, it's worth noting that consumer satisfaction is currently not as low as it was during The Great Recession.

Table 5.7.2.1. Household Savings Rates as a Percent of Disposable Income (in %)

	2010	2012	2013	2014	2015	2016	2017	2018	2019	2020
Austria	9.1	7.4	9	7.1	10	7.3	6.8	7.8	7.7	7.7
Belgium	10.1	8.8	7.5	4.9	8.3	5.1	4.3	3.9	4.8	5.1
Canada	4.8	3.5	5.2	4.8	3.5	3.6	4.6	3.4	1.4	1.6
Czech Republic	6.8	4.9	6.2	5.6	6.6	6.6	6.8	6.5	6.0	6.7
Denmark	-1	-0.6	-1.2	2.3	-1	-2.9	4.3	4.6	6.6	3.9
Finland	3.3	1.1	0.6	1.3	1.3	-0.4	-0.7	-1.8	-1.2	-0.4
France*	15.9	16.2	14.9	14	14.9	14.2	13.8	13.7	13.8	14.7
Germany	10.9	10.4	9.4	9	9.9	9.5	9.7	9.8	11.0	11.0
Hungary	5.4	5.1	4.8	7.1	5.9	8	6.2	8.1	6.9	6.6
Ireland	7	5.4	5.2	4.9	3.9	3.6	4.2	3.8	5.8	5.8
Italy	5.3	4.3	3.1	3.6	6.3	3.9	3.3	3.2	2.5	4.3
Japan	2.1	2.9	1.3	0.3	2.3	-0.4	0.8	2.6	4.3	4.5
Netherlands	3.4	5	6.5	7.3	6.1	9.9	9.6	10	8.4	7.8
Norway	6.1	7.8	8.3	7.6	5	8.2	10.3	7.3	6.5	6.7
Poland	5.9	3.5	2.6	0	1.5	-0.4	-0.4	1.5	0.3	1.4
Portugal*	10.2	10	9.5	7.8	8.4	5.2	5.3	5	6.5	7.0
Slovakia	5.7	4.8	1.9	0.2	1.1	1.5	3	3	2.6	4.0
Spain	13.1	11	4.4	3.8	3.2	3.5	2.9	1.8	1.5	2.3
Sweden	8.3	10	15.1	15	10.4	16.4	15	16	15.4	17.1
Switzerland	11.3	12.7	17.5	17.5	16	18.9	18.2	18.7	17.3	17.6
United Kingdom*	6.6	6	7.3	8.7	8.5	8.6	9.4	6.7	6.1	6.4
United States	5.1	4.2	7.2	5	5.3	7.4	7.6	6.7	7.7	8.1

Source: Organization for Cooperation and Development (“OECD”) European Federation of Building Societies – Annual Report 2019.

*Estimate

China’s Savings Rate

China’s economy is the second largest in the world. Its economic growth rates have been extremely high, many years climbing into the double digits. It also has high rates of government, corporate, and household savings. In a working paper from the International

Monetary Fund (part of the World Bank), Zhang et al. identify three phases that they contend influenced the savings rate of Chinese households.

1. The first phase was in the 1980s, following the introduction of the one-child policy and de-collectivization of agriculture in rural areas. Beginning in 1976, the one-child policy freed disposable income, and since children traditionally took care of their parents in old age, the one child policy also incentivized older Chinese to save more. The savings rate rose from 5 to 20 percent of disposable income (albeit with a temporary dip in the late 1980s, possibly due to a GDP growth slow down).
2. The second stage was in the 1990s, after Deng's southern tour reaffirmed China's policy to reform and open-door policy. In addition, the massive lay-offs resulting from the state-owned enterprises (SOE) reform in the late 1990s also put downward pressure on wage growth. SOE reform took center stage in this period and was accompanied by the transformation of the social safety net and job security, leading to savings rising to 25 percent of disposable income.
3. The third stage came after China entered the World Trade Organization in 2001. Savings rose to 30 percent of disposable income during an export-driven boom. Notably, since 2012, household savings have plateaued and gradually begun to decline (2018).

China's saving rate was also affected by its conversion from a centrally planned economy to a market economy. This resulted in massive layoffs; 27 million people lost their jobs between 1997 and 2002. Along with these reforms, the social safety net was dismantled, and as a result, Chinese people paid an increasingly larger share of their healthcare costs (from 20% in 1978 to 60% in 2002, although it has declined since then). The layoffs and unexpected health care costs further incentivized the Chinese people to save.

The Chinese economy shows us some of the reasons savings rates can fluctuate from country to country, largely in response to demographic and economic changes. Let's now take an overview of the reasons individuals and households save.

Influences on the Rate of Savings

In general, people save for the following reasons:

- Emergency/ unforeseen expenditures (especially unexpected medical expenses)
- Down payment on a house (although often a 5% down payment is enough)
- Down payment on a car (although less and less is required these days)
- Retirement Income
- Education for yourself or your children

The savings rates as a percentage of disposable income vary from country to country (in some places, quite significantly). The dominant influences on these differing savings rates are explained below:

1. The social safety net varies significantly from country to country. Is there a national healthcare system (e.g. Canada)? Are there generous retirement pension plans (e.g. Finland)?
2. Certain countries have a cultural disposition to savings (e.g., France and Germany). This is likely due to the trauma of World War II.
3. A national tragedy or recent disaster can cause an increase in the savings rate. For example, China was occupied by the Japanese in the 1920's and again in World War II. After World War II, a civil war erupted between Mao Tse Tung and Chang Kai Sheck with Mao winning and turning China Communist in 1948. After the collectivization of all farms, Mao led the Great March, an event that led to the deaths of thirty million people.

Interestingly, Megan McArdle states that some of the reasons people used to save, such as taking a vacation or for holiday gifts are now just put on our credit cards (2018). This means we are buying what we want without having the money for it, which means we have to pay the credit card bill every month. This increases our monthly expenses and conversely decreases our monthly savings.

Global Consequences of a Lack of Savings

Previously, I stated the following:

$$\text{Savings} = \text{Investment}$$

The graph below shows this correlation in the United States from 1970 to 2019. (I did not include 2020 in the graph due to the extraordinary temporary jump in the savings rate during the Pandemic Recession.)

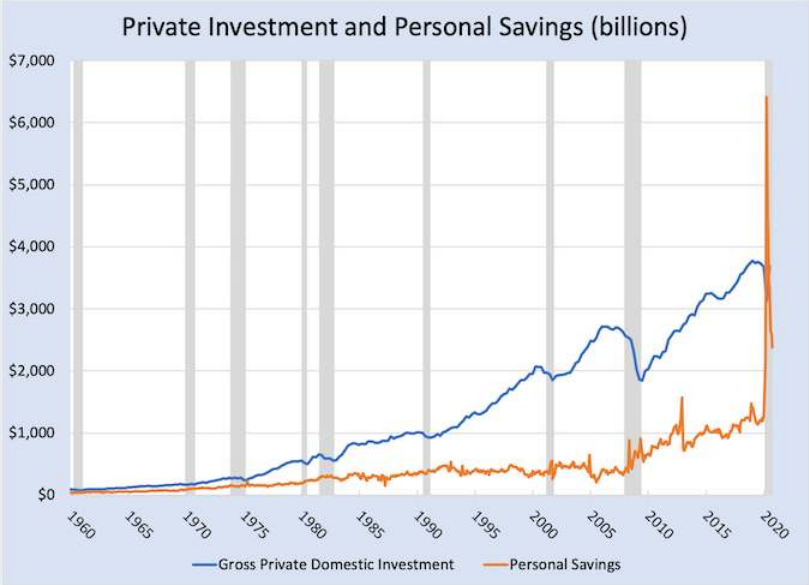


Figure 5.7.2.3: Private Investment and Personal Savings by Fred Rowland is used under a CC BY-NC 4.0 License. Source: Federal Reserve Economic Data (FRED) (12/2020).

This correlation of investment to savings is also true in the rest of the world:

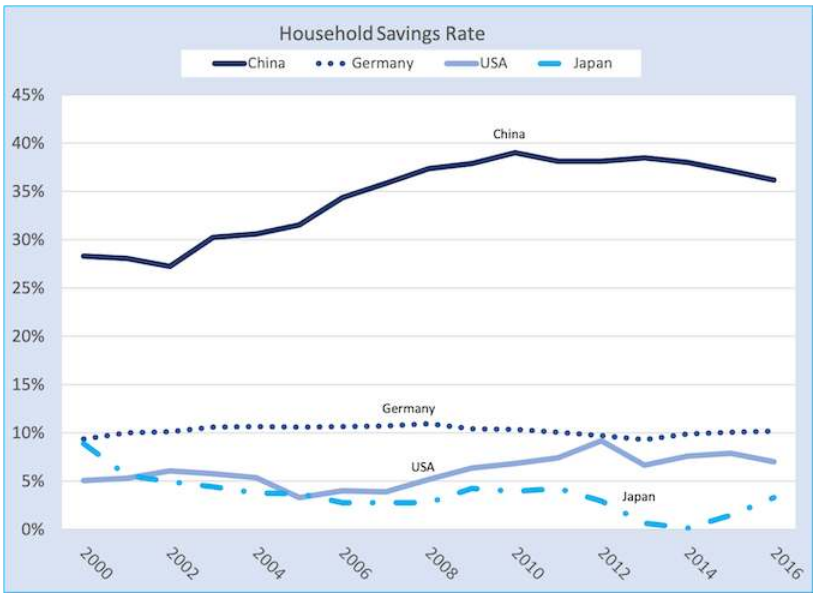


Figure 5.7.2.4: Household Savings Rates as a Percent of Disposable Income (in %) by Fred Rowland is used under a CC BY-NC 4.0 License. Source: OECD iLibrary data (11/24/2020).

From this, we see that one of the things a country can do to stimulate investment (and economic growth) is to encourage higher rates of savings among its citizens. The consequences of low rates of savings can be seen best in Sub-Saharan African countries. Many citizens in these countries are subsistence farmers and have almost no savings. As a result, there is not a large supply of loanable funds, which are essentially deposits in local banks. Since the supply is low, interest rates are high on loans, which curtails investment. Low ratios of capital equipment to labor results in low productivity of workers. Low productivity of workers results in workers being paid low wages. Low wages mean workers have low or non-existent savings. You can see how this is a vicious circle.

How Much You Should Save

You should begin saving now, even if you can only set aside $100.00 per month. Your goal should be to ramp this up to 10% to 15% of your disposable income, but that is impossible when you are just beginning your career. As we saw in the chart from the OECD above, the savings rate in the United States from 2010 to 2019 ranged from a low of 4.2% of disposable income to a high of 8.1% of disposable income. That gives us average savings rates of:

2010 to 2019 (10-year average =6.4 % of disposable income
2015 to 2019 (5-year average =7.5 % of disposable income

However, one of the drawbacks of using the average rates is the increasing income inequality in the U.S. Lower income households have a much lower savings rate as a percentage of disposable income than high income households. Therefore, we should look at savings rates for income quintiles or deciles before we decide on a reasonable expectation for a savings rate.

I have my retirement fund at the nonprofit mutual fund company TIAA. The TIAA website contained an article by personal finance journalist Paula Pant, who has been featured on MSN Money, Bankrate, Marketplace Money, AARP Bulletin, and more. Her website, “Afford Anything,” draws 30,000 visitors each month. Paula recommends saving 10% to 15% of your disposable income. However, she also recommends the 20/50/30 Rule for personal budgets (Pant, 2020):

- 20% of your disposable income goes to savings
- 50% of your disposable income goes to necessities
- 30% of your disposable incomes goes to discretionary expenditures, such as entertainment

The 20/50/30 rule seems like an impossible goal. Perhaps more realistically, Vanguard, one of the largest mutual fund companies in the world, advises the following:

- Save at least enough to get the full match offered by your employer retirement plan, if you have one.
- Work your way up to 12%–15% of your pay, including any employer match.

This goal seems more reasonable, although when you are starting your career, it may be very difficult to save anything. The important thing, however, is to begin the habit of saving something every month. As you see your savings grow, you will appreciate the feeling of security and will want to save even more.

Your Budget

Keep in mind that the purpose of budgeting is to get to savings. You do not need a complicated budget; instead, focus on keeping track of your spending. Then just subtract that from your disposable income to get your cash flow. You can easily track your spending with a simple spreadsheet. For a young person, a budget like the example below is all you should need (until you make your first million, that is).

Table 5.7.2.2. Personal Cash Flow Statement

	Budget	Actual	Budget	Actual
Income	**Month #1**	**Month #1**	**Month #2**	**Month #2**
Disposable (after-tax) income				
Interest on Bank Account				
Dividend payments				
Total Cash Income				
Expenditures				
Rent				
Electricity and Water				
Cable and Internet				
Mobile Phone				
Groceries				
Health Insurance				
Clothing				
Car Payment				
Car Expenses				
Entertainment				
Other Expense (Credit Card)				
Total Expenditures				
Net Cash Flow				

Create a budget like the one above to start keeping track of your spending, then track your spending for the month and enter it in the actual column. Next, create a revised budget for month number two based on your actual experience. If you see that your net cash flow is zero or negative, look at the actual spending for month number one and decide where you can cut back. Entertainment is the easiest place to cut spending.

For a real-world perspective, I asked a student of mine to create the monthly budget below for when he is at college.

Table 5.7.2.3. Personal Cash Flow Statement Example

	Budget	Actual	Budget	Actual
Income		**Month #1**	**Month #2**	**Month #2**
Disposable (after-tax) income	0			
Interest on Bank Account	0			
Dividend payments	0			
Income from Summer Work	1200			
Total Cash Income	1200			
Expenditures				
Rent (loan from last year)	650			
Electricity and Water (loan)	165			
Cable and Internet (loan)	60			
Mobile Phone (parents)	45			
Groceries (loan and personal)	200			
Health Insurance (parents)	500			
Clothing	0			
Car Payment	0			
Car Expenses	0			
Entertainment	75			
Other Expense	50			
Net Cash Flow	0			
Summary of Expenditures				
Total Expenditures	1745			
Parents Expenditures	545			
Loan Expenditures	1075			
Personal Expenditures	125			

Why Budgets Do Not Work (most of the time)

Budgeting is all about savings. Otherwise, you could just spend your paycheck until there is nothing left (and maybe that is exactly what you do), and then what do you do with all the leftover bills? Unfortunately, budgets are much like diets, and neither diets nor budgets work most of the time. Each is complicated, and both take time to add up your calories or expenditures. Neither is any fun at all. Despite all our good intentions, diets and budgets usually go the way of many of our New Year's resolutions; that is, they do not last.

David Bach, co-founder of AE Wealth Management recently told CNBC his key to getting to savings:

> *If you want to save more money and build wealth, you do not necessarily have to create a detailed budget that allocates money for categories like clothes, coffee and bars. Instead,*

> *simply commit to paying yourself first…Whenever you earn money, set aside a portion for your future self (2019).*

In her article "Why a Budget is Like a Diet—Ineffective," Tara Siegal Bernard provides advice from experts (including herself) and concludes that budgeting does not work. Despite this, she still had this to say:

> *But there are plenty of mental tricks and strategies that can make your budgeting more sustainable now. In fact, the best strategy is not to think about it as budgeting at all. Instead, set up broad goals and automate all savings and other priorities where you can (201).*

How to Use Behavioral Economics to Create a Workable Budget

The way to stay committed to your budget is to establish some external controls on yourself. Behavioral economists call these "nudges." The best way to keep on track is to use your accounts at your financial institution to automatically stay on budget. I use the term "financial institution" purposely, because there are certain truths you should know about financial institutions that are not easily evident:

- Commercial banks are not your friends.
- If you have your main checking account at a commercial bank, do not set up automatic bill paying there. You will be stuck! Switch to a credit union first.
- Credit unions are your friends.
- Most online stock trading companies such as Robinhood, TD Ameritrade, E*TRADE, etc. are not your friends.
- Non-profit mutual fund companies, such as Vanguard, and TIAA are your friends.

Almost all stockbrokers and mutual fund companies currently allow you to trade stocks for free—that is, no stockbroker commissions on stock trades. If you want to trade stocks, I recommend Charles Schwab as the best broker to set up an account with.

With these facts in mind, we can now talk about how to use your financial institution to nudge you to stay on budget.

First, keep your checking and savings account at a credit union, not a commercial bank. Commercial banks such as Wells Fargo, Bank of America, JP Morgan/Chase and Citicorp are in business to make a profit. They have to generate enough profit to pay dividends to their shareholders. The upshot of this is that they charge higher interest rates on their loans and pay lower interest rates on their deposits than credit unions.

Commercial banks, savings banks, and credit unions are called financial intermediaries. This means they take money in from depositors (to whom they pay interest) and lend it out to borrowers (who pay the bank interest). In order to cover their overhead (salaries, rent, advertising), financial intermediaries charge higher rates to their borrowers than they pay to their depositors. In addition, commercial banks also borrow money in the short-term money markets (also known as a Commercial Paper Market) at a low rate and lend it out to borrowers at a higher rate.

Since the commercial banks must pay interest to their depositors and interest to the Commercial Paper Market lenders, they are essentially borrowing all their money. Additionally, commercial banks must pay dividends to their owners and stockholders, adding to their expenditures. Thus, commercial banks must do the following:

1. Pay interest to their depositors.
2. Pay interest to their lenders in the short-term Commercial Paper market.
3. Cover their overhead (salaries, buildings utilities, advertising, rent).
4. Pay dividends to their owners and stockholders.

In general, commercial banks add a mark-up on the cost of funds between 3% and 4%. That is, if the bank is paying their depositors 1% on their savings accounts (and 1% on the Commercial Paper they borrow, since all short-term interest rates move in synchronization) this is their average cost of funds. On average, they will then charge 4% on their portfolio of loans.

The difference between what a financial institution charges its borrowers and what it pays its depositors (and lenders) is called the interest rate spread or the net interest margin. Below is the historical data on the interest rate spread at all U.S. Banks.

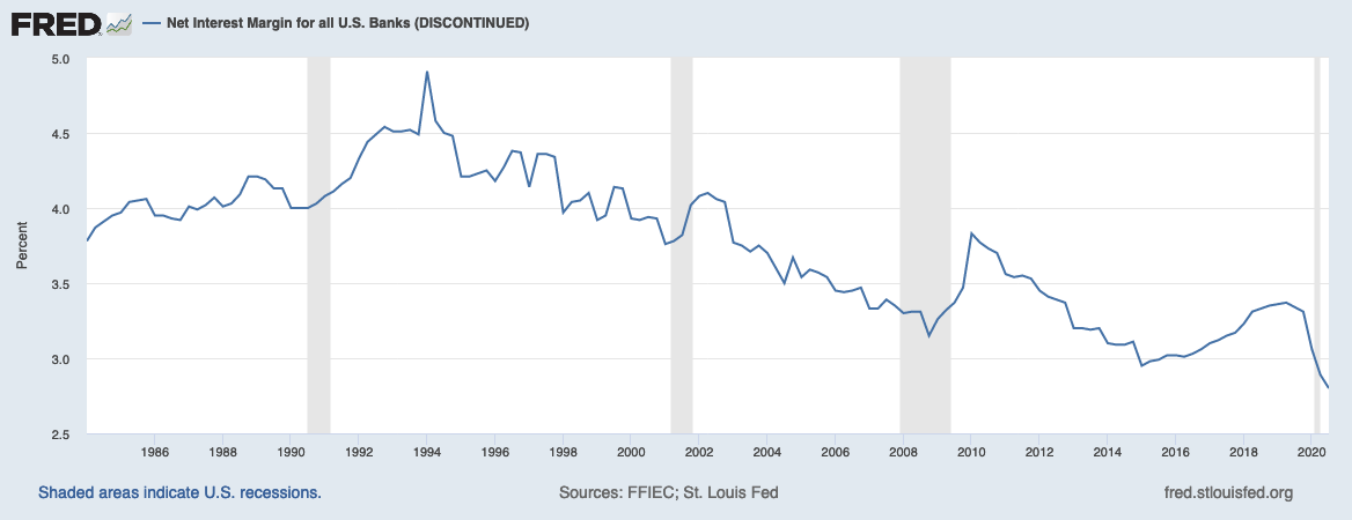


Figure 5.7.2.5: Federal Financial Institutions Examination Council (US) and Federal Reserve Bank of St. Louis, Net Interest Margin for all U.S. Banks (DISCONTINUED) [USNIM], retrieved from FRED, Federal Reserve Bank of St. Louis; September 30, 2021.

If you look closely, you will see two big spikes in the interest rate spreads, in 1994 and 2010. In these two years, the Federal Reserve Bank reduced the Federal Funds Rate dramatically as part of Monetary Policy to help the economy recover following recessions. Since all short-term interest rates (including deposit interest rates and Commercial Paper rates) move in lockstep with the Fed Funds Rate, this effectively reduces the cost of funds to banks, allowing them to make larger profits.

Credit unions, on the other hand, are all non-profit mutual institutions, entirely owned by their depositors. Therefore, these are the only expenses they have to cover:

1. Pay interest to their depositors.
2. Cover their overhead (salaries, buildings utilities, advertising, rent).

This is why credit unions can pay higher interest rates on saving accounts and charge lower interest rates on all their loans. They just need a slightly lower interest rate spread to cover their expenses. A recent average interest rate spread for credit unions was 3.15%.

Unfortunately, the basic business model for all financial intermediaries is inherently unstable. They are all subject to what is known as disintermediation. Disintermediation occurs when depositors demand their money back, but the bank does not have it. This can occur because financial intermediaries borrow short term and lend long term. Banks and credit unions borrow their money from depositors (or Commercial Paper Markets, in the case of commercial banks). and the depositors can demand its return at any time. However, the financial intermediaries have lent the depositors' money out in loans that are paid back over time—auto loans, mortgages, credit card loans, etc.

When depositors demand more of their money back than the bank has on hand, this is known as a run on the bank. During the Great Depression (1929 to 1940) there were several runs on banks, and many banks went bankrupt, while numerous depositors lost their money. As a result, the Federal Deposit Insurance Corporation (FDIC) was created in 1933 by the federal government to insure depositors' money. FDIC currently insures up to $250,000.00 per account in commercial banks against the bank's insolvency. In 1970, in response to the explosive growth of credit union membership, the National Credit Union Share Insurance Fund ("NCUSIF") was created by the federal government to fulfill a parallel function to the FDIC, but for credit unions. The NCUSIF also currently insures up to $250,000.00 per account in credit unions against the credit union's insolvency.

Credit unions were initially set up to benefit employees at the same company, such as the Pentagon Federal Credit Union, the General Motors Employees Credit Union, or the AFL-CIO Credit Union. In the expansion of credit union membership after 1970, many of the credit unions relaxed their membership regulations and now anyone can join almost any credit union. Usually to join a credit union currently, you merely need to deposit a minimum of $5.00 in a savings account. Choose a credit union that has an

office convenient to you (although that may not even be necessary, as you can do all your banking with credit unions electronically).

Credit Union Accounts to Facilitate Budgeting

In order to use your credit union to facilitate your budgeting (and savings), you need to set up the following accounts:

1. Checking Account #1 for expenses.
2. Savings Account connected to your checking account.
3. An overdraft Line of Credit connected to Checking Account #1, so if you overdraw your account, the Line of Credit will automatically deposit money into the Checking Account to cover the overdraft. This will save you a lot of overdraft fees.
4. Checking Account #2 for your monthly entertainment.
5. Arrange for Debit Cards for both checking accounts.

This arrangement is analogous to having different envelopes in your drawer with allocations of your cash for expenses, entertainment and savings, but it accomplishes it electronically. Once these accounts and facilities are set up, take the following actions:

1. Have your paycheck electronically deposited to Checking Account #1.
2. Have a certain savings amount automatically transferred from Checking Account #1 to the associated Savings Account.
3. Have a monthly entertainment amount automatically transferred to Checking Account #2. Use this debit card to pay for your monthly entertainment. When the account is depleted, stop spending and wait for your next paycheck.
4. Use the credit union's electronic bill pay for all of your bills. Between this and your debit card, you will have a full accounting of your expenses at the end of each month. Most credit unions will allow you to categorize each payee and will aggregate the payments for each budget category.

For example, say your monthly disposable income is $3,500. Your budget includes $2,900 on monthly expenses, $500 for entertainment, and $100 for savings. To manage this, you would do the following:

1. Have your paycheck deposited directly into Checking Account #1. Most likely you will be paid on the last day of the month.
2. Set up an automatic bill pay to transfer $500 into your Checking Account #2 and $100 into your Savings Account each payday.
3. Use your debit card for Checking Account #1 or automatic bill pay to cover monthly expenses.
4. Use your debit card for Checking Account #2 to pay monthly entertainment expenses. When this account is empty, stop spending until you put more money in the entertainment account.
5. Do not touch your savings account unless you are ready to make a purchase you were saving for, for example, to put a down payment on a car or some other long-term goal.

As I mentioned before, do not set up automatic bill pay at a commercial bank. Studies have shown that 95% of customers who set up automatic bill pay do not leave their financial institution. The customer views it as too much work to set up all the accounts again at another financial institution. Move to a credit union before you set up automatic bill pay.

Establishing Financial Goals

All animals are goal directed: find food, find a burrow, find a mate. The human animal is no exception. Use these innate tendencies to help your budget. The basic necessities of life (rent or mortgage payment, food, transportation) scream at us to be paid every month, so it does not take much to keep them at the forefront of our mind. Getting to savings is the hard part. To do this, we have to set (and write down) financial goals, utilizing one of the key techniques of behavioral economics: making a commitment. You can write your goals down anywhere, but I recommend you write them at the bottom of your budget, ensuring that you will see them regularly.

The priority for your savings account is to keep a stash of money for unforeseen expenses, like car repairs or medical expenses. Try to save six months of your basic expenses, not including entertainment. Six months of basic expenses helps protect against job layoffs, as in normal economic times, 90% of workers find a new job within six months (though this gets skewed during recessions). The goal is to give yourself a safety net in addition to unemployment compensation, because unemployment compensation varies from state to state and pays an average of a little over $300.00 per week for an average of 26 weeks. Six

months of base expenses is an extremely difficult savings goal at the beginning of your career. However, it is a goal you need to work towards. Having this savings will give you great peace of mind.

A second financial goal is to save for future purchases, such as a new car, a down payment on a house, or even just new furniture for your apartment. For example, a house down payment typically equals 5% of the purchase price. Since the median sales price of houses in the United States in 2020 is $320,000.00, a 5% down payment would be $15,000.00. Do not be discouraged, though; in a lot of cases, banks will accept a 3% down payment on a house, especially for a first-time home buyer.

The third thing to save for are what are typically the three big purchases in your life.

- The down payment on a house
- College tuition for your children
- Your retirement

We discuss buying a house and saving for retirement in upcoming chapters, but as to education, we can look at the 2019-2020 average cost of tuition to gain perspective. Among national colleges and universities, the College Board (2022) reported the following average cost of tuition and fees for the 2021–2022 school year:

In 2021-22, the average published (sticker) tuition and fees for full-time students are:

- Public four-year in-state: $10,740
  - $170 higher than in 2020-21 (+1.6% before adjusting for inflation)
- Public four-year out-of-state: $27,560
  - $410 higher than in 2020-21 (+1.5% before adjusting for inflation)
- Public two-year in-district: $3,800
  - $50 higher than in 2020-21 (+1.3% before adjusting for inflation)
- Private nonprofit four-year: $38,070
  - $800 higher than in 2020-21 (+2.1% before adjusting for inflation)

Add to this anywhere from $5,000 to $10,000 per year for room and board, and a state resident at a four-year public college could pay up to $85,000.

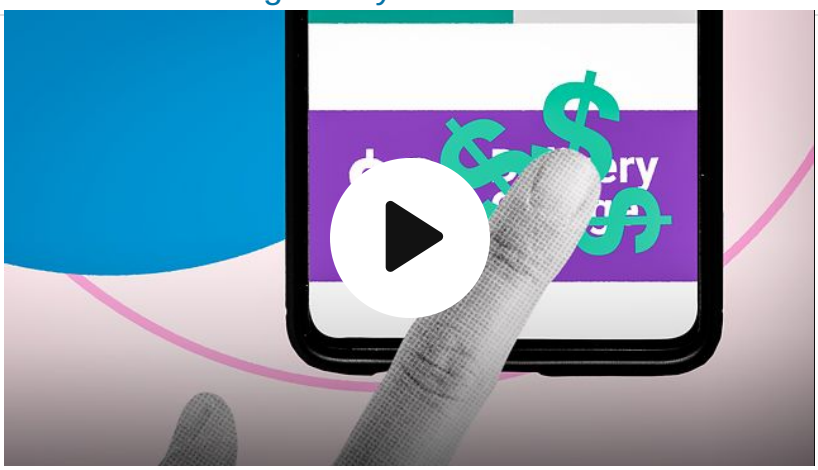
The good news is that with financial aid, very few students pay the full cost of tuition. However, according to the College Board, the average amount borrowed by 2017-2018 bachelor's degree recipients was $29,000 ($26,900 for public colleges and $32,600 for private colleges).

Reviewing Your Budget

In the beginning, review your budget in the middle and at the end of the first month. Reviewing it in the middle of the month gives you some time to correct your behavior; reviewing at the end will help you revise for the next month. Once you feel that you are comfortably running, compiling your actual expenses and revising can be done once per month.

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5.7.3: Video- Can't Stick to a Budget? Try these tweaks Instead



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CHAPTER OVERVIEW

6: Taxes and Tax Planning

This chapter discusses the role of taxation in personal finance and its effects on earnings and on accumulating wealth. The chapter emphasizes the types, purposes, and impacts of taxes; the organization of resources for information; and the areas of controversy that lead to changes in the tax rules.

6.1: Introduction

6.2: Sources of Taxation and Kinds of Taxes

6.3: The U.S. Federal Income Tax Process

6.4: Record Keeping, Preparation, and Filing

6.5: Taxes and Financial Planning

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6.1: Introduction

All developed and most less-developed economies have a tax system that finances their governments, at least in part. The design of that tax system reflects the society's view of the responsibilities of government and its citizens to their government. The U.S. tax code (Internal Revenue Code) is based on the principle that everyone should contribute to their government's finances according to their ability to pay. Changes in how "everyone" is defined and how "ability to pay" is measured have led to changes in tax laws. The system keeps evolving.

In the United States, tax laws are written by Congress, and therefore, through a process of compromise. As views on government financing have changed, tax laws have been amended, refined, enacted, and repealed. The result is a tax code that can seem overly complex, unreasonable, or illogical. However, the system is based on logic and has a purpose. The better you understand the elements of the tax system, the better you will understand how to live with it and use it to your advantage.

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6.2: Sources of Taxation and Kinds of Taxes

Learning Objectives

1. Identify the levels of government that impose taxes.
2. Define the different kinds of incomes, assets, and transactions that may be taxed.
3. Compare and contrast progressive and regressive taxes.

Any government that needs to raise revenue and has the legal authority to do so may tax. Tax jurisdictions reflect government authorities. Federal, state, and municipal governments impose taxes in the United States. Similarly, in many countries, there are national, provincial or state, county, and municipal taxes. Regional economic alliances, such as the European Union, may also impose taxes.

Jurisdictions may overlap. Federal, state, and local governments may all tax income. Reporting income and paying taxes can be complicated for individuals who earn income in more than one state or live in one state and work in another. Governments tax income because it is a way to tax broadly based on the ability to pay. Most adults have an income from some source, even if it is simply a government payment.

Income tax is usually a **progressive tax**: the higher the income or the more to be taxed, the greater the tax rate. The percentage of income that is paid in tax increases as income rises. Those income categories are called **tax brackets** (Table 6.2.1).

Source: Federal Income Tax Rates and Brackets (www.irs.gov/filing/federal-income-tax-rates-and-brackets)

Table 6.2.1 : U.S. Income Tax Brackets in 2023 (Single Filing Status)

If your taxable income was between			Your tax bracket is
$ 0	and	$ 11,000	10%
$ 11,001	and	$ 44,725	12%
$ 44,726	and	$ 95,375	22%
$ 95,376	and	$ 182,100	24%
$ 182,101	and	$ 231,250	32%
$ 231,251	and	$ 578,125	35%
$ 578,126	and	above	37%

Tax is levied on income from many sources:

- Wages (selling labor)
- Interest, dividends, and gains from investment (selling capital)
- Self-employment (operating a business, or selling a good or service)
- Property rental
- Royalties (rental of intellectual property)
- “Other” income, such as alimony, gambling winnings, or prizes

A **sales tax** or **consumption tax** taxes the consumption financed by income. In the United States, sales taxes are imposed by state or local governments; as yet, there is no national sales tax. Sales taxes are more efficient and fair in that consumption reflects income. Income levels determine the ability to consume and, therefore, the level of consumption. Consumption is also hard to hide, making sales tax a good way to collect taxes based on the ability to pay. Consumption taxes typically apply to all consumption, including nondiscretionary items such as food, clothing, and housing. Opponents of the sales tax argue that it is a **regressive tax**. Low-income taxpayers spend a higher percentage of their incomes on nondiscretionary purchases than those with higher incomes. Another example of a regressive tax is Social Security Taxes, also known as the Federal Insurance Contributions Act (FICA).

Excise taxes are taxes on specific consumption items such as alcohol, cigarettes, motor vehicles, fuel, or highway use. In some states, excise taxes are justified by the discretionary nature of the purchases. They may be criticized as exercises in social engineering (i.e., using the tax code to dictate social behaviors). For example, people addicted to nicotine or alcohol tend to purchase cigarettes or liquor even if an excise tax increases their cost; therefore, they are a reliable source of tax revenue.

Property taxes are used more by local governments. State, municipal, provincial, and county taxes are all examples. Taxes are most commonly imposed on real property (land and buildings), but may also apply to personal assets (e.g., vehicles and boats). Property values theoretically reflect wealth (accrued income) and thus the ability to pay taxes. Property values are also a matter of public record (real property is deeded, boats or automobiles are licensed), which allows for more efficient tax collection.

Estate taxes are taxes on the transfer of wealth from the deceased to the living. Estate taxes are usually imposed on the very wealthiest. Because death and the subsequent dispersal of property are legally a matter of public record, estate taxes are generally easy to collect. Estate taxes are controversial because they can be seen as a tax on the very concept of ownership, particularly for incomes that have already been taxed and saved, or stored as wealth and property.

A summary of the kinds of taxes used by the three different jurisdictions is shown in Table 6.2.2 .

Table 6.2.2 : Taxes and Jurisdictions

Type of Tax	National or Federal	Provincial or State	County or Municipal
Income	✓	✓	✓
Sales		✓	✓
Excise	✓	✓	✓
Property		✓	✓

Summary

- Governments at all levels use taxes as a source of financing
- Taxes may be imposed on the following:
  - Incomes from
    - wages
    - interest, dividends, and gains
    - rental of real or intellectual property
  - Consumption of discretionary and nondiscretionary goods and services
  - Wealth from
    - asset ownership
    - asset transfer after death
- Taxes may be
  - progressive, such as the income tax, in which you pay in proportion to your income
  - regressive, such as a sales tax, in which you pay proportionally more taxes the less income you have

Exercises

1. Examine state, federal, and other tax returns you filed last year. Alternatively, estimate based on your present financial situation. On what incomes were you (or would you be) taxed? What tax bracket were you (or would you be) in? How did (or would) your state, federal, and other tax liabilities differ? What other types of taxes did you (or would you) pay and to which government jurisdictions?
2. Match the description to the corresponding tax type. (Write the number of the tax type before its description.)
   - Description:
     1. _____ tax on the use of vehicles, gasoline, alcohol, cigarettes, highways, and the like.

2. _____ tax on the wealth and property of a person upon death.
3. _____ tax on purchases of both discretionary and nondiscretionary items.
4. _____ tax on wages, earned interest, capital gain, and the like.
5. _____ tax on home and land ownership.
6. _____ tax on purchases of discretionary items.
7. _____ tax on items during their production as well as upon consumption.

- Type of Tax:

1. Property tax
2. Consumption tax
3. Value-added or goods and services tax
4. Income tax
5. Excise tax
6. Sales tax
7. Estate tax

3. In your financial planning journal, record all the types of taxes you will be paying next year and to whom. How will you plan to pay these taxes? How will your tax liabilities affect your budget?
4. According to *Investopedia*, Types of Income the IRS Can't Touch (www.investopedia.com/articles/personal-finance/062716/types-income-irs-cant-touch.asp), include veteran benefits, child support, workers' compensation, and so on. Create a list of your income sources that are protected from taxation. Poll classmates about whether they think student income can be taxed. Review this article from Ramsey Solutions about Five Tax Myths (www.ramseysolutions.com/taxes/tax-myths). Is it true that students are often exempt from income taxes?

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6.3: The U.S. Federal Income Tax Process

Learning Objectives

1. Identify the taxes most relevant for personal financial planning.
2. Identify taxable incomes and the schedules used to report them.
3. Calculate deductions, exemptions, and credits.
4. Compare methods of tax payment.

The U.S. government relies on an income tax. Income tax is a crucial factor in personal financial planning, as everyone has some form of income throughout their lifetime. Most states model their tax systems on the federal model or base their tax rates on federally defined income.

Figure 6.3.1 shows an individual tax return, U.S. Form 1040.

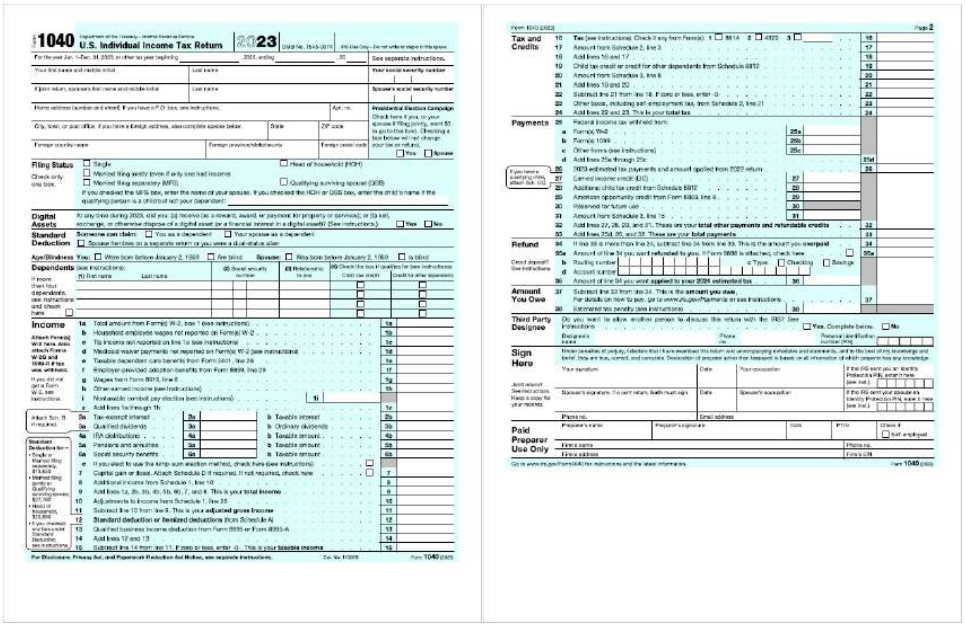


Figure 6.3.1 : U.S. Individual Tax Form 1040, 2023[1]

Taxable Entities

There are four taxable entities in the federal system: individuals or family units, corporations, nonprofit corporations, and trusts. Personal financial planning focuses on your decisions as an individual or family unit, but other tax entities can affect individual income. Corporate profit may be distributed to individuals as a **dividend**, for example. That dividend must be included in the individual's taxable income. Likewise, funds established for a specific purpose may distribute money to an individual that is taxable as individual income. A **trust** is a good example. It is a legal arrangement whereby control over property is transferred to a person or organization (the trustee) for the benefit of someone else (the beneficiary). If you are a beneficiary and received a distribution, that money is taxable as individual income.

The definition of the taxable "individual" is determined by filing status:

- Single, never married, widowed, or divorced
- Married, in which case two adults file as one taxable "individual," combining all taxable activities and incomes, deductions, exemptions, and credits
- Married filing separately, in which case two married adults file as two separate taxable individuals, individually declaring and defining incomes, deductions, exemptions, and credits
- Qualified Surviving Spouse, valid for two years following the year the spouse died, and the surviving spouse has a dependent
- Head-of-household, for a family of one adult with dependent(s)

Some taxes are levied differently depending on filing status, based on the assumption that family structure affects one's ability to pay taxes.

Not everyone who files a return pays taxes. Individuals with low incomes and tax-exempt, nonprofit corporations typically do not. Nevertheless, all potential taxpayers are required to declare their income and demonstrate their obligations to the government. For the individual, that declaration is filed on Form 1040, U.S. Individual Income Tax Return, **OR** a Form 1040-SR, U.S. Tax Return for Seniors.

Income

For individuals, the first step in the process is to calculate total income. Income may come from various sources, and each source of income must be calculated and declared. Some kinds of income have a separate form or schedule to show their more detailed calculations. The following schedules are the most common for reporting incomes separately by source.

Schedule B: Interest and Dividend Income

Interest income is income from selling liquidity. For example, the interest your savings account, certificates of deposit, and bonds earn in a year is income; however, some interest income may not be taxable. When you deposit funds, you are essentially earning interest from lending cash to a bank, a money market mutual fund, a government, or a corporation. Dividend income, on the other hand, is income from investing in the stock market. Dividends are your share of corporate profits as a shareholder, distributed in proportion to the number of shares of corporate stock you own.

Schedule C: Business Income

Business income is income from self-employment, entrepreneurial ventures, or business enterprises. For many sole proprietors and partners in a partnership, business income may be their primary source of income. Other individuals may rely on wages, but have a small business on the side for extra income. Business expenses can be deducted from business income. For example, business use of your car or home is considered a business expense. If expenses exceed income, the business is operating at a loss. Business losses can be deducted from total income, just as business income adds to total income.

The tax laws distinguish between a business and a hobby that earns or loses money. You are considered to have a business for tax purposes if you made a profit in three of the past five years, including the current year, or if you are operating as a registered business and intending to make a profit. If you are operating your own business, you must also pay self-employment tax on business income. In addition, if you are self-employed, you must pay estimated income taxes in quarterly installments based on your expected income.

Schedule SE: Self-Employment Tax

Self-employment tax is an additional tax on income from self-employment or business income earned by a sole proprietor. It represents the employer’s contribution to Social Security, the federal government's mandatory retirement savings program. Both employers and employees are required to contribute to the employee’s Social Security account. When you are both the employee and the employer, as in self-employment, you must contribute both your share and the employer's share of the contribution.

Schedule D: Capital Gains (or Losses)

Gains or losses from investments derive from changes in asset value between the asset’s original cost and its market value at the time of sale. Recurring gains or losses from investments are derived from returns on financial instruments, such as stocks and bonds. One-time gains, such as profits from the sale of a home, are also reported on Schedule D.

The tax code distinguishes between assets held for a short time (one year or less) and assets held for a long time (over a year). Short-term capital gains are taxed at a different rate than long-term capital gains (Table 6.3.2). When you invest in financial assets, such as stocks, bonds, mutual funds, property, or equipment, be sure to keep good records by noting the date when you bought them and the original price. These records establish the **cost basis** of your investments, and you will use that to calculate gains or losses when you sell them.

Source: Topic no. 409: Capital gains and losses (www.irs.gov/taxtopics/tc409)

Table 6.3.2 : Capital Gains Tax Rates

Type of Capital Asset	Holding Period	Tax Rate for Tax Year 2023
Short-term capital gains (STCG)	One year or less	Ordinary income tax at graduated tax rates
Long-term capital gains (LTCG)	More than one year	A Long-term capital gain (LTCG) rate of **0%** applies if your taxable income is less than or equal to • $44,625 for single and married filing separately; • $89,250 for married filing jointly and a qualifying surviving spouse; and • $59,750 for head of household. An LTCG rate of **15%** applies if your taxable income is • more than $44,625 but less than or equal to $492,300 for single; • more than $44,625 but less than or equal to $276,900 for married filing separately; • more than $89,250 but less than or equal to $553,850 for married filing jointly and qualifying surviving spouse; and • more than $59,750 but less than or equal to $523,050 for head of household. An LTCG rate of **20%** applies to the extent that your taxable income exceeds the thresholds set for the **15%** capital gain rate.

Schedule E: Rental and Royalty Income; Income from Partnerships, S Corporations, and Trusts

Rental or royalty income is income earned from renting an asset, such as real property or a creative work, including a book or a song. This can be a primary source of income, although many individuals rely on wages and have some rental or royalty income on the side. Homeownership may be made more affordable, for example, if the second half of a duplex you live in can be rented for extra income. Rental expenses can also be deducted from rental income, possibly creating a net loss from rental activity. Unlike a business, which must become profitable to remain a business for tax purposes, rental activities can generate losses for years. Such losses are a tax advantage, as they reduce total income.

Partnerships and S corporations are alternative business structures for businesses with one or more owners. For example, partnerships and S corporations are commonly used by professional practices, such as accounting firms, law firms, and medical practices, as well as family businesses.

The partnership or S corporation is not a taxable entity; however, the share of its profits distributed to each owner is taxable income for the owner and must be reported on Schedule E.

Schedule F: Farm Income

Farm income refers to the money earned from growing food, raising livestock, or producing related products, such as wool, for sale. Farmers have a special status in the tax code, stemming from the original agricultural basis of the U.S. economy and the strategic importance of food self-sufficiency. Thus, the tax code offers numerous exemptions that are specifically tailored to farmers.

Other Taxable and Nontaxable Income

Other taxable income includes alimony, state or local tax refunds, retirement fund distributions from individual retirement arrangements (IRAs) and/or pensions, unemployment compensation, and a portion of Social Security benefits.

Your total income is then adjusted for items that the government determines should not be taxed under certain circumstances, such as some expenses of educators, performing artists, and military reservists; savings in health savings or retirement accounts; moving expenses; a portion of self-employment taxes; student loan interest; and alimony paid. Income that is not taxed by the U.S. government and does not have to be reported as income includes the following:

- Welfare benefits
- Interest from *most* municipal bonds
- *Most* gifts
- *Most* inheritance and bequests
- Workers compensation
- Veteran's benefits
- Federal tax refunds
- *Some* scholarships and fellowships

However, not everything you might think qualifies as non-taxable does. It is important to read tax filing instructions carefully. The government allows adjustments to be reported (or not reported) as income only under certain circumstances or up to certain income limits, and some adjustments require special forms.

The result of deducting adjustments from your total income is a calculation of your adjusted gross income (AGI). Your AGI is further adjusted by amounts that may be deducted or exempted from your taxable income and by amounts already credited to your tax obligations.

Deductions and Credits

Deductions and exemptions reduce taxable income, while credits reduce the amount of tax owed. Deductions are tax breaks for incurring certain expenditures or living in certain circumstances that the government thinks you should not have to include in your taxable income. There are deductions for age and blindness. For other deductions, you can claim a standard, lump-sum deduction, or you may choose to itemize your deductions. You can detail each deduction separately and then calculate the total. If your itemized deductions are more than your standard deduction, it makes sense to itemize.

Other deductions involve financial choices that the government encourages by offering an extra incentive in the form of a tax break. For example, home mortgage interest is a deduction that encourages home ownership; investment interest is a deduction that encourages investment; and charitable donations are deductions that encourage charitable giving.

Deductions are also created for expenditures that may be considered nondiscretionary, such as medical and dental expenses, or state and local income and property taxes. However, as with income adjustments, you must read the instructions carefully to know what expenditures qualify as deductions. Some deductions only qualify if they exceed a certain percentage of income, while others may be deducted regardless. Some deductions require an additional form to calculate specific details, such as charitable gifts not given in cash, investment interest, and certain types of mortgage interest.

After deductions are subtracted from adjusted gross income, the remainder is your taxable income. Your tax is based on your taxable income, on a progressive scale. You may have additional taxes, such as self-employment tax, and you may be able to apply credits against your taxes, such as the Child Tax Credit or the Earned Income Tax Credit for lower-income taxpayers with children.

Deductions and credits are among the most disputed areas of the tax code. Due to the depth of the dispute, they tend to change more frequently than other areas of the tax code. For example, in 2009, a credit was added to encourage first-time homebuyers to purchase a home, hoping to stimulate the residential real estate market. In 2017, Congress passed the Tax Cuts and Jobs Act, which introduced significant tax law changes, including modifications to the home mortgage deduction, charitable contributions, and a generous deduction known as the Qualified Business Income Deduction. As a taxpayer, you need to be alert to changes that may be to your advantage or disadvantage. Typically, such changes are introduced gradually, allowing you to incorporate them into your financial planning process.

Payments and Refunds

Once you have calculated your tax obligation for the year, you can compare that to any taxes you have paid during the year, and then calculate the amount still owed or the amount to be refunded to you.

You pay taxes during the tax year by having them withheld from your paycheck if you earn income through wages, or by making quarterly estimated tax payments if you have other kinds of income. When you begin employment, you fill out a Form W-4, Employee's Withholding Certificate, to determine the taxes to be withheld from your regular pay. You may adjust this amount, within limits, at any time. If you have both wages and other incomes, but your wage income is your primary source of income, you may be able to increase the taxes withheld from your paychecks. This additional withholding could cover the taxes on your other income and help avoid making estimated payments. However, if your non-wage income is substantial, you will have to make estimated payments to avoid a penalty and/or interest.

The government requires that taxes be withheld or paid quarterly during the tax year because it uses tax revenues to finance its expenditures; it needs a steady and predictable cash flow. Steady payments also decrease the risk of taxes being uncollectible. State and local income taxes must also be paid during the tax year and are similarly withheld from wages or paid on a quarterly basis.

Besides income taxes, other taxes are withheld from your wages: payments for Social Security and Medicare. Social Security, also known as the Federal Insurance Contributions Act (FICA), and Medicare are federal government programs. Social Security is insurance against loss of income due to retirement, disability, or loss of a spouse or parent. Individuals are eligible for benefits based on their contributions (or contributions from a parent or spouse) during their working lives. Medicare finances health care for the elderly. Both programs were designed to provide minimal benefits to those no longer able to sell their labor in exchange for wage income. Under Social Security and Medicare, your contributions pay for benefits that current beneficiaries receive.

If you paid more during the tax year than your actual obligation, you are due a refund of the difference. You may have that amount directly deposited into a bank account, or the government will send you a check.

If you have paid less during the tax year than your actual obligation, you will need to pay the difference (by Direct Debit, check, or credit card) and may incur a penalty and/or interest, depending on the size of your payment.

The deadline for filing income tax returns and paying any necessary amounts is generally April 15th (or the first business day after) following the end of the tax year on December 31st. You may file a request to extend the deadline for six months to October 15th. Should you miss a deadline without filing for an extension, you will owe penalties and interest, even if your actual tax obligation results in a refund. It pays to get your return in on time.

Summary

- The most relevant tax for financial planning is income tax, as it affects taxpayers over their entire lifetime.
- Different types of income must be defined and declared on specific income tax schedules and are subject to taxation.
- Deductions and exemptions reduce taxable income.
- Credits reduce tax obligations.
- Payments are made throughout the tax year through withholding from wages or through quarterly payments.

Exercises

1. Read the IRS document defining tax liability (www.irs.gov/publications/p17#en_US_publink100031858). Do you have to file a tax return for the current year? Why or why not? (Identify all the factors that apply.) Which tax form(s) should you use?
2. Download and study the following schedules or their equivalent for the current year. In what circumstances would you have to file each one? Tentatively fill out any schedules that apply to you for the current year.
   - Schedule A (www.irs.gov/pub/irs-pdf/f1040sa.pdf)
   - Schedule B (www.irs.gov/pub/irs-pdf/f1040sb.pdf)
   - Schedule C (www.irs.gov/pub/irs-pdf/f1040sc.pdf)
   - Schedule D (www.irs.gov/pub/irs-pdf/f1040sd.pdf)
   - Schedule E (www.irs.gov/pub/irs-pdf/f1040se.pdf)

- Schedule F (www.irs.gov/pub/irs-pdf/f1040sf.pdf)

3. Find answers to the following questions about the taxability of scholarships (www.finaid.org/scholarships/taxability/):
    1. Is financial aid for college subject to federal income tax?
    2. Can federal and state education grants be taxed as income?
    3. Are student loans taxable?
    4. When is a scholarship tax-exempt?
    5. Do you have to be in a degree program to qualify for tax exemption?
    6. When can the cost of textbooks be deducted from gross income for tax reporting purposes?
    7. Can the amount of a scholarship used for tuition be deducted?
    8. Can living expenses while on scholarship be deducted?
    9. Is the income and stipend from a teaching fellowship or research assistantship tax-exempt?
    10. Are the tuition, books, and stipends of ROTC students tax-exempt?

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[1] IRS Form IRS Form 1040 2023. www.irs.gov/pub/irs-pdf/f1040.pdf.

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6.4: Record Keeping, Preparation, and Filing

Learning Objectives

1. Identify sources of tax information.
2. Explain the importance of verifiable records and record keeping.
3. Compare sources of tax preparation assistance.
4. Trace the tax review process and its implications.

The Internal Revenue Code (IRC), the federal tax law, is written by the U.S. Congress and enforced by the Internal Revenue Service (IRS), which is a part of the U.S. Department of the Treasury. The IRS is responsible for collecting tax revenues.

To inform the public, the IRS offers over six hundred separate publications covering various aspects of the tax code. More than a thousand forms and accompanying instructions exist to file complete tax information, although most taxpayers typically file only about half a dozen forms each year. Additionally, the IRS offers online support (www.irs.gov) and telephone assistance to address questions and help with tax filing preparation.

By far, the majority of income taxes from wages are collected through withholding. For most taxpayers, wages represent the primary form of income; therefore, most of their tax payments are withheld or paid as wages are earned. Still, everyone has to file to summarize the details of the year's income for the IRS and to calculate the final tax obligation. In 2021, the IRS collected 160,824,340 individual tax returns, representing $2.1 trillion in tax revenue. [1]

Keeping Records

The individual filer must collect and report information on tax forms and schedules. Fortunately, this is not as difficult as the volume of data would suggest. Employers are required to send Form W-2 to each employee at the end of the year, detailing the total wages earned, as well as taxes and contributions withheld. If you have earned other kinds of income, your clients, customers, retirement fund, or other source of income may have to file a Form 1099 to report that income to you and the IRS. The bank or brokerage firm also reports interest and dividend income on Form 1099. The information on the W-2 and Form 1099 is reported to both the IRS and you.

Incomes may be summarized and reported to you, but only you know your expenses. Tracking expenditures, such as charitable gifts and medical expenses, is important if they are allowed as deductions, so data should be collected throughout the tax year. If you do not keep detailed records, you will have to search your banking history to identify deductible expenses for the tax year. Financial software applications can make this task easier; most allow you to flag deductible expenses during your initial setup.

You should also keep receipts of purchases that may be deductible. Credit or debit card statements and bank statements provide convenient backup proof, but save receipts in case the IRS questions the accuracy of your return. The receipts are your primary evidence of expenditures.

Tax Preparation and Filing

After you have collected the necessary information, you fill out the forms. Most taxpayers need to complete only a few schedules and forms to supplement their Form 1040. Most taxpayers have the same kinds of taxable events, incomes, and deductions every year, and generally file the same kinds of schedules and forms.

The IRS offers several electronic filing (e-filing) options (www.irs.gov/filing/individuals/how-to-file#partner), available to filers depending on their specific tax situation, including the IRS Free File Program. You may prefer to consult a professional tax preparer. Professional help is useful if you have a relatively complex tax situation, such as unusual sources of income or expenditures that may be deductible under certain circumstances. Some taxpayers use a tax preparer simply to protect against making a mistake. Filing errors, no matter how innocent, may prove costly to fix. Fees for tax preparers depend on how complex your return is, the number of forms that need to be completed, and the type of professional you consult.

Professional tax preparers may be Enrolled Agents, Certified Public Accountants (CPAs), lawyers, personal financial planners, or tax consultants. You may have an ongoing relationship with your tax preparer, who may also be your accountant or a financial

planner advising you on other decisions. You might also use a tax preparer only to help you prepare and file taxes. Tax preparers may be independent practitioners who work during tax season or employees of a national chain that provides year-round tax services.

Generally, there is no standard certification to be a professional tax preparer. An enrolled agent (www.irs.gov/tax-professionals/enrolled-agents/enrolled-agent-information) is someone who has successfully passed training courses from the IRS or previously worked for the IRS. A CPA has specific training and experience in accounting. When looking for a tax preparer, your lawyer, accountant, or financial planner may be a suitable option or be able to make a recommendation. If your information is fairly straightforward, you may minimize costs by using a preparer who simply does taxes. If your situation is complex (especially if it involves other entities such as businesses or trusts, or unusual circumstances such as a gain, gift, or distribution) you may want to consult a professional with a range of expertise, such as an Enrolled Agent, CPA, or a lawyer who specializes in taxes. Many professionals also offer a “guarantee;" they will help you if the IRS questions the information on your return.

Whether you prepare your tax return by yourself or with a professional, you are the one who must sign the return and assume responsibility for its details. You should review your return with your tax preparer to ensure you understand and can explain the information accurately. You should question anything that you cannot understand or that seems contrary to your original information. You should also know your tax return because understanding how and why tax obligations are created or avoided can help you plan for tax consequences in future financial decisions.

Tax Preparation and Filing Software Apps

You may choose to prepare the return yourself using a tax preparation software app. Many are available, and several are compatible with personal financial software apps, enabling you to download or transfer data from your financial software directly into the tax software. Software applications are typically designed as a series of questions that guide you through Form 1040 and the supplemental schedules, prompting you to fill in the data based on your answers. Once you have been through the “questionnaire,” it tells you which forms were completed, and you can file them electronically with the IRS. Most programs also allow you to enter data directly into the individual forms.

Many tax preparation software packages are available, and most are reviewed in the business press or online. Start with an internet search for "free tax filing" or "free tax software," and compare the results to your personal goals and needs.

If the IRS free online filing option does not work for you, you have many other choices. Some popular programs include TurboTax, TaxSlayer, and FreeTaxUSA, but there are many others. Compare features and reviews before selecting a tool.

These tools can be useful because they automatically calculate unusual circumstances, limitations, or exceptions to rules using your complete data. Some programs even prompt you to include additional information based on the data you submit. Overlooking exemptions is a common error that software programs can help you avoid. The programs include all the necessary forms and schedules. If you prefer to file hard copy versions, you can download and print them directly from the IRS website or request that they be sent to you by calling the IRS. Once your return is completed, you must file it with the IRS, either by mail or by e-file. The latter option has become increasingly popular.

Following Up and Handing Audits

After you file your tax return, the IRS will process and review it. If you are owed a refund, it will be sent to you; if you make a payment, it will be deposited into your account. The IRS reviews returns for accuracy, based on redundant reporting and its “sense” of your data. For example, the IRS may investigate any discrepancies between the wages you report and the wages your employer reports for you. As another example, if your total wages are $23,000 and you show a charitable contribution of $20,000, that contribution seems too high for your income, although there may be an explanation.

The IRS may follow up by mail or by a personal interview. It may simply request verification of one or two items, or it may conduct a full **audit—**a thorough financial examination of your return. In any case, you will be asked to produce records or receipts that will verify your reported data. Therefore, it is essential to save a copy of your return, along with the records and receipts used to prepare it. See the IRS website (www.irs.gov/businesses/small-businesses-self-employed/irs-audits) for information on audits and recommendations for the number of years to save your tax data.

If you have a personal interview, your tax preparer may accompany you to help explain and verify your return. Ultimately, however, you are responsible for it. If you have made errors, and if those errors result in a larger tax obligation (if you owe more), you may have to pay penalties and interest in addition to the tax you owe. You may be able to negotiate a payment schedule with the IRS.

Each year, the IRS randomly chooses a certain number of returns for review and possible audit, even where no discrepancies or unusual items are noticed. The threat of a random audit may deter taxpayers from cheating or taking shortcuts on their tax returns. Computerized recordkeeping has made it easier for both taxpayers and the IRS to collect, report, and verify tax data.

Filing Strategies

Most citizens recognize the need to contribute to the government's revenues, but they want to avoid paying more than necessary. **Tax avoidance** is the practice of ensuring that you have no excess tax obligations. Strategies for minimizing or avoiding tax obligations are perfectly legal. However, **tax evasion**, fraudulently reporting tax obligations by understating incomes and gains or overstating expenses and losses, is illegal.

The definition of expenses and the way you claim them can affect your tax rates. You may be able to deduct more expenses if you itemize your deductions than if you do not, or it may not make a difference. Also, there is some discretion in classifying expenses. For example, suppose you are a high school Spanish teacher. You also tutor students privately. You buy Spanish books to improve your language skills and to keep current with the published literature. Are the costs of those books an unreimbursed employee expense related to your job as a teacher, or are they an expense of your private tutoring business? If it is a cost of your tutoring business, you may be able to fully expense it from your business income.

There are many ideas about how to avoid an audit or what will trigger one, such as certain types of income or expenses, or filing earlier or later. In truth, with the increased sophistication of computerization, the review process is much better at noticing discrepancies and choosing audits randomly. Time and effort (and cost) invested in outsmarting a possible audit are usually wasted. The best protection against a potential audit is to have verification, such as a receipt, a bill, or a canceled check, for all the income and expenses that you report.

Summary

- Tax code information is available from the Internal Revenue Service.
- Verifiable records must be kept for all taxable incomes, expenses, and other taxable events and activities.
- Professional tax assistance and tax preparation software are readily available.
- The Internal Revenue Service reviews tax returns for errors and may conduct an informal or formal audit process to follow up.
- Tax avoidance is the legal practice of minimizing tax obligations.
- Tax evasion is the illegal process of fraudulently presenting information used in calculating tax obligations.
- Tax avoidance strategies can involve timing income and/or expenses to take advantage of changing tax circumstances.

Exercises

1. Read the article Policy Basics: Where Do Our Federal Tax Dollars Go (www.cbpp.org/research/federal-budget/where-do-our-federal-tax-dollars-go). In 2023, what were the federal government's three largest expenditures of tax dollars?
2. According to the IRS.gov article How to choose a tax return preparer (www.irs.gov/taxtopics/tc254), when should you look for a professional tax preparation service provider, and what fees should you avoid paying?
3. Gather a current sample of the kind of records you will use to calculate your tax liability this year and verify your tax return. List each type of record and identify exactly what information it will give you, your tax preparer, and the IRS about your tax situation. What additional records will you need that are not yet in your possession?
4. Do searches online to compare and contrast tax preparation software. What are the chief differences among the top three or four programs? Also, check out the IRS Free File program (www.irs.gov/filing/individuals/how-to-file#partner). Would you qualify for Free File?

5. Use your spreadsheet program to create a document that shows monthly cash flows for income and expenses to date, for which you have written records. If you continue to develop this document for the remaining months, how will it help you prepare your tax returns?
6. Research how you can reduce your tax liability and/or avoid paying taxes when you file this year.

[1] IRS, "SOI Tax Stats - Individual Statistical Tables by Filing Status", Tax Year 2021, https://www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-filing-status#_grp3. www.irs.gov/statistics.

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6.5: Taxes and Financial Planning

Learning Objectives

1. Trace the tax effects of life stages and life changes.
2. Identify goals and strategies that provide tax advantages.
3. Identify tax advantages that may be useful in pursuing your goals.
4. Discuss the relationship of tax considerations to financial planning.

You may anticipate significant changes in income or expenses due to a change in job or career, or a change in life stage or lifestyle. Not only may the amounts of income or expenses change, but the kinds of income or expenses may change as well. Planning for changes in relation to tax obligations is an essential part of personal financial planning.

Tax Strategies and Life Stages

Although everyone is different, there is a typical pattern to aging, earning, and taxes, as shown in Table 6.5.1 .

Table 6.5.1 : Life Stages and Tax Implications

	Young Adulthood	Middle Adulthood	Older Adulthood	Retirement
Source of income	Wages	Wages/investment	Wages/investment	Investment
Asset base	None	Accumulating	Growing	Depleting
Adjusted Gross Income	Low	Higher	Highest	Lower
Deductions	Low	Higher	High	Low

In young adulthood, you rely on income from wages, and you usually have yet to acquire an asset base, so you have little income from interest, dividends, or capital gains. Your family structure does not include dependents, so you have few deductions but also low taxable income.

As you progress in your career, you can expect wages, expenses, and probably dependents to increase. You are building an asset base by buying a home, possibly saving for your children's education, or saving for retirement. Because these kinds of assets are encouraged by the government, they not only build wealth but also create tax advantages, such as the mortgage interest deduction, retirement savings exemption, or education savings exemption.

As an older adult, you may begin to build an asset base that can no longer provide these limited tax advantages, or you may create taxable income, such as interest, dividends, or rental income. In retirement, most people can anticipate a significant decrease in income from wages and a significant increase in reliance on income from investments such as interest, dividends, and capital gains. Some of those assets may be retirement savings accounts, such as an Individual Retirement Arrangement (IRA) or a 401(k), which are tax-deferred savings plans. These create tax advantages while growing, but will also cause tax obligations when income is drawn from them.

Generally, at the stages of your life when your income is higher, so are your deductions and exemptions. Deductions and exemptions will tend to decrease as your income decreases. Although your incomes change over your lifetime, your tax obligations change proportionally, so they remain relative to your ability to pay.

The tax consequences of such changes should be considered when evaluating financial strategies. Because the tax code is a matter of law, it does change, but because it is also a matter of politics, it changes slowly and only after much public discussion. You can usually be aware of any tax code changes far enough in advance to incorporate them into your planning.

Tax Strategies and Personal Financial Planning

Tax advantages are sometimes created to support personal financial strategies that encourage specific goals. In the United States, as in most developed economies, specific goals—such as homeownership, retirement savings, and education and health financing—

are viewed as personal objectives that benefit both society and the individual.

In most cases, tax advantages are created to encourage progress toward those goals. For example, most people can only buy a home if they can use debt financing, which creates additional costs. So, mortgage interest, that added cost, is tax-deductible (up to a limit) to make home financing and, therefore, home ownership more affordable and attractive.

Retirement savings are encouraged, so some savings plans, such as an IRA or a **defined contribution** plan like a 401(k) or 403(b) (named for the sections of the Internal Revenue Code that represent them), offer tax advantages. The deposits made to those plans may be used to reduce taxable income, although there are limits to the amount of those deposits. There are also retirement savings strategies that do not create tax advantages, such as saving outside of a tax-advantaged account. There are limited tax-advantaged savings accounts for education savings and health care expenses as well.

When you have a choice, it makes sense to use a strategy that will allow you to progress toward your goal and realize a tax advantage. However, your enthusiasm for the tax advantage should not define your goals. Taxes affect the value of your alternatives, so recognizing tax implications should inform your choices without defining your goals.

Unanticipated events, such as an inheritance, a gift, lottery winnings, casualty and theft losses, or medical expenses, can also have tax consequences. They are often unusual (and therefore unanticipated) events, and may be unfamiliar and financially complicated. In those circumstances, it may be wise to consult an expert.

Your financial plans should reflect your vision for your life: What you want to have, how you want to get it, and how you want to protect it. You will want to be aware of tax advantages or disadvantages, but tax consequences should not drive your vision. For example, you would not buy a house only to get the mortgage interest deduction. However, if you are buying a home, you can plan to do so in the most tax-advantageous way.

Summary

- Tax strategies may need to be adjusted as life stages and family structures change.
- Some personal finance goals may be pursued in a more or less tax-advantaged way, so you should evaluate the tax effects on your alternatives.
- Tax strategies are a means to an end, that is, to achieve your personal finance goals at a minimal cost.

Exercises

1. Review your list of personal financial goals. For each goal, how does the U.S. Tax Code help or hinder you in achieving it?
2. Research online to investigate tax strategies that would benefit you in your present life stage. What tax strategies would benefit you in your next life stage?

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CHAPTER OVERVIEW

7: Financial Management

This chapter focuses on maturity matching; financing consumption using current earnings and/or credit, and financing longer-term assets with debt.

7.1: Introduction
7.2: Your Own Money- Cash
7.3: Your Own Money- Savings
7.4: Other People's Money- Credit
7.5: Other People's Money- An Introduction to Debt
7.6: Alternate Perspectives
7.6.1: Credit Reports
7.6.1.1: Free Credit Reports
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7.6.2: Taxes
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7.6.2.4: Frequently Requested Tax Benefits
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7.6.3: Credit Cards Auto Loans and Other Personal Debt
7.6.4: Banks and Financial Institutions

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7.1: Introduction

Learning Objectives

- Describe the functions and traits that define money.
- Explain how money solves transaction complexity.
- Connect abstract economic concepts of monetary trust to real-life decision-making.

The Fiction That Works

Money is the starting point. Before we talk about saving, borrowing, or building wealth, we need to understand what money *is* and what it isn't. Most people treat it as a given, like gravity or Wi-Fi. It is always there and rarely questioned. However, upon examining its function and design, money becomes one of the most fascinating and fragile systems humans have ever created.

Before we talk about debt, credit, savings, or spending, we need to get something straight: Money isn't a thing. It's a shared idea—one so powerful and so trusted that it shapes everything around it.

Money has no value on its own. You can't eat it, wear it, or build shelter out of it. But with enough of it, you can access all those things and more. It works only because we agree it works. The dollar in your wallet, or the number on your banking app, is a promise. What gives that promise power is belief, reinforced by habit, tradition, and systems that rarely break down.

The Three Jobs Money Must Do

To understand why money matters, we have to understand what it *does*, not just for economists, but for you. Imagine trying to trade a sandwich for a haircut. Or a bus ride for two hours of babysitting. Without a common standard, every exchange would require haggling, approximating, or awkward math. Money fixes that.

In modern economies, money plays three essential roles:

- **It's a medium of exchange.** It replaces bartering and allows people to trade goods and services with confidence. You don't need your landlord to want your sourdough starter; you just need them to accept your payment.
- **It's a store of value.** You can earn money today and spend it later. Without this function, you'd have to trade your labor or goods *now*, before they spoiled or expired.
- **It's a unit of account.** You can compare prices and assign value across things that don't naturally relate, like tacos, textbooks, and car insurance.

These may sound basic, but together they explain why money is a tool for building systems, not just buying snacks. Economists refer to these as the **functions of money,** and if money fails to perform any one of them, the entire system begins to break down.

Why Trade Needed Help

Before money existed, every transaction required coincidence, timing, and negotiation. If you wanted shoes and had eggs, you needed a shoemaker who wanted eggs right away, and who thought your dozen was worth one pair of boots. That kind of direct trade is called **barter**, and while it works in very small groups with limited needs, it collapses fast under complexity.

Economists refer to this as the **double coincidence of wants**, and it's rare. Bartering breaks down when wants don't match, when goods aren't divisible, or when timing is off. You can't trade perishable goods for long-term services. You can't slice a couch in half to pay for half a haircut.

Money solves this. It acts as a neutral stand-in for value, making transactions flexible and scalable. It lets people trade asynchronously, across distances, and without needing to know or trust each other personally. It breaks open closed loops of barter and turns them into wide, open webs of exchange.

Once you see this, the purpose of money sharpens: It doesn't just enable trade; it **simplifies the transaction itself**. It makes the economy faster, broader, and more resilient. Without it, systems shrink. With it, they expand.

You don’t need to memorize these terms. However, you need to understand that these functions explain *why* money matters and *how* it behaves in various financial decisions. A currency that fails at even one of these jobs loses its usefulness fast. If money can’t store value, people rush to spend it. If it can’t serve as a unit of account, prices make no sense. If it’s not accepted in exchange, it becomes trivia, not currency.

The Traits That Make Money Work

If the functions of money explain what it *does*, then its traits explain *how* it can do those things effectively.

First: **Durability.** Money has to last. If your paycheck dissolved in the rain or your coins rusted through your pockets, it wouldn’t make a reliable store of value. That’s one reason societies moved beyond salt and silk.

Second: **Portability.** Imagine carrying a cow to pay your taxes. Not ideal. Money needs to be easily transferable and convenient to exchange. Paper and digital forms consistently outperform livestock.

Third: **Divisibility.** You should be able to split money into smaller pieces without losing its function. This is why a dollar breaks into cents, and why barter systems ("I'll trade you five apples for one hammer") don’t scale well.

Fourth: **Scarcity.** If money were limitless, it wouldn’t hold value. Consider tulip bulbs in 17th-century Holland or hyperinflation in modern Venezuela. When supply explodes, value vanishes.

When something has all four of these traits, we trust it to behave like money, even if it’s just paper or pixels. Economists refer to these as the **characteristics of money**. You don’t need to memorize the label, but once you’ve seen them in action, you’ll spot why some systems work and others crumble.

Why It Matters Now

This might sound abstract, but it’s not academic fluff. It’s the foundation for everything else that’s coming: Interest, inflation, credit, investment, and debt. None of it makes emotional or intellectual sense without understanding what money is, and what it isn’t.

Think of this section as the platform you’ll stand on when you look out at the financial landscape. With it, you’ll see farther. Without it, everything just looks like math.

Summary

Money is more than paper—it's a social contract. To function, it must act as a

- medium of exchange
- store of value
- unit of account

But for that to work, money must be

- portable
- durable
- divisible
- scarce

This section explores how money evolved into the tool it is today and why we rely on it so deeply.

Exercises

1. What traits make your preferred form of payment feel trustworthy?
2. What happens to an economy when the public stops believing in its currency?
3. Match each function of money to a real-life scenario: buying coffee, comparing prices, saving for tuition.

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7.2: Your Own Money- Cash

Learning Objectives

1. Explain the role and function of depository and non-depository institutions.
2. Describe common account types and how they facilitate everyday financial activity.
3. Demonstrate how intentional account structures can reduce friction and improve financial control.

Accounts, Institutions, and Access

When Cash Is in Control

Cash gives you access, but that access can feel like chaos when it's unmanaged. A paycheck arrives. Bills go out. There's a late-night charge at a taco truck and a scheduled transfer that hits early. Suddenly, your balance isn't what you thought, and your financial footing feels unstable.

Cash might seem neutral when it just sits there, but how and where it sits matter. When money is scattered across apps and accounts or stashed in physical form, it can't support you. It can only react to you.

Liquidity and Its Limits

Cash is liquid, but liquidity isn't everything. Liquidity means you can use money immediately. But the more liquid money is, the more vulnerable it becomes to impulse, error, or oversight.

A healthy system strikes a balance between liquidity and purpose. That starts with knowing *where* your money lives.

From Concept to Container

Money doesn't just exist; money flows. For that flow to be safe, usable, and meaningful, it requires structure. That structure is provided by financial institutions, which exist to hold and manage money on your behalf.

Broadly speaking, there are two types of financial institutions:

Depository institutions, such as banks and credit unions, accept deposits. They're in the business of holding your money, keeping it safe, and offering tools like checking accounts, savings accounts, debit cards, and personal loans. When most people say they're "going to the bank," this is what they mean. These institutions also provide access to ATM networks, fraud protection, and customer service systems that resolve disputes and help restore access when issues arise.

Non-depository institutions, such as fintech apps, digital wallets, and peer-to-peer platforms, offer financial services, but they don't hold your money directly. They typically act as interfaces or intermediaries. The money may pass through their systems, but it's held elsewhere, often in a partner bank's name, not yours. These tools can be fast, convenient, and useful, but they shift the nature of the trust required.

The difference may feel subtle, but it matters. Depository institutions take custody. Custody brings with it legal obligations, protections, and oversight. Non-depositories provide access and innovation, but without the same guarantees or regulatory framework.

Trust and Regulation: Why It Matters

We didn't always trust banks. In the early 20th century, it was common for people to lose their life savings if a bank failed. There was no safety net, just a handshake promise and a lot of risk.

That changed in 1933, with the creation of the **FDIC**—the Federal Deposit Insurance Corporation. The FDIC insures deposits at participating banks up to $250,000 per depositor, per institution. That means if your bank fails, your money is protected. Credit unions offer similar protection through the **NCUA**—the National Credit Union Administration.

These protections don't make banks infallible, but they do make the system resilient. They allow consumers to trust that a dollar in the bank today will still be there tomorrow, even if something goes wrong behind the scenes. Such trust is rare in global finance, but in the U.S., it is often taken for granted.

Non-Depository Tools: Access, Not Custody

The rise of mobile apps, peer-to-peer payments, and instant checkout options has made non-depository tools more common than ever. But it's worth asking: why do some of these apps *feel* like banks?

Part of the answer is design. They show balances. They let you "send money" or "pay bills." They even offer rewards or link to your debit card. But beneath the surface, they're structured differently. Most don't insure your balances. Many hold funds temporarily or route them through third-party institutions. If something goes wrong, your protections depend on user agreements, not federal law.

Some newer tools mimic features of banks—like deposit accounts or early paycheck access—but don't offer the same protections. Others provide a specific financial function—like Buy Now, Pay Later (BNPL), which splits a purchase into multiple payments—but lack the transparency and regulation of traditional lending. These systems are fast, sleek, and persuasive. But they often come with unclear terms, limited recourse, and little incentive to help you recover from a problem.

This doesn't mean you shouldn't use them, but it does mean you need to know what you're using. Who holds your money? What happens if the app disappears? And how quickly can you recover from a mistake?

Institutions, Interfaces, and the Flow Between Them

Your financial life operates on two layers: *where* the money lives, and *how* you access it. You might store your paycheck in a traditional bank, but interact with it through apps, cards, or platforms that create the illusion of seamless control.

That illusion can break down during a problem, such as a failed transfer, a delayed settlement, or a miscommunication between systems. To navigate this world effectively, you need to understand how transactions actually work.

When you swipe a debit card or tap to pay, you're not completing a transaction; you're initiating one. First, an **authorization is performed to verify that your account has sufficient** funds. Then comes a **settlement**, where the money is actually transferred. In the meantime, a **pending** transaction appears, but it doesn't reduce your actual balance until it is posted.

This time lag is where overdrafts happen. It's why your account can say one thing and your bank says another. Understanding this flow gives you power; it helps you stay ahead of errors, mismatches, and misfires.

Building Flow and Resilience

With the infrastructure clear, you can begin designing a system that supports your financial life. That system doesn't need to be fancy, but it does need to be intentional.

Start by assigning roles: Use a checking account for spending and deposits. Use a savings account for protection and planning. Automate what you can: paychecks, transfers, and minimum payments. Reduce your decision load so that good behavior happens by default.

But no system is perfect. Payments get missed. Cards get hacked. Apps go offline. That's why resilience matters. Turn on alerts. Keep support contact info somewhere offline. Know how to dispute charges. Build a small emergency buffer in a separate account.

Resilience isn't paranoia; resilience is strategy. It keeps the unexpected from becoming unmanageable.

The System Is the Strategy

In personal finance, structure *isn't* the opposite of freedom; it's what makes freedom possible. A well-designed system reflects personal priorities, absorbs distractions, and moves money in a way that supports goals instead of sabotaging them.

You don't need to be wealthy to benefit from structure. Structure is *how* most people build wealth: by automating savings, limiting exposure, managing cash flow, and avoiding catastrophic mistakes.

A strong system builds momentum. A strong system buys time. A strong system empowers you to act with intention rather than react in crisis.

Your money deserves a system. Build one with care, and it will return the favor.

Summary

Cash is the most immediate and visible form of money, yet it is also the most misunderstood. It offers liquidity and control, but without structure, it slips through your fingers. This section shows how to assign purpose to your cash, manage its flexibility, and avoid letting “just in case” become “just gone.” When you manage your cash intentionally, you manage your options and your stress.

Exercises

1. What cash habits have helped—or hurt—you in the past?
2. Why might liquidity feel safer than it really is?
3. Design a three-part cash strategy: daily use, short-term buffer, and emergency reserve.

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7.3: Your Own Money- Savings

Learning Objectives

1. Identify different types of credit and their structural features.
2. Evaluate the costs, risks, and benefits of using credit.
3. Apply maturity matching and credit management strategies to real-life decisions.

Borrowing with Strategy

What Credit Really Is

Simply put, credit is borrowed money. But it's also borrowed trust. When you use credit, you're not just spending money you don't currently have; you're promising to repay it, usually with interest, on a future schedule.

In everyday life, credit smooths the gaps. It allows you to access things, such as cars, education, or even lunch, without having to pay the full amount upfront. But credit isn't free, and it isn't magic. It has structure: principal, interest, terms, and payments. And when misunderstood, it has consequences.

To use credit well, we need to look under the hood.

The Building Blocks: Principal, Interest, Term, and Payment

Every form of credit is built from four core parts:

- **Principal** – The amount you borrow
- **Interest** – The cost of borrowing, expressed as a percentage
- **Term** – The length of time you agree to repay
- **Payment** – The amount due at each interval (usually monthly)

Together, these determine the total cost of credit. The longer the term, the more interest you usually pay. The higher the interest rate, the more expensive it is to borrow, even if the principal seems small.

Understanding these components makes it easier to compare offers, anticipate tradeoffs, and manage repayment without surprises.

Types of Credit

Credit comes in different formats depending on how it's issued and repaid:

- **Installment credit** involves borrowing a set amount and repaying it over time in fixed installments. Mortgages, auto loans, and student loans fall into this category. The terms are clear, the payments are structured, and the debt is paid off over time.
- **Revolving credit** lets you borrow up to a limit, repay what you choose, and borrow again. Credit cards are the classic example. There's flexibility but also risk. Interest is charged on what you don't repay, and balances can persist.
- **Secured credit** requires collateral, an asset that can be reclaimed if you fail to repay. This lowers the lender's risk (and your interest rate), but increases your personal exposure.
- **Unsecured credit** is based solely on trust, including your credit score, income, and credit history. Credit cards, personal loans, and most student loans are unsecured. Because there's no collateral, rates tend to be higher.

Different tools serve different goals. Choosing the right one starts with knowing what you're really borrowing and why.

Cost of Credit: Interest, APR, and Compound Trouble

Interest is the fee you pay to borrow. It's often expressed as an **APR (Annual Percentage Rate)**, which includes not just interest but also fees that affect the loan's actual cost.

Compound interest, especially on credit cards, means you're charged interest on your interest. That's how a $300 purchase can become a $500 balance if paid slowly over time.

Making only the minimum payment may feel manageable, but it dramatically increases the total cost. Your balance shrinks slowly, if at all, and the lender profits while your progress stalls.

Credit Reports and FICO Scores

Your credit behavior is recorded, scored, and shared. That record, your **credit report**, is maintained by three main bureaus: Equifax, Experian, and TransUnion. Lenders report your payments, balances, and account activity to these agencies.

From this data, your **FICO score** is calculated. Ranging from 300 to 850, it reflects your trustworthiness as a borrower. Five core components shape your score:

Payment history (35%)

On-time payments matter most.

Amounts owed (30%)

Also called utilization: how much of your available credit you're using.

Length of credit history (15%)

Older accounts show experience.

Credit mix (10%)

Having both installment and revolving accounts helps.

New credit (10%)

Opening many new accounts at once is risky.

Your FICO score influences what you can borrow, how much it will cost, and whether doors open or stay closed.

Maturity Matching: Timing Matters

Smart credit users align their purchases with how long they expect to take to pay them off. This is called **maturity matching**.

Use short-term debt (like credit cards) for short-term purchases like groceries or fuel. Use longer-term loans (like installment credit) for long-term assets like a car or education.

Problems arise when people mismatch their financial commitments, putting a wedding on a credit card and paying it off over five years, or financing a phone for 24 months when they'll upgrade in 12. You're still paying long after the value has disappeared.

Credit as a Strategic Tool: A Real SWOT Analysis

Let's examine credit with a strategic lens by identifying its Strengths and Weaknesses as well as exploring the Opportunities and Threats (SWOT Analysis) it presents:

	Helpful	Harmful
Internal	**Strengths** Credit expands access. It helps build financial history, smooth income variability, and offers fraud protection and travel perks. With responsible use, it opens doors to car loans, home mortgages, and even better insurance rates.	**Weaknesses** Credit makes overspending easy. The gap between *what you can buy* and *what you can afford* becomes invisible. Interest can silently grow a balance into something unmanageable.
External	**Opportunities** Credit can be leveraged for major purchases, used to seize time-sensitive opportunities, or as a buffer in emergencies when cash falls	**Threats** High-interest debt, late payments, and credit dependency can trap users in long-term cycles of debt. One emergency (job loss, medical issue, identity theft) can drag down

short. Responsible users build positive credit signals without carrying debt.

a score and raise future borrowing costs for years.

Credit is powerful, but only when used with clarity.

Building and Managing Credit Intentionally

Want to build credit from scratch or intentionally rebuild it? Here's how:

1. **Start with a secured credit card**, where your deposit becomes your credit limit. It's a training tool and trust builder.
2. **Use it monthly for small expenses**, like a streaming subscription or gas, and pay the full balance on time.
3. **Pay in full,** not just because it's responsible, but because it avoids interest, aligns with maturity matching, and sends the strongest signal to lenders.
4. **Keep your utilization low.** If you have a $1,000 limit, don't carry $700. Stay under 30%, ideally under 10%.
5. **Don't open too many accounts at once.** Every inquiry is recorded, and excessive activity can spook lenders.
6. **Use autopay wisely,** not just to avoid late fees, but to build consistency. If you're forgetful, automation is your ally.

Finally, check your credit report once a year at AnnualCreditReport.com (www.annualcreditreport.com). It's free, it's your history, and it helps you spot errors before they become problems. Your credit history is a portrait of how you manage your financial commitments. Make sure the picture is one you're proud of.

Summary

Credit is borrowed trust, not free money. It lets you act today using tomorrow's income, but that power comes at a cost. This section breaks down principal, interest, and repayment terms, introduces the FICO system, and compares credit structures. Readers explore how to use credit as a lever, not a trap, and how alignment, visibility, and responsibility shape long-term outcomes.

Exercises

1. What kind of credit do you already use? How does it shape your daily decisions?
2. What makes it hard to pay off a credit card once it starts carrying a balance?
3. Compare snowball vs. avalanche payoff methods. Which feels more motivating and why?

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7.4: Other People's Money- Credit

Learning Objectives

1. Describe why savings matter and how they protect your future self.
2. Differentiate between types of savings goals, tools, and strategies.
3. Design a layered savings strategy that aligns with your personal time frames, risk tolerance, and liquidity needs.

Paying Your Future Self

Why Save at All?

Let's start with a harsh truth: saving isn't natural. Our brains are wired for now - today's hunger, today's stress, today's temptation. So when we talk about savings, we're talking about rewiring your instincts in favor of your future self.

Think of savings as a financial time machine. It allows you to transfer money from a period when you have more than you need to a time when you might not have enough. It's how you buy groceries in July with dollars you set aside in March. It's how your fall tuition gets covered by your summer job.

Saving isn't just responsible, it's powerful. It turns uncertainty into options. It gives you room to breathe. It means your next unexpected expense doesn't have to become your next unplanned debt.

And let's be clear: S**aving is not the same as investing**. Savings are for stability. Investments are for growth. This section focuses on savings stability, but we'll talk about investing soon.

What Are You Saving *For*?

Not all savings are created equal. To make it stick, you need to connect your dollars to your goals. That's where buckets come in:

Emergency savings

For the flat tire, the lost shift, or the dental surprise

Short-term savings

For upcoming expenses: travel, textbooks, tech upgrades

Long-term savings

For dreams that need time: a house, a sabbatical, a business launch

When you name your goals, your savings start to feel less like a sacrifice and more like a strategy. You're not depriving your present - you're funding your future.

Where Does the Money Go?

Once you know *why* you're saving, the next question is *where to save*. Different tools are designed for various timeframes, levels of access, and risk levels. Let's explore the most common options:

Basic savings accounts

Safe and easy to access. Insured by the FDIC or NCUA. Low interest, but low risk.

High-yield savings accounts

Typically online only. Same safety as basic savings, but better returns.

Money market accounts

Like savings, but with limited check-writing and higher minimum balances. Slightly better interest.

Certificates of Deposit (CDs)

Lock your money away for a fixed time. In return, you receive a higher rate, but can't access the funds without incurring a penalty.

Each of these tools exists on a spectrum of **liquidity** (how quickly it can be accessed) and **yield** (how much it earns). In economic terms, we might say these tools express an inverse relationship between access and return. That's not a fluke; it's the price of patience.

This tradeoff is central to understanding your savings strategy, as your timeline influences your risk tolerance. If you need the money tomorrow, you can't afford to chase high returns. However, if your goal is a year or more away, you may be willing to accept some constraints in exchange for a little extra growth.

Laddering and Layering: Strategy in Action

One way to optimize yield without giving up all your liquidity is through **laddering**. This involves spreading your money across CDs with staggered maturity dates. For example, you put

- $500 in a 6-month CD
- $500 in a 12-month CD
- $500 in an 18-month CD

Every six months, one CD matures, giving you the option to access the cash or reinvest. Over time, this provides you with rolling access without compromising the benefits of longer-term returns. This practice mirrors a basic finance principle: reduce reinvestment risk by spreading out your decisions over time.

Layering, meanwhile, means thinking about savings like a pyramid:

- The **base layer** is your emergency fund - liquid and stable.
- The **middle layer** is short-term savings for upcoming expenses.
- The **top layer** might include CDs or money market accounts that serve longer timelines.

This layered structure reflects both purpose and priority: what is urgent, what is upcoming, and what is aspirational. It also introduces a key academic concept: the **hierarchy of needs in relation to liquidity planning**.

How Much Should You Save?

The internet loves throwing out numbers: Ten percent of your income, three months of expenses, $1,000 emergency cushion. And while those are all reasonable targets, the honest answer is more personal.

Start with what you *can save*, not what you *should save*. Automate what you can. Ten dollars a week is better than zero. Two dollars from every twenty dollars counts. It's not about reaching perfection; it's about building momentum.

And don't fall into the all-or-nothing trap. Saving doesn't mean you can't spend. It means you *choose* when to spend and on what.

As your goals grow, so can your strategy. At that point, we start to ask more technical questions: What's your timeline? What's your tolerance for delay? How will inflation or opportunity cost affect your decision? These questions aren't just academic; they shape real behavior.

Saving Isn't Passive - It's a Practice

Here's the paradox: Savings feel static, but they're dynamic. They reflect your values, your priorities, and your planning. Saving is a verb. It's something you *do*, even when you're not doing it consciously.

That's why systems help. Automation, buckets, visual reminders, and separate accounts are all systems that can be utilized. Anything that reduces friction, protects your goals, and makes it easier to say "yes" to your future self is a system you should consider.

One day, your future self will face a challenge, an opportunity, or a turning point. You'll either have the resources to act or the regret that you didn't prepare. And that's what savings are: **a message in a bottle to the person you're becoming.**

Summary

Savings are an act of self-respect. It is an intentional investment in your future stability and freedom. This section reveals how to:

- align savings goals with timelines

- choose the right tools
- and develop habits that stick

Reframe savings not as a restriction, but as a form of resilience.

Exercises

1. What savings goals have you had in the past, and how did you pursue them?
2. What makes it hard to save consistently? Is the issue income, habits, or clarity?
3. Create a short-term savings plan by defining the goal, target amount, timeline, and account type.

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7.5: Other People's Money- An Introduction to Debt

Learning Objectives

1. Explain how debt structures repayment and interest over time.
2. Evaluate the cost and value of different types of debt.
3. Develop a strategy for managing or escaping high-interest debt.
4. Interpret the legal and financial implications of bankruptcy.

Digging In and Climbing Out

What Debt Really Means

Debt is money you've already spent, or promised to spend, without yet paying for it. It's the opposite of savings. Instead of giving your future self a gift, debt hands them a bill.

But debt isn't always a mistake. It's a tool, just like credit. And sometimes, it's the only way forward. Few people can buy a house, pay for college, or cover emergency surgery without borrowing. The danger isn't in using debt, it's in using it without understanding what it costs.

Debt always comes with strings. It creates an obligation, adds pressure, and limits flexibility. When used well, it can move your life forward. When misused, it can pin you in place.

How Debt Works (and Grows)

Every debt has three core parts: principal, interest, and term. Together, they shape your repayment. Most debts are paid off in monthly installments, which blend interest and principal.

Early in a loan, the majority of your payment goes to interest. Over time, this shifts, and more of the balance is allocated to the actual balance. This structure, called amortization, is predictable but often misunderstood. The borrower sees a payment going out, but the balance barely moves. That disconnect is built into the system.

Amortization tables show how this works. They list each payment, breaking it down into interest and principal. Understanding this table helps you see where your money is really going and how long you'll be in repayment.

Miss a payment, and things get worse. Late fees will apply and interest compounds. Your total cost grows. In academic terms, this isn't just a payment problem; it's a cost acceleration curve.

Good Debt, Bad Debt, and Real Life

There is a popular idea that some debt is considered "good" (such as student loans or mortgages) and some is considered "bad" (like payday loans or maxed-out credit cards). But real life is more complex.

The true measure of debt is **value over time**: What you got, what you paid, and whether the payoff justifies the pressure. Debt isn't just about interest rates; it's about outcomes.

We evaluate debt not only by its APR, but also by its **opportunity cost**, or what else those payments could be used for. A 7 percent car loan might be worth it if it helps you get to a job that pays well—but financing a luxury item that depreciates quickly? That's often just future stress disguised as a lifestyle upgrade.

When Debt Gets Out of Hand

Debt becomes dangerous when it outpaces your income, your planning, or your awareness. The warning signs aren't always dramatic; they're subtle at first. Using credit for essentials, skipping one bill to pay another, and dreading reading your account balances all signal impending financial trouble.

Academic frameworks refer to this as a **debt spiral,** where interest and fees grow faster than your payments can reduce the balance. Even when you're making progress, it can feel like you're standing still.

The earlier you intervene, the more options you have. Intervention isn't about shame, it's about strategy. That might mean contacting lenders, consolidating balances, or speaking with a nonprofit credit counselor.

The system isn’t designed to call a timeout. You have to press pause yourself.

Climbing Out: Structure Over Shame

Getting out of debt isn’t about guilt or grit, it’s about structure. The right plan creates momentum. The wrong one creates exhaustion.

Start by listing every debt, including the balance, rate, payment, and due date. This gives you a map. From there, you can apply one of two major strategies:

Snowball

Pay off the smallest debt first for quick wins and motivation

Avalanche

Pay off the highest-interest debt first for long-term savings

Neither is “right,” but they solve different problems. One builds a habit. The other saves money. Many students succeed by starting with a snowball strategy and then transitioning to an avalanche strategy as their confidence grows.

While you pay down debt, don’t forget about **sinking funds**. A sinking fund is a mini-savings account set aside for *anticipated* expenses. Without them, you risk sliding back into borrowing.

Bankruptcy: Last Resort or Fresh Start?

For some, debt becomes mathematically impossible to repay. Even if you're making monthly payments, interest and fees may grow faster than your ability to reduce the balance. Imagine owing $20,000 with a 24 percent interest rate and only making minimum payments; it would take decades and cost thousands more than you borrowed.

At that point, bankruptcy becomes not just a legal option, but a necessary reset. However, like any reset, it has structure, and that structure matters.

There are two main types of personal bankruptcy in U.S. federal law:

Liquidation

Chapter 7: This process erases most unsecured debts after nonexempt assets are sold. It’s fast, but not everyone qualifies. There’s a means test based on your income.

Reorganization

Chapter 13: You keep your property and repay some or all of your debts through a court-supervised payment plan over 3–5 years. It offers structure for people with steady income who need breathing room.

The key legal term is **discharge**, a court order that erases qualifying debts and prevents creditors from trying to collect them. Some debts, such as recent taxes, child support, and most student loans, are not eligible for discharge.

Bankruptcy remains on your credit report for 7 to 10 years; however, its impact begins to fade earlier than most people think, especially if you establish good habits for rebuilding your credit. Bankruptcy is serious but survivable. It is not a character flaw. It is a legal tool designed to give people a second chance.

Debt-to-Income Ratio and the Limits of Leverage

In lending, one of the most important indicators is your **Debt-to-Income (DTI) Ratio,** which is calculated by dividing your total monthly debt payments by your gross monthly income. Lenders use it to determine whether you can afford to take on new debt.

But DTI isn't just for lenders. It’s for you. It's a mirror. If your DTI climbs above 36 percent, your budget is under pressure. Above 50 percent, you're likely robbing one category to cover another. At that point, debt stops being a tool and starts being a cage. When DTI rises, other things shrink, such as your ability to save, seize opportunities, and get a good night's sleep. A high DTI doesn’t just limit your loan options. It limits your life options.

Understand your DTI: How amortization slows your payoff early, how compounding punishes delay, and how opportunity cost shifts the true value of debt. These aren’t advanced theories. They’re survival skills.

Summary

Debt is more than borrowed money. It’s a commitment shaped by:

- structure
- time
- and consequence

This section examines how debt accumulates, accelerates, and how to manage or overcome it. Students learn to recognize early warning signs, evaluate repayment strategies, and understand the legal framework of bankruptcy. With the right tools, debt becomes navigable, and even reversible.

Exercises

1. What role does interest play in your current or past debt decisions? How did you understand it at the time?
2. If you had to restructure your current debt today, what would your strategy be?
3. Calculate your own DTI. What would that number say to a lender, and what does it tell you?

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7.6: Alternate Perspectives

Learning Objectives

1. Synthesize knowledge of cash, savings, credit, and debt into a personalized financial plan.
2. Evaluate your current financial situation and align your money tools with your future goals.
3. Develop a resilient, values-based plan for ongoing financial decision-making.

Putting It All Together

It's A Map, Not a Script

Personal finance doesn't come with a finish line. It's not a perfect sequence or a one-size-fits-all plan. What you've learned so far isn't a script to follow; it's a map to navigate. Cash, savings, credit, and debt are not separate chapters in your life. They're interconnected systems that shape how you move through the world.

This section will help you step back and connect the dots. You cannot predict an imaginary future where you're always prepared, perfectly disciplined, and never surprised; however, you can start building a reliable plan that will fit your actual life.

Start Where You Are

Before you plan forward, you have to take inventory. That means getting honest about your current state:

- How much cash do you have on hand?
- What are you saving for, and where does that money live?
- What credit do you have access to, and how are you using it?
- What debt are you carrying? What's the interest rate? Are you paying it down or just keeping it afloat?

You should not make judgments, but you should seek clarity. This is your financial snapshot. And it's the foundation of every move that follows.

Align Your Tools with Your Timeline

Different financial tools serve different time horizons. Once you've mapped where you are, you can start aligning your habits with your goals:

Cash	Savings	Credit	Debt
For immediate access (next 30 days)	For short to medium-term goals (3–12 months or more)	As a buffer or accelerator (but not a crutch)	Only when the value it *creates* is outweighed by the cost you *pay*

Planning is really about **assigning time to money**. That's how you reduce stress, increase flexibility, and build toward the life you actually want.

Design Your Flow

Planning isn't just about what you earn; it's about how money moves through your life. Start simple:

- What comes in each month?

- What goes out (needs, wants, debt payments, savings)?
- What gets stuck or lost in the cracks?

From there, you can start shaping a rhythm:

- Automate savings where possible
- Schedule bill payments to avoid late fees
- Set calendar reminders for financial check-ins

This isn't about micromanaging every dollar. It's about creating a **structure that supports your values** and reduces decision fatigue.

Plan for the Unexpected (and the Inevitable)

No plan survives contact with real life. But good plans bend instead of breaking. That's where emergency savings, flexibility, and habit formation play a crucial role.

You will face unexpected expenses. You will get tired of being responsible. You will be tempted to ignore it all.

That's why your plan doesn't need to be airtight. It needs to be resilient. It needs to be something you can return to, revise, and recover from.

You're not aiming for perfection. You're aiming for momentum, alignment, and the ability to act with intention.

Because in the end, personal finance isn't about having all the answers. It's about asking the right questions and having a system in place when the answers change.

Summary

This final section connects the dots. Personal finance isn't a checklist; it's a living system. Here, students learn to treat cash, savings, credit, and debt not as isolated topics, but as parts of a dynamic plan. By inventorying their current status, aligning tools with timelines, and designing intentional money flow, students shift from passive reactors to active planners.

Financial planning is less about perfection and more about rhythm, revision, and resilience. The section closes with a powerful reframing: you're not building a flawless plan. You're building the capacity to adapt when life surprises you.

Exercises

1. Can you describe how cash, credit, savings, and debt interact in your current life?
2. What part of your financial life do you currently avoid thinking about? What would change if you gave it more attention?
3. Draft a simple 30-day cash-flow statement: estimate your income, fixed expenses, variable expenses, and any planned savings or debt payments. What patterns do you notice?

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SECTION OVERVIEW

7.6.1: Credit Reports

7.6.1.1: Free Credit Reports

7.6.1.2: Building a Better Credit Report

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7.6.1.1: Free Credit Reports

Visit annualcreditreport.com to get your free credit report.

A link to an interactive elements can be found at the bottom of this page.

The Fair Credit Reporting Act (FCRA) requires each of the nationwide credit reporting companies — Equifax, Experian, and TransUnion — to provide you with a free copy of your credit report, at your request, once every 12 months. The FCRA promotes the accuracy and privacy of information in the files of the nation's credit reporting companies. The Federal Trade Commission (FTC), the nation's consumer protection agency, enforces the FCRA with respect to credit reporting companies.

A credit report includes information on where you live, how you pay your bills, and whether you've been sued or have filed for bankruptcy. Nationwide credit reporting companies sell the information in your report to creditors, insurers, employers, and other businesses that use it to evaluate your applications for credit, insurance, employment, or renting a home.

Here are the details about your rights under the FCRA, which established the free annual credit report program.

Q: How do I order my free report?

The three nationwide credit reporting companies have set up a central website, a toll-free telephone number, and a mailing address through which you can order your free annual report.

To order, visit annualcreditreport.com, call 1-877-322-8228. Or complete the Annual Credit Report Request Form and mail it to: Annual Credit Report Request Service, P.O. Box 105281, Atlanta, GA 30348-5281. Do not contact the three nationwide credit reporting companies individually. They are providing free annual credit reports only through annualcreditreport.com, 1-877-322-8228 or mailing to Annual Credit Report Request Service.

You may order your reports from each of the three nationwide credit reporting companies at the same time, or you can order your report from each of the companies one at a time. The law allows you to order one free copy of your report from each of the nationwide credit reporting companies every 12 months.

A Warning About "Imposter" Websites

Only one website is authorized to fill orders for the free annual credit report you are entitled to under law — annualcreditreport.com. Other websites that claim to offer "free credit reports," "free credit scores," or "free credit monitoring" are not part of the legally mandated free annual credit report program. In some cases, the "free" product comes with strings attached. For example, some sites sign you up for a supposedly "free" service that converts to one you have to pay for after a trial period. If you don't cancel during the trial period, you may be unwittingly agreeing to let the company start charging fees to your credit card.

Some "imposter" sites use terms like "free report" in their names; others have URLs that purposely misspell annualcreditreport.com in the hope that you will mistype the name of the official site. Some of these "imposter" sites direct you to other sites that try to sell you something or collect your personal information.

Annualcreditreport.com and the nationwide credit reporting companies will not send you an email asking for your personal information. If you get an email, see a pop-up ad, or get a phone call from someone claiming to be from annualcreditreport.com or any of the three nationwide credit reporting companies, do not reply or click on any link in the message. It's probably a scam. Forward any such email to the FTC at spam@uce.gov.

Q: What information do I need to provide to get my free report?

A: You need to provide your name, address, Social Security number, and date of birth. If you have moved in the last two years, you may have to provide your previous address. To maintain the security of your file, each nationwide credit reporting company may ask you for some information that only you would know, like the amount of your monthly mortgage payment. Each company may ask you for different information because the information each has in your file may come from different sources.

Q: Why do I want a copy of my credit report?

A: Your credit report has information that affects whether you can get a loan — and how much you will have to pay to borrow money. You want a copy of your credit report to:

- make sure the information is accurate, complete, and up-to-date before you apply for a loan for a major purchase like a house or car, buy insurance, or apply for a job.
- help guard against identity theft. That's when someone uses your personal information — like your name, your Social Security number, or your credit card number — to commit fraud. Identity thieves may use your information to open a new credit card account in your name. Then, when they don't pay the bills, the delinquent account is reported on your credit report. Inaccurate information like that could affect your ability to get credit, insurance, or even a job.

Q: How long does it take to get my report after I order it?

A: If you request your report online at annualcreditreport.com, you should be able to access it immediately. If you order your report by calling toll-free 1-877-322-8228, your report will be processed and mailed to you within 15 days. If you order your report by mail using the Annual Credit Report Request Form, your request will be processed and mailed to you within 15 days of receipt.

Whether you order your report online, by phone, or by mail, it may take longer to receive your report if the nationwide credit reporting company needs more information to verify your identity.

Q: Are there any other situations where I might be eligible for a free report?

A: Under federal law, you're entitled to a free report if a company takes adverse action against you, such as denying your application for credit, insurance, or employment, and you ask for your report within 60 days of receiving notice of the action. The notice will give you the name, address, and phone number of the credit reporting company. You're also entitled to one free report a year if you're unemployed and plan to look for a job within 60 days; if you're on welfare; or if your report is inaccurate because of fraud, including identity theft. Otherwise, a credit reporting company may charge you a reasonable amount for another copy of your report within a 12-month period.

To buy a copy of your report, contact:

- Equifax:1-800-685-1111; equifax.com
- Experian: 1-888-397-3742; experian.com
- TransUnion: 1-800-916-8800; transunion.com

Q: Should I order a report from each of the three nationwide credit reporting companies?

A: It's up to you. Because nationwide credit reporting companies get their information from different sources, the information in your report from one company may not reflect all, or the same, information in your reports from the other two companies. That's not to say that the information in any of your reports is necessarily inaccurate; it just may be different.

Q: Should I order my reports from all three of the nationwide credit reporting companies at the same time?

A: You may order one, two, or all three reports at the same time, or you may stagger your requests. It's your choice. Some financial advisors say staggering your requests during a 12-month period may be a good way to keep an eye on the accuracy and completeness of the information in your reports.

Q: What if I find errors — either inaccuracies or incomplete information — in my credit report?

A: Under the FCRA, both the credit reporting company and the information provider (that is, the person, company, or organization that provides information about you to a consumer reporting company) are responsible for correcting inaccurate or incomplete information in your report. To take full advantage of your rights under this law, contact the credit reporting company and the information provider.

1. Tell the credit reporting company, in writing, what information you think is inaccurate.

Credit reporting companies must investigate the items in question — usually within 30 days — unless they consider your dispute frivolous. They also must forward all the relevant data you provide about the inaccuracy to the organization that provided the information. After the information provider receives notice of a dispute from the credit reporting company, it must investigate, review the relevant information, and report the results back to the credit reporting company. If the information provider finds the disputed information is inaccurate, it must notify all three nationwide credit reporting companies so they can correct the information in your file.

When the investigation is complete, the credit reporting company must give you the written results and a free copy of your report if the dispute results in a change. (This free report does not count as your annual free report.) If an item is changed or deleted, the credit reporting company cannot put the disputed information back in your file unless the information provider verifies that it is accurate and complete. The credit reporting company also must send you written notice that includes the name, address, and phone number of the information provider.

2. Tell the creditor or other information provider in writing that you dispute an item. Many providers specify an address for disputes. If the provider reports the item to a credit reporting company, it must include a notice of your dispute. And if you are correct — that is, if the information is found to be inaccurate — the information provider may not report it again.

Q: What can I do if the credit reporting company or information provider won't correct the information I dispute?

A: If an investigation doesn't resolve your dispute with the credit reporting company, you can ask that a statement of the dispute be included in your file and in future reports. You also can ask the credit reporting company to provide your statement to anyone who received a copy of your report in the recent past. You can expect to pay a fee for this service.

If you tell the information provider that you dispute an item, a notice of your dispute must be included any time the information provider reports the item to a credit reporting company.

Q: How long can a credit reporting company report negative information?

A: A credit reporting company can report most accurate negative information for seven years and bankruptcy information for 10 years. There is no time limit on reporting information about criminal convictions; information reported in response to your application for a job that pays more than $75,000 a year; and information reported because you've applied for more than $150,000 worth of credit or life insurance. Information about a lawsuit or an unpaid judgment against you can be reported for seven years or until the statute of limitations runs out, whichever is longer.

Q: Can anyone else get a copy of my credit report?

A: The FCRA specifies who can access your credit report. Creditors, insurers, employers, and other businesses that use the information in your report to evaluate your applications for credit, insurance, employment, or renting a home are among those that have a legal right to access your report.

Q: Can my employer get my credit report?

A: Your employer can get a copy of your credit report only if you agree. A credit reporting company may not provide information about you to your employer, or to a prospective employer, without your written consent.

For More Information

The FTC works for the consumer to prevent fraudulent, deceptive, and unfair business practices in the marketplace and to provide information to help consumers spot, stop, and avoid them. To file a complaint, visit ftc.gov/complaint or call 1-877-FTC-HELP (1-877-382-4357). The FTC enters Internet, telemarketing, identity theft, and other fraud-related complaints into Consumer Sentinel, a secure online database available to hundreds of civil and criminal law enforcement agencies in the U.S. and abroad.

Report Scams

If you believe you've responded to a scam, file a complaint with:

- the FTC
- your state Attorney General

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7.6.1.2: Building a Better Credit Report

What is a credit report?

A credit report includes information on where you live, how you pay your bills, and whether you've been sued or have filed for bankruptcy. Nationwide credit reporting companies sell the information in your report to creditors, insurers, employers, and other businesses that, in turn, use it to evaluate your applications for credit, insurance, employment, or renting a place to live.

Why should I check my credit report?

Some financial advisors and consumer advocates suggest that you review your credit report several times a year. Why?

- The information in it affects whether you can get a loan — and how much you will have to pay to borrow money.
- To make sure the information is accurate, complete, and up-to-date before you apply for a loan for a major purchase like a house or car, buy insurance, or apply for a job.
- To help repair possible identity theft. Identity thieves may use your information to open new credit accounts in your name. Then, when they don't pay the bills, the delinquent account is reported on your credit report. Inaccurate information like that could affect your ability to get credit, insurance, or even a job.

How do I get my credit report?

By law, you're entitled to a free copy of your credit report from each of the nationwide credit reporting companies — Equifax, Experian, and TransUnion — once every 12 months. To order, visit **annualcreditreport.com** or call 1-877-322-8228.

You may order reports from one, two, or all three of the companies at the same time, or you may stagger your requests. Some financial advisors say staggering your requests during a 12-month period may be a good way to keep an eye on the accuracy and completeness of the information in your reports. If you're getting ready to apply for a loan or job, you might want to check all three reports at the same time.

To learn more, read **Free Credit Reports** at **consumer.ftc.gov**.

How do I correct errors on my credit report?

Both the credit reporting company and the information provider (that is, the person, company, or organization that provides information about you to a credit reporting company) are responsible for correcting inaccurate or incomplete information in your report once you bring it to their attention. Letting them know involves two steps:

Step One

Tell the **credit reporting company,** in writing, what information you think is inaccurate.

A sample dispute letter is at **consumer.ftc.gov**. Your letter should identify each item in your report you dispute, explain why you dispute the information, and ask that it be removed or corrected. Include copies (NOT originals) of documents that support your position. You may want to enclose a copy of your report with the items in question circled. Send your letter by certified mail, "return receipt requested," so you can document what the credit reporting company received. Keep copies of your dispute letter and enclosures.

Credit reporting companies must investigate the items in question usually within 30 days, unless they consider your dispute frivolous. They also must forward all the relevant data you provide about the inaccuracy to the information provider, which reviews the relevant information, investigates, and reports the results back to the credit reporting company. If the information provider finds the disputed information is inaccurate, it must notify all three nationwide credit reporting companies so they can correct the information in your file.

What happens after the investigation?

When the investigation is complete, the credit reporting company must give you the results in writing and a free copy of your report if the dispute results in a change. If an item is changed or deleted, the credit reporting company cannot put the disputed

information back in your file unless the information provider verifies that it is accurate and complete. The credit reporting company also must send you written notice that includes the name, address, and phone number of the information provider.

If you ask, the credit reporting company must send notices of any corrections to anyone who received your report in the past six months. You can have a corrected copy of your report sent to anyone who received a copy during the past two years for employment purposes.

What if the investigation doesn't resolve my dispute?

Ask that a statement of the dispute be included in your file and in future reports. You also can ask the credit reporting company to provide your statement to anyone who received a copy of your report in the recent past. Expect to pay a fee for this service.

Step Two

Tell the i**nformation provider,** in writing, that you dispute an item in your credit report.

A sample dispute letter is at **consumer.ftc.gov**. Include copies (NOT originals) of documents that support your position. If the provider listed an address on your credit report, send your letter to that address. If no address is listed, contact the provider and ask for the correct address to send your letter. If the information provider does not give you an address, you can send your letter to any business address for that provider.

What if the provider continues to report the disputed item to a credit reporting company?

The provider must let the credit reporting company know about your dispute. And if you are correct — that is, if the information you dispute is found to be inaccurate or incomplete — the information provider must tell the credit reporting company to update or delete the item.

To learn more, read **Disputing Errors on Credit Reports** at

consumer.ftc.gov.

How long can negative information stay on my credit report?

A credit reporting company can report most accurate negative information for seven years and bankruptcy information for 10 years. There is no time limit on reporting information about criminal convictions; information reported in response to your application for a job that pays more than $75,000 a year; and information reported because you've applied for more than $150,000 worth of credit or life insurance. Information about a lawsuit or an unpaid judgment against you can be reported for seven years or until the statute of limitations runs out, whichever is longer. The standard method for calculating the seven-year reporting period starts with the date that the event took place.

How can my credit report affect my job application?

When you apply for a job, employers look at the application you complete and the resume you prepare. Some employers also check into your background before they hire you. Depending on the employer and the job, that background information might include your employment history, your driving record, criminal records, and your credit report.

An employer must get your permission before asking for a report about you from a credit reporting company or any other company that provides background information. If you don't give your okay, your application for employment may not get a second look. That's up to you. But if you don't get the job because of information in your report, the employer has some legal obligations: First, the employer must show you the report; second, the employer must tell you how to get your own copy. The report is free if you ask for it within 60 days of learning the bad news.

To learn more about your rights, read **Employment Background Checks** at **consumer.ftc.gov**.

What is a credit freeze?

A credit freeze, also known as a security freeze, lets you restrict access to your credit report, which in turn makes it more difficult for identity thieves to open new accounts in your name. That's because most creditors need to look at your credit report before approving a new account. If they can't see your file, they may not extend the credit.

You may want to place a credit freeze on your credit reports if you're concerned about the potential consequences of data breaches.

To place a freeze on your credit reports, contact each of the nationwide credit reporting companies:

Equifax — 1 - 800 - 525 - 6285; equifax.com

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

TransUnion — 1 - 800 - 680 - 7289; transunion.com

You'll need to supply your name, address, date of birth, Social Security number and other personal information. Fees vary based on where you live; they commonly range from $5 to $10.

A credit freeze does not:

- affect your credit score
- prevent you from getting your free annual credit report
- keep you from opening a new account, applying for a job, renting an apartment, or buying insurance. If you're doing any of these, you'll need to lift the freeze temporarily, either for a specific time, or for a specific party, say, a potential landlord or employer. The cost and lead times to lift a freeze vary, so it's best to check with the credit reporting company in advance.
- prevent a thief from incurring charges on your existing accounts. You still need to monitor all bank, credit card and insurance statements for fraudulent transactions.

What is a fraud alert?

Unlike a credit freeze that locks down your credit, a fraud alert allows creditors to get a copy of your credit report as long as they take steps to verify your identity. For example, if you provide a telephone number, the business must call you to verify whether you are the person making the credit request. Fraud alerts may be effective at stopping someone from opening new credit accounts in your name, but they may not prevent the misuse of your existing accounts. You still need to monitor all bank, credit card and insurance statements for fraudulent transactions.

There are three types of fraud alerts:

Initial Fraud Alert

If you're concerned about identity theft, but haven't yet become a victim, this fraud alert protects your credit from unverified access for at least 90 days. You may want to place a fraud alert on your file if your wallet, Social Security card, or other personal, financial or account information are ever lost or stolen.

Extended Fraud Alert

For victims of identity theft, an extended fraud alert protects your credit for seven years.

Active Duty Military Alert

For those in the military who want to protect their credit while deployed, this type of fraud alert lasts for one year.

To place a fraud alert on your credit reports, contact one of the nationwide credit reporting companies. A fraud alert is free. You must provide proof of your identity. The company you call must tell the other companies; they, in turn, will place an alert on their versions of your report.

To learn more, visit **ftc.gov/idtheft**.

What is a credit score?

Credit scoring is a system creditors use to help determine whether to give you credit. It also may be used to help decide the credit terms you are offered or the rate you will pay for the loan.

Information about you and your credit experiences, like your bill-paying history, the number and type of accounts you have, whether you pay your bills by the date they're due, collection actions, outstanding debt, and the age of your accounts, is collected from your credit report. Using a statistical program, creditors compare this information to the loan repayment history of consumers with similar profiles. For example, a credit scoring system awards points for each factor that helps predict who is most likely to repay a debt. The total number of points — a credit score — helps predict how creditworthy you are: how likely it is that you will

repay a loan and make the payments when they're due. A higher credit score is taken to mean you are less of a risk, which, in turn, means you are more likely to get credit or insurance — or pay less for it.

What factors affect my credit score?

Credit scoring systems are complex and vary among creditors or insurance companies and for different types of credit or insurance. If one factor changes, your score may change — but improvement generally depends on how that factor relates to others the system considers. Only the business using the system knows what might improve your score under the particular model they use to evaluate your application.

Nevertheless, scoring models usually consider the following types of information in your credit report to help compute your credit score:

Have you paid your bills on time?

You can count on payment history to be a significant factor. If your credit report indicates that you have paid bills late, had an account referred to collections, or declared bankruptcy, it is likely to have a negative effect on your score.

Are you maxed out?

Many scoring systems evaluate the amount of debt you have compared to your credit limits. If the amount you owe is close to your credit limit, it's likely to have a negative effect on your score.

How long have you had credit?

Generally, scoring systems consider your credit track record. An insufficient credit history may affect your score negatively, but factors like timely payments and low balances can offset that.

Have you applied for new credit lately?

Many scoring systems consider whether you have applied for credit recently by looking at "inquiries" on your credit report. If you have applied for too many new accounts recently, it could have a negative effect on your score. Every inquiry isn't counted: for example, inquiries by creditors who are monitoring your account or looking at credit reports to make "prescreened" credit offers are not considered liabilities.

How many credit accounts do you have and what kinds of accounts are they?

Although it is generally considered a plus to have established credit accounts, too many credit card accounts may have a negative effect on your score. In addition, many scoring systems consider the type of credit accounts you have. For example, under some scoring models, loans from finance companies may have a negative effect on your credit score.

Scoring models may be based on more than the information in your credit report. When you are applying for a mortgage loan, for example, the system may consider the amount of your down payment, your total debt, and your income, among other factors.

Improving your score significantly is likely to take some time, but it can be done. To improve your credit score under most systems, focus on paying your bills in a timely way, paying down any outstanding balances, and staying away from new debt.

To learn more, read **How Credit Scores Affect the Price of Credit and Insurance** at **consumer.ftc.gov**.

What are my options for dealing with debt?

Many people face a financial crisis at some point in their lives. Whether the crisis is caused by illness, the loss of a job, or overspending, it can seem overwhelming. But often, it can be overcome. Your financial situation doesn't have to go from bad to worse.

If you get into financial hot water, there are options: credit counseling from a reputable organization, debt consolidation, or bankruptcy. Which path works best for you depends on your level of debt, your level of discipline, and your prospects for the future.

Contact your creditors immediately if you ever have trouble making ends meet. Tell them why it's difficult for you to pay your bills, and try to work out a modified payment plan that reduces your payments to a manageable level. Don't wait until your accounts have been turned over to a debt collector. At that point, your creditors have given up on you.

To learn more, read **Coping with Debt** at **consumer.ftc.gov**.

Got bad credit?

Steer clear of credit repair scams

You see the ads in newspapers, on TV, and online. You hear them on the radio. You get fliers in the mail, email messages, and maybe even calls offering credit repair services. They all make the same claims:

Credit problems? No problem!

We can remove bankruptcies, judgments, liens, and bad loans from your credit file forever!

We can erase your bad credit — 100% guaranteed.

Create a new credit identity — legally.

Do yourself a favor and save some money, too. Don't believe these claims: they're very likely signs of a scam. Indeed, attorneys at the Federal Trade Commission, the nation's consumer protection agency, say they've never seen a legitimate credit repair operation making those claims. The fact is there's no quick fix for creditworthiness. No one can legally remove accurate and timely negative information from a credit report. You can improve your credit report legitimately, but it takes time, a conscious effort, and sticking to a personal debt repayment plan.

To learn more read, **Credit Repair Scams** at

consumer.ftc.gov.

For more information

The FTC works to prevent fraudulent, deceptive and unfair business practices in the marketplace and to provide information to help consumers spot, stop and avoid them. To file a complaint or get free information on consumer issues, visit **ftc.gov** or call toll-free, 1-877-FTC-HELP (1-877-382-4357); TTY: 1-866-653-4261.

Watch a video, **How to File a Complaint,** at **consumer.ftc.gov/media** to learn more. The FTC enters consumer complaints into the Consumer Sentinel Network, a secure online database and investigative tool used by hundreds of civil and criminal law enforcement agencies in the U.S. and abroad.

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SECTION OVERVIEW

7.6.2: Taxes

7.6.2.1: After You've Filed Your Federal Taxes

7.6.2.2: Business Tax Information

7.6.2.3: Filing Your Federal Taxes

7.6.2.4: Frequently Requested Tax Benefits

7.6.2.5: Get Help with Your Taxes

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7.6.2.1: After You've Filed Your Federal Taxes

Find tax information for after you've filed your federal taxes.

What's on This Page

- Check Your Federal Tax Refund Status
- Get Copies and Transcripts of Your Tax Returns
- Pay Federal Taxes and Resolve Tax Disputes
- Tax Liens
- Tax Refund Reductions – Treasury Offset Program
- Undelivered and Unclaimed Federal Tax Refund Checks
- Taxpayer ID Theft: Use IRS.gov to Verify Your Identity

Check Your Federal Tax Refund Status

If you have filed your federal income taxes and expect to receive a refund, you may be eager to find out when you will receive it. You can track the status of your refund using the Internal Revenue Service's Where's My Refund tool or the mobile app, IRS2Go. These systems are updated once every 24 hours. If you prefer, you can call the IRS refund hotline to check on the status of your refund. Refunds are generally issued within 21 days of when you electronically filed your tax return or 42 days of when you filed paper returns.

Get Copies and Transcripts of Your Tax Returns

Do you need a copy of your prior year tax return? If you need an exact copy of a previously filed tax return and attachments, you can get it by mailing the following items:

- A completed Form 4506.
- $50 fee for each tax return requested. The check or money order should be made payable to the United States Treasury.

A transcript, which is a computer printout of your return information, may be an acceptable substitute for an exact copy of your tax return. Instead of paying for a copy of your tax return, you can request a transcript online to get the information you need quickly. Transcripts are often used to validate income and tax filing status for mortgage applications, student and small business loan applications, and during tax preparation. Contact the IRS to obtain a free transcript. If you need federal tax returns from earlier than 3 years ago, call 1-800-908-9946 or submit a completed form 4506-T.

Contact your state's Department of Revenue to find out how to get copies of prior years' state returns.

Pay Federal Taxes and Resolve Tax Disputes

There are several ways to pay your federal taxes: direct pay, debit or credit card, electronic federal tax payment system, and check or money order. Find out how to make a tax payment.

Payment Options for Back Taxes

The IRS provides these options to help you pay your tax debt:

- Call the phone number listed on any letters or documents you received from the IRS for help with tax payments.
- Get information on alternative payment plans and hardship information.
- Learn about the IRS Fresh Start Program to help you pay back taxes and avoid tax liens.

Resolve Tax Disputes

Get help resolving your tax disputes with the IRS and understanding your rights and responsibilities as a taxpayer:

- Taxpayer Advocate Service (TAS) – Find out if you are eligible for this free service by contacting TAS at 1-877-777-4778 (TTY: 1-800-829-4059) or by checking with a local taxpayer advocate.
- Low-Income Taxpayer Clinics (LITCs) – Contact a local LITC for free or low-cost services. This resource is also available to taxpayers who speak English as a second language (ESL).

- Office of Appeals – This independent organization within the IRS helps resolve your tax disputes without going to tax court. Learn whether an appeal is right for you.

Tax Liens

A tax lien is the government's legal claim against your property when you neglect, or fail, to pay a tax debt. As a tax lien can affect you in many ways, it's helpful to know the steps you can take to find a solution.

How a Tax Lien Affects You

- **Assets** – A lien attaches to all of your assets (property, securities, vehicles) and to future assets acquired during the period of the lien.
- **Credit –** Tax liens can show up on your credit report, making it more difficult for you to get a loan, or buy and sell property.
- **Business** – A lien is tied to all business property and to all rights to business property, including accounts receivable.
- **Bankruptcy –** If you file for bankruptcy, your tax debt, lien, and all public documents alerting creditors that the government has a right to your property may continue after the bankruptcy.

How to Get Rid of a Tax Lien

Paying your tax debt in full is the best way to get rid of a tax lien. The Internal Revenue Service (IRS) will release a federal tax lien within 30 days after you have paid your tax debt. However, there are other options to reduce the impact of a tax lien:

- **Discharge of property –** A "discharge" removes the lien from selected property, but there are several Internal Revenue Code (IRC) conditions. For more information, refer to Publication 783, Instructions on How to Apply for Certificate of Discharge From Federal Tax Lien.
- **Subordination –** While "subordination" does not remove the lien, it allows other creditors to move ahead of the IRS, which may make it easier to get a loan or mortgage. To learn more, read Publication 784, Instructions on How to Apply for a Certificate of Subordination of Federal Tax Lien.
- **Withdrawal –** A "withdrawal" removes the public Notice of Federal Tax Lien and assures that the IRS is not competing with other creditors for your property. But you are still liable for the amount due. For eligibility, refer to Form 12277, Application for the Withdrawal of Filed Form 668(Y), Notice of Federal Tax Lien, Internal Revenue Code Section 6323j.

For assistance removing a state tax lien, contact your state revenue department. To help release a local government tax lien, contact your local government tax entity.

IRS Resources

Centralized Lien Operation

To resolve basic and routine lien issues, such as verifying a lien, requesting a lien payoff amount, or releasing a lien, call or write to:

Phone: 1-800-913-6050
Internal Revenue Service
Lien Processing Unit
PO Box 145595
Stop 8420G
Cincinnati OH 45250-5595

IRS Video Portal

Watch informational videos on various tax lien issues, including lien notice withdrawal, selling or refinancing when there is an IRS lien, and applying to the IRS for a lean discharge or subordination.

Tax Refund Reductions – Treasury Offset Program

If you owe money to a federal or state agency (including past-due child support), the federal government may deduct your debts from your federal tax refund. Known as the Treasury Offset Program (TOP), the Bureau of Fiscal Service (BFS) collects such delinquent debts (typically more than 90 days overdue) on behalf of other federal and state government agencies.

BFS will cross check your name and taxpayer information against its delinquent debtor database. If there is a match, BFS will notify you that it is deducting the amount you owe from the payment you were going to receive. BFS will send the outstanding amount to the federal or state government agency to which you owed the money. If you owe more money than the payment you were going to receive, then BFS will send the entire amount to the other government agency. If you owe less, BFS will send the agency the amount you owed, and then send you the remaining balance.

For example, if you were going to receive a $1,500 federal tax refund, but you have been delinquent on a student loan and have $1,000 outstanding, BFS will deduct $1,000 from your tax refund and send it to the U.S. Department of Education. It will also send you a notice of its action, along with the remaining $500 that was due to you as a tax refund.

The Internal Revenue Service (IRS) provides helpful tips to help you understand tax refund offsets. If you believe that a deduction was made in error, you should contact the agency that said you owed money, not the IRS. Call the TOP call center at 1-800-304-3107 if you need help locating the agency you need to contact. If you have questions about this program, check out the frequently asked questions or contact the Bureau of Fiscal Service.

Undelivered and Unclaimed Federal Tax Refund Checks

Every year, the Internal Revenue Service (IRS) has millions of dollars in tax refunds that go undelivered or unclaimed.

Undelivered Federal Tax Refund Checks

Refund checks are mailed to your last known address. If you move without notifying the IRS or the U.S. Postal Service, your refund check may be returned to the IRS.

If you were expecting a federal tax refund and did not receive it, check the IRS' Refund Status. You'll need to enter your Social Security number, filing status, and the exact whole dollar amount of your refund. You may be prompted to change your address online. You can also call the IRS' Refund Hotline.

If you move, submit a Change of Address – Form 8822 to the IRS; you should also submit a Change of Address to the U.S. Postal Service.

Unclaimed Federal Tax Refunds

If you are eligible for a federal tax refund and do not file a return, then your refund will go unclaimed. Even if you aren't required to file a return, it might benefit you to file if:

- Federal taxes were withheld from your pay

and/or

- You qualify for the Earned Income Tax Credit (EITC)

If you didn't file a tax return because your wages were below the filing requirement, you can still file a return within three years of the filing deadline in order to get your refund.

State Refund Checks

For information about your state tax refund check, contact your state revenue department.

Contact the IRS

For more information, contact the Internal Revenue Service.

Taxpayer ID Theft: Use IRS.gov to Verify Your Identity

The IRS stops and flags suspicious or duplicate federal tax returns that falsely represent your identity, such as your name or social security number. If the IRS suspects tax ID theft, the agency will send a 5071C letter to your home address. If you receive this letter, verify your identity at idverify.irs.gov or call the toll free number listed in the letter.

If you are a victim of state tax ID theft, contact your state's taxation department or comptroller's office about the next steps you need to take.

The IRS provides more information about IDVerifyIRs.gov and your 5071C letter.

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7.6.2.2: Business Tax Information

Learn about business taxes and incentives.

What's on This Page

- Business Taxes
- Energy Tax Incentives
- Estimated Taxes

Business Taxes

As a business owner, it's important to understand your federal, state, and local tax requirements. This will help you file your taxes accurately and make payments on time. The business structureyou choose when starting a business will determine what taxes you must pay and how you pay them.

Business taxes cover a wide range of categories:

Income Tax

All businesses, except partnerships, must file and pay taxes on any income earned or received during the year. Partnerships file an annual information return to report income, gains, losses, and other important tax information. Almost every state imposes a business or corporate income tax, though each state and locality has its own tax laws. Find out the business income tax requirements in your state or territory.

Employment Taxes

If you have employees, there are federal tax requirements for what you must pay and the forms you have to file. These employment taxes include Social Security and Medicare taxes, federal income tax withholding, and federal unemployment (FUTA) tax. In all states, businesses must pay state workers' compensation insurance and unemployment insurance taxes.

Excise Tax

The federal government taxes businesses that manufacture or sell certain products. You may also have to pay this tax in other situations, including if your business uses various types of equipment, facilities, or other products. Learn about federal excise tax requirements and the forms you must file.

Property Tax

Each of the 50 states have different definitions of what property is taxable. Some states collect property tax from businesses in commercial real estate locations. Certain states also collect property tax for business assets, such as vehicles, computer equipment, and peripherals. The amount of tax you pay is calculated by the total value of the property or on a certain percentage of the value. Search for property tax requirements in your state.

Sales and Use Tax

States may impose a tax on the sale of goods and services. Check whether your business has to register to pay and/or collect sales tax in your state. Exclusions in sales tax often include food, clothing, medicine, newspapers, and utilities.

States may also tax your business on the use of goods and services when sales tax has not been collected. This typically applies to goods and services purchased outside of the state where you conduct business.

Estimated Tax

You must pay federal tax on income that is not subject to withholding or when the amount of your federal income tax being withheld is not enough. Find out if your business has to pay estimated taxes and the steps to follow.

Self-Employment Tax

When conducting your own business, you must pay Social Security and Medicare taxes to be covered under the Social Security system. Learn about who must pay self-employment tax and how to pay it.

Energy Tax Incentives

Purchasing energy efficient appliances or making energy saving improvements to your home or business can save money, in the form of tax incentives (tax credits and rebates) or sales tax holidays. Tax credits can help reduce the amount of tax you owe, while rebates can lead to cash back from your purchase.

Find out if you qualify for state, local, utility, and federal incentives:

- Database of State Incentives for Renewables and Efficiency (DSIRE) – Explore incentives and policies in your state that support renewable energy and energy efficiency.
- Department of Energy (DOE): Tax Credits, Rebates, and Savings – Select your state to find savings that may be available for you or your business in your state.
- Offers and Rebates from Energy Star Partners – Search for rebates on certified energy-efficient products and other special offers in your area.
- Residential Renewal Energy Tax Credit – Qualify for tax credits for buying a solar-electric or solar water-heating property for your home.
- Sales tax holidays– Find out if your state offers a sales tax holiday for buying energy efficient appliances.

Estimated Taxes

Estimated tax is the method used to pay taxes on income that is not subject to withholding. This includes income from self-employment, interest, and dividends. You may also have to pay estimated tax if the amount of income tax being withheld from your salary, pension, or other income is not enough.

Who Has to Pay Estimated Taxes?

Individuals who conduct their own business typically have to make estimated tax payments. You may be charged a penalty if you do not pay enough through withholding or estimated tax payments.

Find out if you have to make estimated tax payments and how to pay.

When Are Estimated Taxes Due?

The year is divided into four periods to pay estimated tax. Each period has a specific payment deadline.

These are the 2017 Estimated Federal Tax due dates:

- April 18
- June 15
- Sept. 15
- Jan. 16 of the next year

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7.6.2.3: Filing Your Federal Taxes

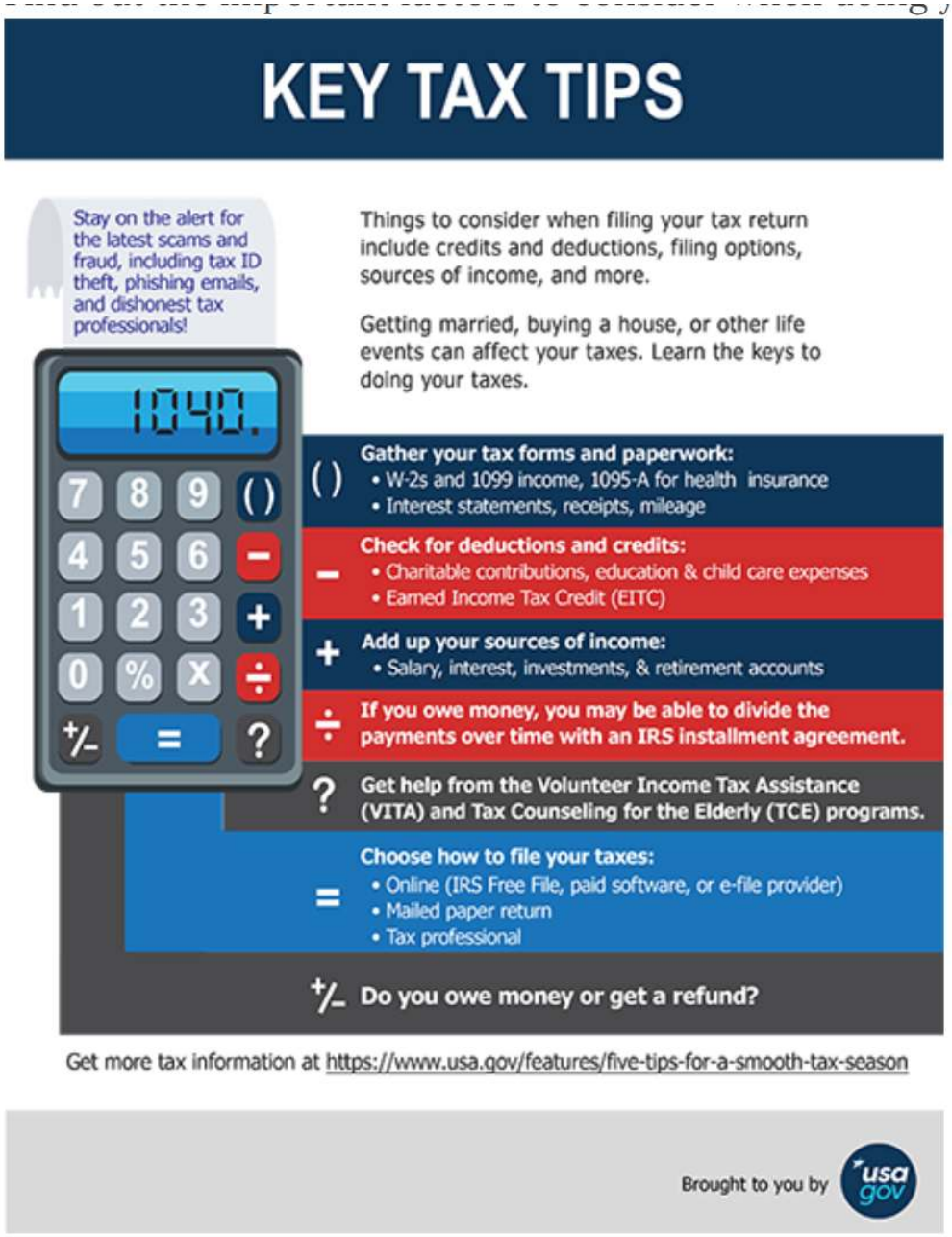
Find out how to file your federal taxes, get an extension, and more.

What's on This Page

- Key Tax Tips
- File a Federal Income Tax Return
- Extension to File Your Tax Return
- IRS Imposter Scams
- 1099 Income Statements
- Federal Tax Filing Season
- Get Tax Forms and Publications
- Get Your W-2 Before Tax Time
- IRS Mailing Addresses
- Taxpayer Identification Numbers (TINs)

Key Tax Tips

Find out the important factors to consider when doing your taxes.



File a Federal Income Tax Return

The government collects taxes to pay its bills and provide public goods and services. The Internal Revenue Service (IRS) is the nation's tax collection agency.

The taxes you owe to the government are generally paid through withholding (money taken out of your paycheck), estimated tax payments, and payments made when you file your taxes each year.

You may not have to file a federal income tax return if your income is below a certain amount. However, you must file a tax return to claim a refundable tax credit or a refund on income tax withheld.

- Find out if you have to file a tax return.

If you have to file a tax return:

- Determine your filing status.
- See if you qualify for free tax return preparation.
- Choose the simplest form for your tax situation.
- Figure your taxes and credits.
- Claim your dependents and exemptions.
- Determine if you need to pay quarterly estimated taxes.
- File your taxes online or mail your paper tax return.

Tax Payment Information

There are several ways to pay your federal taxes: direct pay, debit or credit card, electronic federal tax payment system, or check or money order. Find out how to make a tax payment.

Tax Refund Information

If you are expecting a refund, you can check your federal tax refund status online or call the Refund Hotline. If you have questions about the status of your refund within the first 21 days after filing electronically, the IRS will direct you to the online Where's My Refund? tool.

You can choose to receive your tax refund by direct deposit, U.S. Series I Savings Bonds, or paper check.

Contact the IRS

For more information, contact the IRS.

Extension to File Your Tax Return

Do you need more time to prepare your tax return?

If you are unable to file your federal income tax return by the due date, you may be able to get an extension from the Internal Revenue Service (IRS). But this does not grant you more time to pay your taxes.

You may be able to get an automatic six-month extension to file your return. To do so, you must file IRS Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return by the due date for filing your calendar year return (usually April 15) or fiscal year return. For a Spanish version of this form, download IRS Form 4868sp.

Special rules may apply if you are:

- Living outside the United States.
- Out of the country when your six-month extension expires.
- Living in a combat zone or a qualified hazardous area.

Get filing information about your tax return, including guidelines on extensions of time to file.

IRS Imposter Scams

You may get a call from someone pretending to be from the IRS who claims you owe taxes. This caller will typically demand immediate payment and threaten you with arrest or lawsuits for not paying. Individuals carrying out this fraud will also make the caller ID appear as if the IRS is calling. Learn the signs to watch out for and how to report IRS imposter scams.

Signs of an IRS Imposter Scam

The IRS will always contact you by mail before calling you about unpaid taxes and will never:

- Demand immediate payment
- Ask for a specific payment method, such as a prepaid debit card, gift card, or wire transfer
- Threaten you with arrest or deportation for not paying your taxes
- Request personal or financial information by email, texting, or any social media

Report an IRS Imposter Scam

Follow these steps if you get a call from someone claiming to be from the IRS asking for a payment and have not first been contacted by the IRS by mail:

- If you owe federal taxes or think you might owe taxes, hang up and get helpful online tools from the IRS. You can also call the IRS about payment questions at 1-800-829-1040 or 1-800-829-4059 (TTY).
- If you don't owe taxes, report the scam to the Treasury Inspector General for Tax Administration (TIGTA) by calling 1-800-366-4484.
- You can also file a complaint with the Federal Trade Commission (FTC) or call 1-877-FTC-HELP (1-877-382-4357). Please add "IRS Telephone Scam" to your complaint description.
- Help keep others safe by reporting all unsolicited online messages claiming to be from the IRS (or related to their work) to phishing@irs.gov.
- Learn how to protect yourself from and report other scams and fraud.

1099 Income Statements

Businesses and government agencies use Form 1099 to report various types of income other than wages, salaries, and tips to the Internal Revenue Service (IRS).

Every business or agency must:

- Complete a Form 1099 for each transaction.
- Retain a copy for its records.
- Send a copy to you and to the IRS. You should receive your copy by early February (or mid-to-late February for Form 1099-B).

You must include this income on your federal tax return.

Incorrect or Missing Form 1099

If you do not agree with the information contained in your Form 1099, contact the business or agency that issued it.

If you did not receive your Form 1099, contact the business or agency that should have issued it.

Contact the IRS

If you requested Form 1099 from a business or agency and did not receive it, contact the IRS.

Federal Tax Filing Season

The Internal Revenue Service (IRS) began accepting and processing federal tax returns for tax year 2016 on January 23, 2017. You have until April 18, 2017 to file your tax return unless you file for an extension.

Help and Resources

- To help you prepare and file your return, the IRS offers free online tools and special programs for qualifying taxpayers.
- If you owe the IRS money, learn about your payment options. If the IRS owes you money, you can choose to receive your tax refund by direct deposit, U.S. Series I Savings Bonds, or paper check.
- File your federal tax return online or find out the address for mailing your paper return.
- For more information, contact the IRS.

Get Tax Forms and Publications

Federal Tax Forms

You can get free tax forms and publications you need directly from the Internal Revenue Service (IRS) by downloading them from IRS.gov or ordering by phone at 1-800-829-3676. You can also get them from locations in your community, such as taxpayer

assistance centers and libraries.

Many forms and publications are available in multiple years and file formats, including Section 508 accessible PDFs and Braille or text formats.

State Tax Forms

Download your state's tax forms and instructions and instructions for free

Get Your W-2 Before Tax Time

The Wage and Tax Statement, commonly known as a W-2 form, is an important document to have at tax time. This form shows the income you earned for the year and the taxes withheld from those earnings. If you have had several jobs over the year, you may have several W-2 forms to file your tax return. Employers must send you your W-2 by January 31 for the earnings from the previous calendar year of work.

If you were an employee and haven't received your W-2 by January 31 or the information is incorrect, the Internal Revenue Service (IRS) offers some tips on what you can do. Employers that have questions about filing W-2 forms for your employees can check these resources on where, when, and how to file from the IRS.

For more information, contact the Internal Revenue Service.

IRS Mailing Addresses

The Internal Revenue Service (IRS) provides mailing addresses for tax returns, non-return forms, applications, and payments. There are several mailing addresses; the correct one to use depends on the purpose of contact and the region of the country you are in:

- Paper Tax Returns (with or without a payment)
- Non-Return Forms (applications and payments)

You can also check a form's corresponding instructions for a mailing address.

Contact the IRS

For more information, contact the IRS.

Taxpayer Identification Numbers (TINs)

A Taxpayer Identification Number (TIN) is an identification number that you need to include on returns, statements, and other tax-related documents.

There are many types of TINs for a variety of tax situations:

- Employer Identification Number (EIN) – This is also known as a federal tax identification number, and is used to identify a business.
  - Learn how to apply for an EIN.
  - If your business structure or ownership has changed, you may need a new EIN.
  - Learn about business taxes, the forms you need to file, and more.
- Social Security Number (SSN) – You need this nine-digit number to get a job, receive Social Security benefits, and other government services.
  - Find out how to get a new, replacement, or corrected card.
- Individual Taxpayer Identification Number (ITIN) – This tax processing number is only available for certain nonresident and resident aliens, their spouses, and dependents who cannot get a SSN.
  - To obtain an ITIN, you must complete IRS Form W-7, IRS Application for Individual Taxpayer Identification Number. Note: You must renew your ITIN if it has not been used on a federal income tax return in the last three years or if it was

issued before 2013.

- Adoption Taxpayer Identification Number (ATIN) – A temporary nine-digit number issued by the IRS to individuals who are in the process of legally adopting a U.S. citizen or resident child, but who cannot get an SSN for that child in time to file their tax return.
  - To apply for an ATIN, you must complete Form W-7A, Application for Taxpayer Identification Number for Pending U.S. Adoptions.
- Preparer Tax Identification Number (PTIN) – If you are a paid tax preparer you must use a valid Preparer Tax Identification Number (PTIN) on returns you prepare.
  - To get a PTIN, use the IRS sign-up system.

The Social Security Administration (SSA) issues a SSN and the Internal Revenue Service (IRS) issues all other TINs.

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7.6.2.4: Frequently Requested Tax Benefits

Learn about tax relief, benefits, and incentives.

What's on This Page

- Earned Income Tax Credit
- Tax Benefits for Education
- Energy Tax Incentives
- Federal Tax Deductions for Charitable Donations
- Mortgage Debt Forgiveness
- Tax Relief in Disaster Situations

Earned Income Tax Credit

If you earn a low to moderate income, the Earned Income Tax Credit (EITC) can help you by reducing the amount of tax you owe. To qualify, you must meet certain requirements and file a tax return, even if you do not owe any tax or are not required to file. If EITC reduces your tax to less than zero, you may get a refund.

Who Qualifies for EITC?

You qualify for EITC if:

- You have earned income and adjusted gross income within certain limits; AND
- You meet certain basic rules; AND

You either:

- Meet the rules for those without a qualifying child; OR
- Have a child who meets all the qualifying rules for you, or your spouse if you file a joint return.

EITC has special rules for members of the military, members of the clergy and taxpayers with certain types of disability income or children with disabilities.

EITC Resources

The Internal Revenue Service (IRS) provides resources covering the Earned Income Tax Credit (EITC):

- Use the EITC Assistant to find out your filing status, if your child qualifies, if you are eligible, and the amount of credit you may receive.
- If you or your spouse is a nonresident alien, refer to Publication 519, U.S. Tax Guide for Aliensto find out if you qualify for EITC.

Tax Benefits for Education

Paying for college or graduate school is a big financial responsibility. To help with your expenses for higher education, there are various tax benefits available:

Credits

An education credit helps by reducing the amount of tax owed on your tax return. If the credit reduces your tax to less than zero, you may get a refund.

There are two education credits available:

- **American Opportunity Tax Credit –** This is a credit for qualified education expenses paid for an eligible student for the first four years of higher education. You can get a maximum annual credit of $2,500 per eligible student.
- **Lifetime Learning Credit** – This credit is for qualified tuition and related expenses paid for eligible students enrolled in an eligible educational institution. It can help pay for undergraduate, graduate, and professional degree courses—including courses to acquire or improve job skills. There is no limit on the number of years you can claim the credit.

Deductions

A deduction reduces the amount of your income that is subject to tax, thus reducing the amount of tax you may have to pay.

There are several types of deductions for education:

- Tuition and fees deduction
- Student loan interest deduction
- Qualified student loan
- Qualified education expenses

Savings Plans

Some savings plans allow the accumulated earnings to grow tax-free until money is taken out (known as a distribution), or allow the distribution to be tax-free. Other savings plans allow both tax-free accumulated earnings and distribution.

There are two types of savings plans available:

- **529 Plans –** States, colleges, and groups of colleges sponsor these qualified tuition programs—authorized under section 529 of the Internal Revenue Code—to either prepay or contribute to an account for paying a student's qualified higher education expenses.
- **Coverdell Education Savings Account –** This account was created as an incentive to help parents and students save for education expenses. Unlike a 529 plan, a Coverdell ESA can be used to pay a student's eligible K-12 expenses as well as post-secondary expenses.

Scholarships and Fellowships

A **scholarship** generally represents an amount paid for the benefit of a student at an educational institution to aid in the pursuit of studies. The student may be either an undergraduate or a graduate. A **fellowship** is generally an amount paid for the benefit of an individual to aid in the pursuit of study or research.

- Whether the scholarship or fellowship is tax-free or taxable depends on the expense paid with the scholarship or fellowship amount, and whether you are a degree candidate.

Exclusions from Income

You may exclude certain educational assistance benefits from your income. That means that you won't have to pay any tax on them. However, it also means that you can't use any of the tax-free education expenses as the basis for any other deduction or credit, including the lifetime learning credit.

Help and Resources

The IRS provides comprehensive information and resources covering tax benefits for education:

- Refer to Tax Benefits for Education to compare the various benefits.
- Use the Interactive Tax Assistant to help determine if you're eligible for educational credits or deductions, including the American opportunity credit, the lifetime learning credit, and the tuition and fees deduction.

Energy Tax Incentives

Purchasing energy efficient appliances or making energy saving improvements to your home or business can save money, in the form of tax incentives (tax credits and rebates) or sales tax holidays. Tax credits can help reduce the amount of tax you owe, while rebates can lead to cash back from your purchase.

Find out if you qualify for state, local, utility, and federal incentives:

- Database of State Incentives for Renewables and Efficiency (DSIRE) – Explore incentives and policies in your state that support renewable energy and energy efficiency.

- Department of Energy (DOE): Tax Credits, Rebates, and Savings – Select your state to find savings that may be available for you or your business in your state.
- Offers and Rebates from Energy Star Partners – Search for rebates on certified energy-efficient products and other special offers in your area.
- Residential Renewal Energy Tax Credit – Qualify for tax credits for buying a solar-electric or solar water-heating property for your home.
- Sales tax holidays– FInd out if your state offers a sales tax holiday for buying energy efficient appliances.

Federal Tax Deductions for Charitable Donations

You may be able to claim a deduction on your federal taxes if you donated to a 501(c)3 organization. In order to deduct your donations you must file an itemized federal tax return, along with Schedule A and a form 8283 for your non-cash donations.

The amount of money that you can deduct on your taxes may not be equal to the total amount of your donations. If you donate non-cash items, you can claim the fair market value of the items on your taxes.

If you donated a vehicle, the amount of your deduction depends on if the car is used by the organization or sold at an auction. The IRS's publication "A Donor's Guide to Vehicle Donation" explains how your deduction is determined and the documents you must have to claim a deduction.

If you donated money to the charity and you received a gift in exchange, or if part of your contribution paid for a dinner, event entrance, or registration in a race, the entire amount is not tax deductible. Rather, the only part of your donation that you can deduct on your federal income taxes is the amount that is in excess of the value of the gift, dinner, or race.

Recordkeeping

Keep records of your donations to charities. You may not have to send these documents with your tax returns, but these documents are good to include with your other tax records. Some common documents include:

- Canceled check to the organization
- Credit card statement showing a payment to the organization
- Receipt from the organization
- Annual giving statement from the charity or non-profit
- Email confirmation from the organization
- Written acknowledgment for vehicle donations
- Itemized list of the items you donated
- Vehicle identification number for vehicle donations
- Signed over vehicle title
- Phone bill, if you gave a donation through a text message
- Valuations of stocks, real estate, art, or jewelry donated to a charity

There are some pieces of information that may be included in receipts and giving statements:

- Name of the organization
- Date of the donation
- Amount of the donation
- Statement that no goods or services were provided by the charity in return for your donation (if that was the case)
- Vehicle identification number (VIN) for vehicle donations

Mortgage Debt Forgiveness

Canceled debt is normally taxable to you. But homeowners whose mortgage debt was partly or entirely forgiven during tax years 2007 through 2014 may qualify as an exception. The Mortgage Forgiveness Debt Relief Act of 2007 covers key points about mortgage debt forgiveness:

- Homeowners whose mortgage debt was partly or entirely forgiven from tax years 2007 through 2014 may be able to exclude up to $2 million.

- The limit is $1 million for a married person filing a separate return.
- You may exclude debt reduced through mortgage restructuring as well as mortgage debt forgiven in a foreclosure.
- To qualify, the debt must have been used to buy, build, or substantially improve your principal residence and be secured by that residence.
- Refinanced debt proceeds used to substantially improve your principal residence also qualify for the exclusion.
- Proceeds of refinanced debt used for other purposes (to pay off credit card debt, etc.) do not qualify for the exclusion.

Eligibility

To determine if your canceled mortgage debt is taxable, use the Interactive Tax Assistant (ITA) from the IRS.

- If you qualify for the special exclusion, fill out Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, and attach the completed form to your federal income tax return for the tax year in which the qualified debt was forgiven.

Tax Relief in Disaster Situations

Major disasters and emergencies in your area affect families and businesses. The Internal Revenue Service (IRS) offers special tax law provisions to help individuals and businesses recover financially from the impact of a disaster. In a federally-declared disaster area, you can get a faster refund by filing an amended return and claiming disaster-related losses on your tax return for the previous year.

The IRS provides guidance for those affected by disasters, such as how to amend tax returns or file an extension.

You may also contact the IRS for more information on tax relief in disaster situations.

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7.6.2.5: Get Help with Your Taxes

Learn if you're eligible for free help with your tax returns.

What's on This Page

- Free Income Tax Return Preparation Help
- Free Federal Tax Resources for Seniors and Retirees
- Tax Help for Individuals with Disabilities

Free Income Tax Return Preparation Help

The Internal Revenue Service (IRS) provides free publications, forms, and tools to help all taxpayers fulfill their tax obligation:

- Forms and Publications – Get the most popular forms and instructions, or search for specific titles or product numbers. The IRS also offers forms and publications for taxpayers with visual impairments.
- Tools – Find interactive forms, calculators, and other helpful tools.
- Help and Resource Center – Learn about the many free services and resources that the IRS offers to taxpayers.
- Choose a Tax Preparer – Get tips for finding a tax preparer with the credentials and experience to handle your tax needs. Learn how to file a complaint if your preparer has acted improperly.

Special Programs for Eligible Taxpayers

If you qualify, the following free tax return preparation programs are available:

- Volunteer Income Tax Assistance (VITA) – VITA offers free tax help to people who generally make $54,000 or less; persons with disabilities; the elderly; and taxpayers with limited English. IRS-certified volunteers provide information about tax credits and prepare a basic tax return with electronic filing.
- Tax Counseling for the Elderly (TCE) – TCE offers free tax help to all taxpayers. They offer specialized help to those who are 60 years and older, and have pension or retirement questions. IRS-certified volunteers specialize in questions about pensions and retirement-related issues unique to seniors.

Contact the IRS

For more information, contact the Internal Revenue Service.

Free Federal Tax Resources for Seniors and Retirees

The Internal Revenue Service (IRS) offers resources to answer your federal tax questions and address topics that matter to you.

- Seniors and Retirees Page—Find answers to federal tax related issues such as tax preparation and tax counseling, along with information to help you avoid common mistakes or tax related scams.
- Tax Guide for Seniors—Review the federal tax preparation guide for seniors.
- Credits for the Elderly or Disabled—Find out if you qualify for federal tax credits for the elderly.
- Free Tax Preparation Services—See if you qualify for the IRS's Volunteer Income Tax Assistance (VITA) program, which offers free federal tax return preparation for seniors. You can also locate the VITA center near you.
- Frequently Asked Questions—Visit the FAQs for seniors or retirees for answers to your federal tax questions.

For more information about federal tax resources, contact the Internal Revenue Service. Contact your state's tax department to get information about state tax laws and resources.

Tax Help for Individuals with Disabilities

The Internal Revenue Service (IRS) offers tax assistance and resources for individuals with disabilities:

- Contact your local IRS office for more information on services available to people with disabilities.
- Sponsored by the IRS, the Volunteer Income Tax Assistance (VITA) program offers free tax help to persons with disabilities. Find a VITA site near you.
- Find tax forms and publications for people with disabilities at IRS.gov Accessibility. This resource contains a current list of accessible tax products available by download. If you prefer hardcopy Braille or large print, please call the IRS at 1-800-TAX-

FORM (1-800-829-3676).

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7.6.3: Credit Cards Auto Loans and Other Personal Debt

How Much Have Americans Borrowed?

Prior to the Pandemic (and the subsequent recession), household or consumer debt outstanding was at an all-time high.

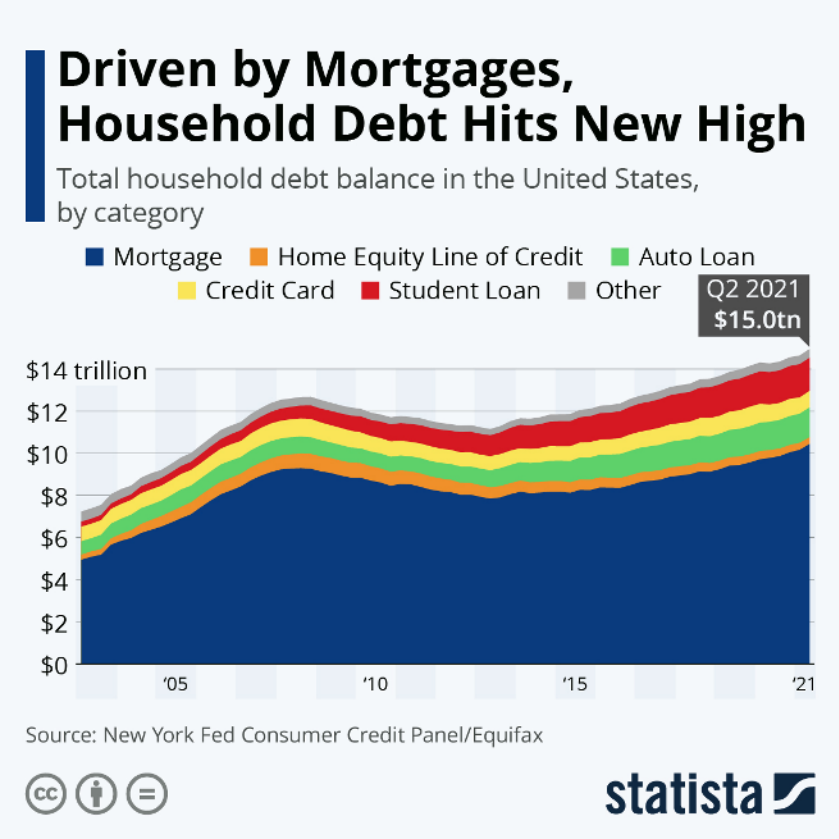


Figure 7.6.3.1: Household Debt Hits New High by Statista is used under a CC BY-ND 3.0 License.

The total amount of consumer credit outstanding at the end of the first quarter of 2020 was $14.3 trillion. Of this amount, here are the types and amounts of the outstanding loans as of the end of Q1, 2020 (note that the Pandemic Recession began in February 2020, but the President's order to shut down restaurants, hotels, bars, etc. was March 16, 2020).

Household Debt and Credit Developments as of Q1 2020

CATEGORY	QUARTERLY CHANGE * (BILLIONS $)	ANNUAL CHANGE** (BILLIONS $)	TOTAL AS OF Q1 2020 (TRILLIONS $)
MORTGAGE DEBT	(+) $156	(+) $469	$9.71
HOME EQUITY LINE OF CREDIT	(-) $4	(-) $20	$0.39
STUDENT DEBT	(+) $27	(+) $49	$1.54
AUTO DEBT	(+) $15	(+) $66	$1.35
CREDIT CARD DEBT	(-) $34	(+) $45	$0.89
OTHER	(-) $5	(+) $23	$0.43
TOTAL DEBT	(+) $155	(+) $632	$14.30

*Change from Q4 2019 to Q1 2020
** Change from Q1 2019 to Q1 2020

Figure 7.6.3.2: Household Debt and Credit Developments as of Q1 2020 by Federal Reserve Bank of New York has no known copyright restrictions.

What Determines Interest Rates

As a practical matter, we need to divide interest rates into short-term interest rates—those where the principle must be repaid in one year or less—and long-term interest rates—those where the principle must be repaid over a period in excess of one year. Some short-term interest rates include credit cards, treasury bonds with maturity of less than one year, business or personal lines of credit, and corporate paper loans. Long-term interest rates include automobile loans, home mortgages, student loans, and home equity lines of credit.

Interest rates, both short- and long-term, are ultimately determined like any good or service; that is, by the laws of demand and supply. The equilibrium interest rate and equilibrium quantity of loans borrowed is determined by the intersection of demand for loans and supply of loans. The graph below calls the good we are examining financial capital. It is often also called the demand and supply of loanable funds or the demand for and supply of loans.

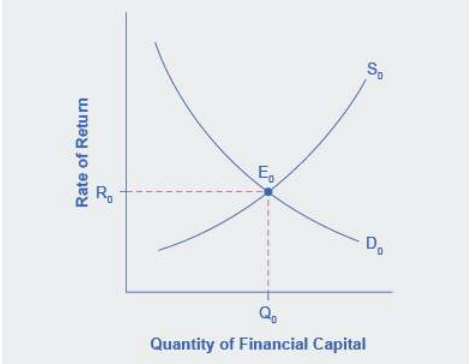


Figure 7.6.3.3: The United States as a Global Borrower Before and After U.S. Debt Uncertainty by Steven A. Greenlaw and David Shapiro is used under a CC BY 4.0 License.

We can see who creates the demand for loans and the supply of loans by using a simple model known as the circular flow of the economy. Households supply labor to firms and receive wages in return. Firms produce goods and services by using labor along with the plants and equipment they own (physical capital), as well as natural resources and raw materials (sometimes called "land"). Firms then sell these goods and services to households (consumption spending). Households spend some of their disposable income and save some of it:

$$\text{Disposable Income} = \text{Consumption} + \text{Saving}$$

Households put their savings into banks or stocks or bonds, therefore:

$$\text{Savings} = \text{Investment}$$

The savings that households deposit in banks are the Supply of Loanable Funds.

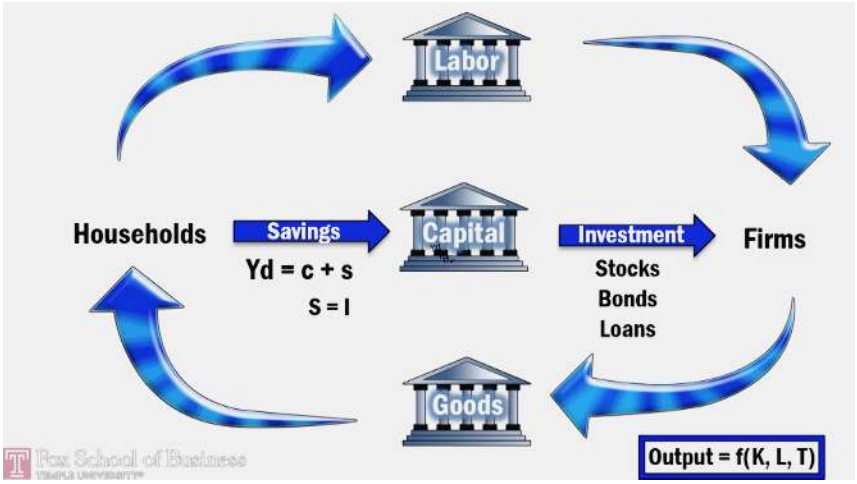


Figure 7.6.3.4: Market for Loanable Funds

Households supply Loanable Funds to banks through deposits. How much Loanable Funds households supply is determined by the price they will be paid for their savings (the interest rate) and other factors, such as how much income they make. Firms, households and the government demand Loanable Funds. The price of Loanable Funds and other factors, such as the state of the economy, determine how large the demand is. Banks are the intermediaries, who collect the deposits and lend them out to the borrowers, adding a markup, of course, to cover their overhead and to create a profit for their stockholders.

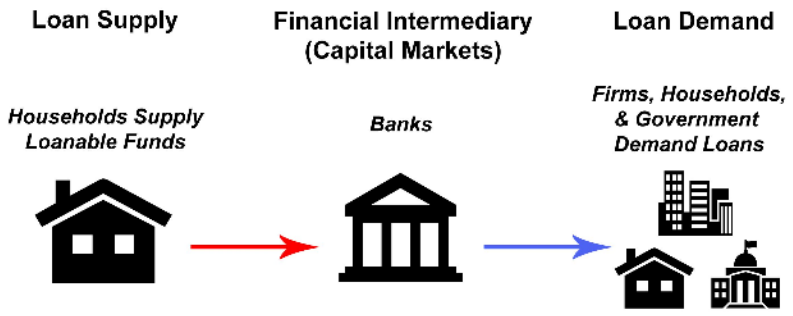


Figure 7.6.3.5: The Three-Sector Economy Model by North Broad Press adapts Owning a Home, Bank Account, Government Building, and Ciudad (by Ecelan) and is used under a CC BY-SA 4.0 License.

In general, financial intermediaries are in business to make a profit. While this is not true of credit unions, they still have to pay interest to their depositors, cover their workers' wages, and fund overhead; they just do not have to make money above their expenses to pay to stockholders. In any case, financial intermediaries supply banking services. As a producer of banking services, we can characterize their production function like any other firm:

$$\text{Output} = f(\text{K}, \text{L}, \text{T})$$

$$\mathrm{K} = PhysicalCapital(Plants, EquipmentandRawMaterials)$$

$$\mathrm{L} = Labor(\#ofEmployeesorAnnualHoursWorked)$$

$$\mathrm{T} = Technology(LevelofTechnology, e.g. handmadeorautomated)$$

For any firm, the definition of profit is:

$$\text{Profit} = \text{Total Revenue} - \text{Total Costs}$$

For financial intermediaries, their total revenue is the interest they earn on the loans they make plus some investment returns (usually Treasury Bonds). Their costs are the interest they pay their depositors, interest on Commercial Paper, physical capital expenses, and employee wages. Thus, a financial intermediary defines profit as such:

Profit = Interest Earned on Loans -

Interest Paid on Deposits Cost of Plants and Equipment - Wages Paid to Employees

To cover all its expenses, the financial intermediary must decide what breakeven interest rate it must charge on its loans. In order to understand this, we can think of interest rates as having three components:

1. A Risk Premium
2. Expected Inflation
3. The Time Value of Money

Let's imagine you are going to throw a party for all your friends. You have saved $1,000 and have exactly enough money to buy 20 kegs at $50.00 apiece. A couple weeks before the party, your best friend says his car broke down, and he really needs it for work. It will cost $1,000 to fix it, and he asks you to lend him $1,000.00 and promises to pay you back within one year with interest. Tough call, right? It is your best friend, of course, so you lend him the money for one year. But what interest rate should you charge? Let's examine the components.

First, you are giving up using your $1,000 for the party (Consumption), and you deserve some interest payment. This is known as the time value of money. The time value of money over the long term has historically been 2 to 3% (a rate we have seen on long-term loans when there is no inflation).

Second, when you get the $1,000 back, you want to still be able to buy 20 kegs of beer. If the cost of the kegs has inflated, you want the principal amount you lent to still be worth $1,000, so you want the future or expected inflation rate to be applied to the principal. Let's say this is 2%.

Finally, there is a risk premium on top of all this. Let's say you expect your friend to only pay back 95% of the principal. You want to be made whole, so you charge this risk premium of 5% on top of the other two components. This part of the analogy does not work as well, but in real world banking, if you have $1,000,00 in loans outstanding and historically 5% of the loans default, you have to get that 5% back first before you can start earning on your money. If we add these components all together, you would charge your friend 9% for a one year loan of $1,000.

1. A Risk Premium: 5%
2. Expected Inflation: 2%
3. The Time Value of Money: 2%

Figuring this all out can be mentally exhausting, so financial intermediaries use a shortcut. U.S. Treasury Bonds are considered the safest investment in the world, so the U.S. is charged an interest rate that includes only the time value of money plus expected inflation. For example, let's say a ten-year U.S. Treasury Bond pays an annual interest of 4%. Since we know the time value of money is 2%, these must be the components of that 4% interest rate:

1. A Risk Premium: 0%
2. Expected Inflation: 2%
3. The Time Value of Money: 2%

As a short cut, financial intermediaries look at the market interest rate on the appropriate term length U.S. Treasury Bond and match it to a loan they are making with the same term length and add a risk premium. Let's look at the current rates for Treasury Bills, Treasury Notes and Treasury Bonds. The maturity of a Treasury obligation is its term; that is, when the principal amount will be paid back in full.

1. Treasury Bills mature in one year or less.
2. Treasury Notes mature in two to ten years.
3. Treasury Bonds mature in longer than ten years.

Table 7.6.3.1: Daily Treasury Yield Curve Rates (Treasuring Bills and Bonds)

Date	1 Mo	2 Mo	3 Mo	6 Mo	1 Yr	2 Yr
8/7/20	0.08%	0.09%	0.10%	0.12%	0.14%	0.13%

Date	3 Yr	5 Yr	7 Yr	10 Yr	20 Yr	30 Yr
8/7/20	0.14%	0.23%	0.41%	0.57%	1.01%	1.23%t

Source: U.S. Treasury

These yields can be graphed into what is known as a yield curve. The yield curve will shift as the various rates change so there will be a new yield curve every day. Note that the longer the maturity of the Treasury Notes and Bonds, the higher the interest rate. To put it simply, the longer the maturity, the higher the expectation of a bigger inflation rate, thus the expected inflation component increases. Note that during the Pandemic Recession, the Federal Reserve Bank reduced short-term interest rates to effectively zero and reduced long-term interest rates to historical lows by buying Treasury Notes. For an example, see below for the historical rates on the bond market bellwether: the Ten-Year Treasury Note. (A bellwether is a leader or a leading indicator of a trend. The lead sheep of a flock has a bell around its neck and is called the bellwether.)

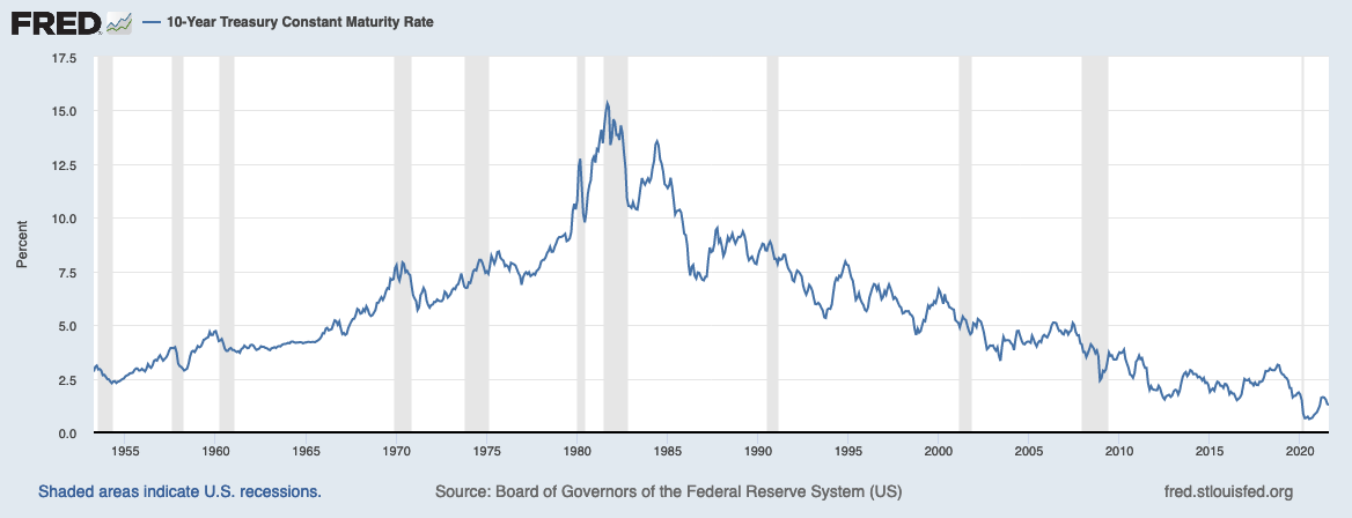


Figure 7.6.3.6: Board of Governors of the Federal Reserve System (US), 10-Year Treasury Constant Maturity Rate [GS10], retrieved from FRED, Federal Reserve Bank of St. Louis; October 1, 2021.

Looking back at setting interest rates, we can examine auto loans and mortgages to get a better idea of how this works. For an auto loan of 48 months, banks will take the 5-year Treasury Note and add a risk premium. For a 30-year mortgage, banks will take the 10-year Treasury Note and add a risk premium. By subtracting the corresponding Treasury Note rate to the auto loan or mortgage rate, we can calculate the risk premium. For example, this is how these rates looked as of August 7, 2020.

Table \(\PageIndex{2}\). Auto Loan and Mortgage Rates

Loan	Loan Rate	Treasury Note Rate	Risk Premium
Auto Loan (48 months)	4.27%	5 yr Note = 0.23%	4.04%
Home Mortgage (30 years)	3.08%	10 yr Note = 0.57%	2.51%

The risk premium added to the similar term length U.S. Treasury Bill or Bond often follows the default rate on that type of loan. This is because if, for example, 3% of your automobile loans are not paid back, you have to recover that 3% before you can earn any interest. Here are the historical delinquency rates on various loans (90 days overdue):

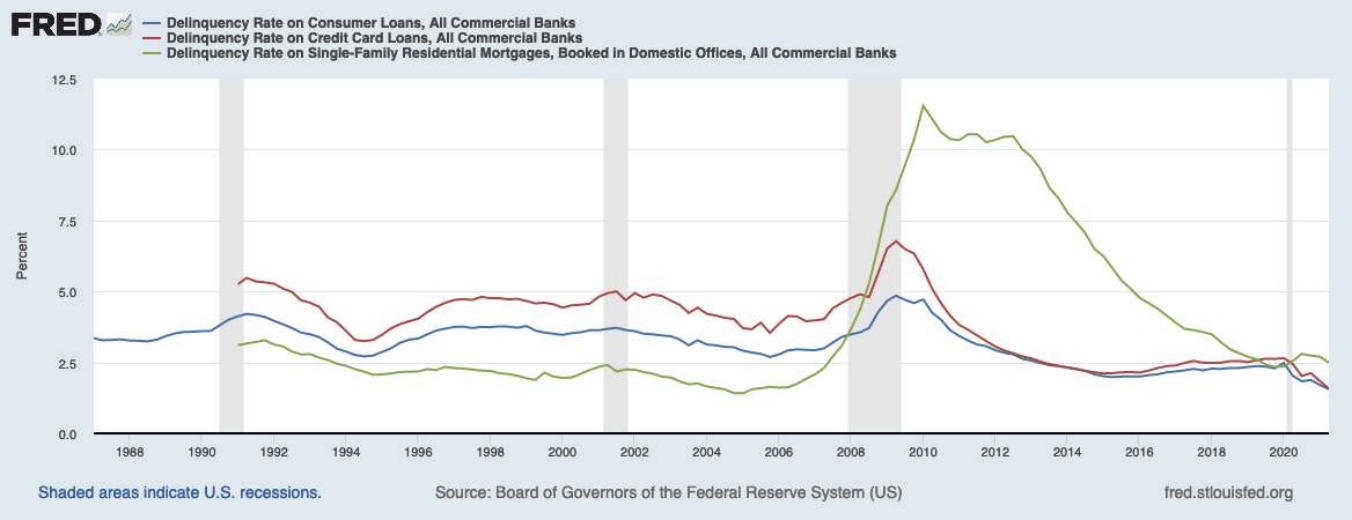


Figure 7.6.3.7: Board of Governors of the Federal Reserve System (US), Delinquency Rate on Consumer Loans, All Commercial Banks [DRCLACBS]; Delinquency Rate on Credit Card Loans, All Commercial Banks [DRCCLACBS]; Delinquency Rate on Single-Family Residential Mortgages, Booked in Domestic Offices, All Commercial Banks [DRSFRMACBS]; retrieved from FRED, Federal Reserve Bank of St. Louis; October 1, 2021.

Your Credit Score

The Fair-Isaac credit score (FICO) is the most popular credit score used by financial institutions and other firms interested in your financial stability. Its scale ranges from 300 to 850, and since most Americans have a score of 700 or above, people with that magic 700 (or higher) are considered prime credit risks. Your FICO score is made up of a weighted mix of your financial transaction history. Here are the weights (and their explanations).

Payment History (35%)

The first thing any lender wants to know is whether you have paid past credit accounts on time. This helps a lender figure out the amount of risk it will take when extending credit. This is the most important factor in a FICO Score. Be sure to keep your accounts in good standing to build a healthy history.

Amounts Owed (30%)

Having credit accounts and owing money on them does not necessarily mean you are a high-risk borrower with a low FICO Score. However, if you are using a lot of your available credit, this may indicate that you are overextended. Banks might interpret this to mean you are at a higher risk of defaulting.

Length Of Credit History (15%)

In general, a longer credit history will increase your FICO Scores. However, even people who have not been using credit for long may have high FICO Scores, depending on how the rest of their credit report looks. Your FICO Score will look at how long your credit accounts have been established, including the age of your oldest account, the age of your newest account, and an average age of all your accounts. It will also factor in how long specific credit accounts have been established and how long it has been since you used certain accounts.

Credit Mix (10%)

FICO Scores will consider your mix of credit cards, retail accounts, installment loans, finance company accounts, and mortgage loans. However, it is not necessary to have one of each.

New Credit (10%)

Research shows that opening several credit accounts in a short amount of time represents a greater risk, especially for people who do not have a long credit history. If you can avoid it, try not to open too many accounts too rapidly.

FICO is the leading credit scoring model. In 2006, the three major credit bureaus—TransUnion, Equifax, and Experian—joined forces to create VantageScore in order to compete with FICO. The VantageScore 3.0 is used mainly by the credit card and auto sectors while the FICO score is used by the mortgage sector. The weights used by VantageScore 3.0 are similar to the weight of your FICO score. Here are a few facts about credit scores:

- Average FICO Score: 706
- Average VantageScore: 685
- Average U.S. Household Credit Card Balance: $8,602
- Average Annual Percentage Rate on Credit Cards: 17%
- Amount of Time Adverse Info Stays on Your Credit Report: 7 years

Source: FICO, Vantage, Federal Reserve Bank, 2019

How to Get and Maintain a Good Credit Score

Your parents and acquaintances likely have a lot of advice on how to get and maintain a good credit score. Some of this advice is correct, but some of it is a myth.

In her 2019 article, “9 Myths About Credit Scores,” Demetria Gallegos presents a comprehensive overview of the do’s and don’ts of credit scores. Gallegos points out that with the near universal use of credit scores today by banks, landlords, employers, rental agencies, and others, your credit score represents more than the financial aspects of your life. Your credit score can be the key to a better standard of living. Gallegos debunks the common myths around credit scores; I have listed these below and included my commentary (Galegos (2019).

Myth: Checking My Credit Score Hurts My Credit Score.

There is a difference between a hard inquiry and a soft inquiry. A hard inquiry is when a bank checks your credit in order to evaluate whether they will extend a loan to you. A soft inquiry is an employer checking your credit as part of a background check on you or a utility company checking your FICO score to set up a new account. Each hard inquiry will drop your FICO score by a few points. Almost all soft inquiries will not. If you are simply checking on your credit score, there will be no loss of points. You can check your credit score for free on a number of websites, like Discover Credit Score, Credit Karma, or Mint.

Discover Credit Score is best in terms of data sharing and solicitation. If you just want to check your credit score, they do not share your info with any other credit card company or commercial enterprise. Credit Karma has the most comprehensive information available, providing a look at all of your outstanding credit and information reported to two of the three credit agencies. It also allows you to dispute a late report or other inaccurate information directly from their website. However, they do sell your info to credit card companies, and you will likely receive credit card solicitations. Mint is owned by the accounting and financial software company, Intuit, and is primarily a free personal budgeting site. You will need to sign up for the personal budget offering before you can enter the site.

Myth: If I Pay My Bills on Time, That is All I Need to Worry About.

All you have to do is look at the credit score components above to realize that paying your bills is not enough on its own. Pay attention to how much credit you have available and how much of your total credit is outstanding. As a rule of thumb, you should only have about 30% of your total credit limit outstanding. Try spreading your purchases among two or more credit cards. Call your credit card companies and ask for your credit limits to be increased. If you have good credit, the credit card companies will oblige you 80% or more of the time. This will immediately reduce the percentage of your outstanding credit.

Myth: Carrying a Balance on My Credit Card Helps Boost My Credit Score.

Carrying a balance will not help your credit score. In fact, if the balance is above 30%, it will hurt your credit score.) In addition, carrying a balance if you can afford to pay it off just costs you interest payments.

Myth: Closing an Old Credit Card with a High Interest Rate Will Help My Score.

Since the amount of outstanding credit in part determines your credit score, it is best to pay off high interest credit cards and leave them open. Do not cancel them unless they charge you an annual fee. If there is a fee involved, call the credit card company and ask them to substitute a card without a fee and ask to have the same credit card number.

Remember, the length of the credit extended helps your score. FICO ignores the closed account status and continues averaging the age of the closed account with your open accounts. Vantage, however, removes closed accounts (and your payment record) from its calculation, so you lose the value of positive payment on a past account. The best policy is to keep high interest credit cards open and use lower interest credit cards for purchases.

Myth: Opening a New Retail Credit Card Is Good for My Credit Score.

Retailers entice you with 0% interest and other incentives to open new credit cards. When you do, the average age of your credit gets younger, and you lose a few points from the inquiry. In addition, the interest rate from the retailer after the initial period is generally higher than the average interest rate on your other credit cards.

Myth: It Hurts My Credit Score to Comparison Shop for a Mortgage, Auto or Student Loan.

The credit rating models take comparison shopping into account. If the credit rating agencies see multiple hard inquiries around the same time, they will assume you are shopping around. However, there is a time limit on this. VantageScore bundles similar inquiries within 14 days into one hard inquiry. FICO has shopping periods of 14 to 45 days, depending on the type of credit. In any event, a good tip if you are buying a house is to wait till after closing to take on any new credit for furniture or appliances. This will assure the highest credit score as you go into closing.

Myth: The Older My Unpaid Debt, The More It Hurts Me.

Late payments, collections, foreclosures and Chapter 13 bankruptcies remain on your credit report and hurt your credit score for seven years. However, the older the credit problem, the less it affects your credit. So if you have an unfortunate event like a bankruptcy or foreclosure, stay current with any new or existing credit you are not delinquent on. As to collections, credit card companies aggressively pursue delinquent accounts for about two years. After that, they often sell the delinquent debt to collection agencies and take the debt off their books. If a legitimate collection company contacts you, you should try to make a deal to pay only part of the debt. Collection companies usually buy delinquent debt for 20% of its full value, so anything they collect over that is profit. The Consumer Financial Protection Bureau (CFPB) has established rights for you when dealing with collection companies. They cannot threaten or harass you. If they do, contact the CFPB.

If you have gone through a bad financial period, a good way to re-establish credit is to get a secured credit card. With this type of card, you deposit money into your financial institution and spend up to that preset limit. If you pay off the charges each month, your credit score will improve, and in about a year (maybe less), you can likely get a regular credit card again.

Myth: Selecting “Credit” While Using Your Debit Card for a Purchase Is Good for My Credit Score.

There is no effect at all on your credit score if you select “credit” when using a debit card. However, you should be sure that your financial institution does not charge any fees for debit transactions.

Myth: Credit Reports Are Accurate.

Credit reporting firms make mistakes. An incorrect score could come from something as simple as someone who shares your name being put on your report; it could also be the result of a criminal stealing your identity and taking out credit cards in your name. Experts advise each of us to check our credit reports every four months. The most effective way to do this is to take advantage of the free credit reports to which every consumer is entitled. You are entitled to one free credit report each year from each of the three credit-reporting companies (Trans-Union, Experian, and Equifax).

Order a credit report every four months but order the report from a different one of the three credit-reporting companies each time. That will give you three free reports each year spaced out every four months. You can also monitor your credit through Credit

Karma. It is free and alerts you if there is a significant change in your credit score or if there is a hard inquiry.

Pay for Deletion

Finally, if you are seriously delinquent on a credit card, you can try a discussion called pay for deletion. Since the financial institution will have to sell the debt for 20% of its face value to a collection company once they write off the debt, the collection specialist at the financial institution (before it gets sold to a collection company) will be willing to make a deal. Offer them 30% or 40% of the outstanding balance with the agreement that he/she will delete the negative reporting from the credit agencies report.

Credit Rating Agencies

The three major credit rating bureaus in the United States are Experian, Equifax, and TransUnion These agencies pay financial institutions to send them your credit data every month. including credit limits, the amount of utilized credit, and your payment history. The credit agencies use this to calculate your credit score and sell these reports to banks, credit unions, landlords, auto finance companies, and even potential employers. Unfortunately, these credit scores have become the be-all and end-all of your ability to get a loan or a credit card, not to mention the interest rate you will pay for that loan or credit card.

As was stated earlier, a FICO score of 700 or higher is golden. In 2019 67% of Americans had a FICO score of 670 or higher. The majority of Americans have a FICO score of good or better. Banks often see a FICO score of 700 or better as the “sweet spot” for them to extend credit at a reasonable interest rate. This does not mean that you cannot get a credit card or an auto loan if you have a score less than 700, but you will pay a higher interest rate, so it is worth aiming for. Your FICO score will improve if you use only 30% or less or your credit limits, so having more credit cards but not using them improves your score. That means you should get credit cards but do not use them.

The financial institutions used to report on your financial activity to the credit scoring agencies at the end of each month, but now they seem to be reporting weekly or even daily, so check Credit Karma at least every two weeks. It will give you a good sense of how credit scores fluctuate based on your activity. Most importantly, you should immediately report any errors. You can do this for free on the Credit Karma website.

Good and Bad Debt

Certain assets are worth borrowing money for. We can call these investments. Borrowing to go to college, to purchase a house, or to buy an automobile are all investments; these are good debt. A house is an investment because it will appreciate in value and will save you rent, while education is an investment because it will lead to a better job and higher income. An automobile is an investment because you will likely need one to commute to your job.

Bad debt is borrowing for consumption. Do not borrow on a credit card unless you can pay it off at the end of the month. You do not really need that 55-inch TV; you can buy it if you have the money to buy it, but do not finance it with a credit card. Of course, if you are unemployed and need to use your credit card to buy food, that is another matter. In that case, the hopeful outcome will be that you will find a new job and the credit card debt will just be temporary.

Credit Cards Are Addictive

The nature and structure of the human brain makes it difficult to not run up credit card debt. Our brain almost automatically compares cost to benefit when we are considering a purchase; however, benefits are evaluated in a different part of the brain than costs. The reward center of the brain, the ventral striatum, activates in response to the item we want. The prospect of getting that item feels good. On the other hand, the insula, the area of the brain that evaluates pain and expected loss, reacts to actually having to pay for the product. Using a credit card to purchase something, whether we need it or not, gives us a sudden rush of instant gratification. However, we do not feel the pain of having to pay for it until the credit card bill arrives.

Credit cards are addictive because they hijack the ventral striatum (part of the dopamine system) which gives us the pleasure of buying something we want. On top of this, at least eight percent of men and women are addicted to shopping, only further triggering the potent addiction mechanism of credit cards.

How to Use Credit Cards Wisely

We all need credit cards. We need them to pay for airplane tickets, hotels, and things we order online. Also, having a large credit limit but using very little of it will increase your FICO Score. However, here is my best advice. Only buy something with a credit card that you can pay off at the end of the month when your credit card bill arrives. It is as simple as that!

Credit Card Providers and the Games They Play

Credit card providers begin their games with enormous marketing efforts. Credit card providers either email or snail mail over two billion new offers for credit cards per year in the United States. Given that there are 159,000,000 individuals employed in the U.S. (and presumably able to pay a credit card bill), this corresponds to six new credit card offers each year for each employed person.

Second, the fees for late payment or exceeding your credit limit are exorbitant, ranging from $30 to $41. According to the Consumer Financial Protection Bureau, credit card companies raked in $12 billion in late fees in 2020, when millions of workers were laid off. Consumers with subprime credit cards and private-label store cards are particularly susceptible, especially in relation to their credit limits. The report also highlights that consumers living in low-income and majority-Black communities are disproportionately impacted by credit card late fees.

Third, the offers of 0% “introductory” interest for a period of time is not really 0% interest. The credit card companies charge you a 3% to 5% “processing fee,” which covers their cost of funds, and then the rate jumps to 15% to 25% when the period is up.

Finally, Visa and Mastercard are virtual duopolies in their marketplace. A duopoly is a market that has only two competitors in it. These credit cards have the overwhelming majority of market share and their above-normal profits are evidence monopolistic behavior.

Auto Loans and Leases

Taking out a loan to buy an automobile is good debt. If you live in America’s suburban sprawl, you typically need a car to travel to work. Purchasing an automobile is a big event in most people’s lives, so try to get advice from a parent or friend who has experience in that area. An automobile is, in economist’s jargon, a durable good, a good that lasts over three years. The price to consider when purchasing a durable good is the user cost. The user cost of a car is the total monthly (or annual) cost of financing and operating the vehicle. Specifically, these are the costs you need to investigate:

- The annual finance payment
- The annual fuel cost
- The annual maintenance cost
- The annual insurance costs
- The annual replacement costs of tires, etc. (most important when a car is over 3 years old)
- The trade-in value

These costs can vary significantly among various makes and models of cars. The largest component of your user cost is the financing. Interest rates for automobile purchases will vary with the market interest rate and generally track the 5-year U.S. Treasury Bill, plus a risk premium. According to The Wall Street Journal, as of August, 2021, the average rate on a 48 month new car loan nationwide was 4.06%. Based on this, we can determine the annual user cost of a $30,000 car:

Table 7.6.3.3. Annual User Cost of a $30,000 Car

Annual Finance Costs	$8,148	($679 per month)
Annual Insurance	$1,134	
Annual Fuel Costs	$2,392	(16,000 miles per year at $2,99/ gallon)
First Year Maintenance	$500	(Oil change and tire rotation)
TOTAL	$12,174	

The financing rate varies significantly with market interest rates, and often the auto manufacturer will give lower rates in order to sell specific models. Be sure to ask for a dealer quote on financing your car. You can use an auto loan calculator to figure out your

monthly finance costs.

A common saying in the auto industry is that your new car is worth 25% less the minute you drive it off the dealer's lot. In actuality, your car's value decreases around 20% to 30% by the end of the first year. From years two to six, depreciation ranges from 15% to 18% per year, according to recent data from Kelley Blue Book, which tracks new and used-car pricing. As a rule of thumb, in five years, cars lose 60% or more of their initial value. However, this can vary widely among makes and models, so it is worthwhile to investigate to what extent your chosen vehicle keeps its value. Remember that you will never recoup the cost of premium customization you may buy on your new car. Special models, expensive wheels, or deluxe sound systems will not increase the trade-in value of your car. Essentially, this money you are throwing away.

Unfortunately, 2021 was a bad year to buy a new or used vehicle. As we exited the Pandemic Recession, the demand for new automobiles increased while at the same time there were serious supply shortages of the computer chips that run everything in today's sophisticated cars. In addition, the prices of used cars increased 40% over the year 2020. However, this inflation in auto prices should be temporary, so here are some ways to minimize your user cost when buying a car in years like 2021.

1. Finance your purchase through a credit union. For example, I have seen rates between 1% and 2% on new auto loans at Pentagon Federal Credit Union.
2. Finance your loan over 60 months in order to bring down your monthly payments.
3. Do not load your car up with customizations.
4. Buy a used car with a warranty instead of a new car.

You should first establish a monthly budget, keeping in mind the user costs. Then make a list of the few cars that will fit that budget. Drive the three cars that fit your budget and choose the one your gut tells you that you like the most. That way you will be happy with the purchase.

As an economist, I recommend leasing your car instead of purchasing it. Leasing is just another method of financing your car purchase, with a number of added benefits. Leasing significantly reduces your monthly payment, helping your cash flow. When you purchase a vehicle outright, you pay interest on the amount you borrow. You also have to pay off (or amortize) the entire cost of the vehicle over the term of the loan (typically 4 to 7 years). When you lease a vehicle, you pay interest on the amount you borrow, but you only have to amortize the difference between the purchase price and the vehicle's residual value. Here is an example of a purchase vs. lease monthly payment:

Purchase

- Price: $32,000
- Loan: $30,000
- Interest rate: 4%
- Term: 48 months
- Monthly Payment: $677.00

Lease

- Price: $32,000
- Loan: $30,000
- Interest rate: 4%
- Term: 36 months (almost all leases are for 36 or 39 months)
- Monthly Payment: $535.00

When you purchase a car, you must pay sales tax up front. Not all states have sales taxes, but in Pennsylvania, for example, where the sales tax is 6%, this would be $1,920. For a lease, you only pay sales tax on the lease payment every month. You can purchase the car or truck at the end of the lease for the residual value, or you can just turn the vehicle in and lease another new vehicle.

What to Do if You Fall Behind

Communicate with your lender if you are having any difficulty in making your vehicle payment, whether you are purchasing or leasing. Often, there are programs to assist you. For example, during the pandemic, Citibank allowed auto loan customers to skip up to three payments. You may also get a cheaper rate. The important thing is to call your lender the first time you are going to miss a payment, before you go into default. Default happens when you are 90 days delinquent on a loan payment. Here is the

delinquency rate of credit card debt compared to other types of debt. Note that student loans have the highest delinquency rate of all types of debt.

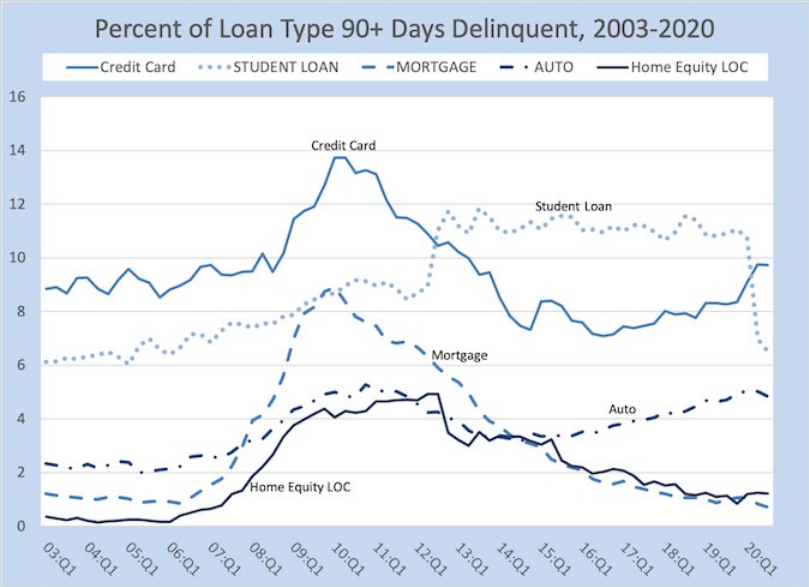


Figure 7.6.3.8: Percent of Balance 90+ Days Delinquent by Loan Type by Fred Rowland is used under a CC BY-NC 4.0 License. Source: Federal Reserve Bank of New York (11/2020).

Personal Loans

It is always a good idea to establish a line of credit, a type of personal loan, with your lenders. Establish a line of credit that covers you if you overdraw the checking account. This way you will avoid any overdraft fees. Revisit this line of credit at least once per year. If your payments have been on time, ask to increase the line of credit. Of course, do not borrow money unless you really need to, but it is good to have a line of credit available for emergencies. Also, your FICO score is based in part on your credit limit and how much of that limit you are using. By increasing your line of credit but not using it, you can improve your FICO score.

Personal loans without collateral to secure them will have a higher interest rate associated with them. However, personal loans are much cheaper than borrowing on your credit card, which is another reason that a line of credit is valuable.

Pay off the Debt With the Highest Interest First

Benjamin Franklin said, “A penny saved is a penny earned.” This is also true of debt. While you might try your best to avoid it, you still can end up with credit card or personal loan debt. Your personal debt will most likely have an interest rate of 9% or above. This is unsecured debt: debt with no asset like a car or house that can be repossessed. Secured debt, like an auto loan, mortgage, or student loan, will have an interest rate under 9%. Be sure to cover your monthly payments so you can maintain your credit rating, but if you have some money left over, make payments on your credit cards and personal loans first.

Identity Theft

There are plenty of criminals out there trying to steal your identity and use it to commit fraud. The internet has made it both much easier to do so and much harder to catch these criminals. Given this serious risk, here are some of the things you should not do:

- Never give out your internet password. Not even your internet provider will ask for it.
- Never give out your social security number. Even your bank or credit union will only ask for the last four digits to use for account access.
- Never give out personal information to someone calling you. If it is someone you do not know, ask for a phone number and say you will call them back.

If you have been the victim of identity theft, the Federal Trade Commission says this is what you should do:

1. Call the companies where you know fraud occurred and speak with their fraud department.

2. Place a fraud alert and get your credit reports. Place a free, one-year fraud alert by contacting one of the three credit bureaus.
3. Report identity theft to the FTC.

After this, you will need to try to recover from the identity theft.

1. Close any new accounts opened with your stolen identity.
2. Call your accounts and get them to remove any bogus charges.
3. Call the credit bureaus and correct your reports.
4. Consider a freeze on all your accounts and credit cards. Open new ones.
5. Check your credit reports each month.

The Last Resort: Bankruptcy

If you cannot get accommodation or your debt is just too high to work out from under, the last resort is bankruptcy. Keep in mind, however, that it will not discharge your student debt. Ask someone you know to be informed for a good bankruptcy attorney or look up legal aid. Do not think that bankruptcy is a stigma. Plenty of people have declared bankruptcy, recovered and become successful.

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7.6.4: Banks and Financial Institutions

Different Types of Financial Institutions

Financial innovation describes the changes in the types of institutions or services offered in the financial marketplace. Here are some financial innovations that have occurred recently:

- The expansion of insurance companies into banking (e.g., Travelers Insurance merged with Citibank to form Citicorp)
- The expansion of automated teller machines
- The invention of online payment systems (e.g., Paypal, Apple Pay, etc.)
- The expansion of investment banks into commercial banking (e.g., Goldman Sachs now offers checking accounts and other services.)
- The creation of completely online banks (e.g., SoFi) and completely online insurance companies (e.g., bestow.com)

As we discussed before, depository institutions are known as financial intermediaries. They accept deposits on which they pay interest and make loans on which they charge higher interest, making a profit on the difference. The loans they make include credit cards, mortgage loans, personal loans, and business loans. All are set at different interest rates.

The difference between the average aggregate rate financial intermediaries pay on their total deposits and the average aggregate rate they charge on their total portfolio of loans is called the net interest margin. This must be enough to pay for the overhead plus make a profit for their stockholders. The net interest margin can vary, so here is a snapshot going all the way back to the 1980's:

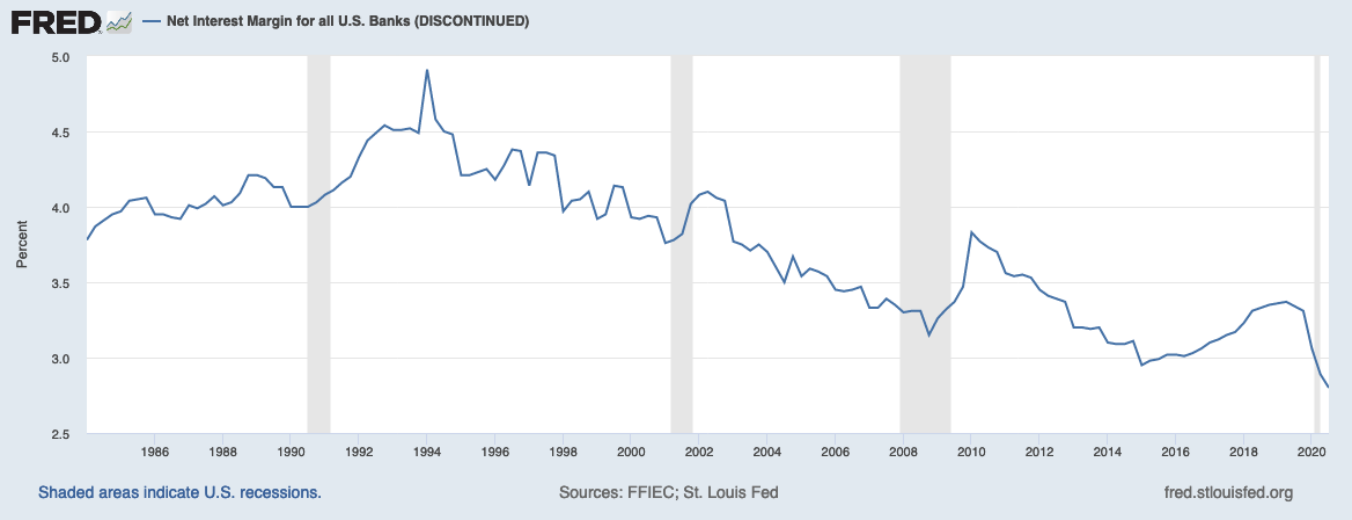


Figure 7.6.4.1: Federal Financial Institutions Examination Council (US) and Federal Reserve Bank of St. Louis, Net Interest Margin for all U.S. Banks (DISCONTINUED) [USNIM], retrieved from FRED, Federal Reserve Bank of St. Louis; September 30, 2021.

Note that there is a lower limit to the net interest margin, and this gives us an insight into the business banking model. If the net interest margin for a bank gets significantly below 3%, the bank will likely be unable to meet its overhead costs, putting it into serious financial trouble. Similarly, according to the National Credit Union Administration, the net interest margin on credit unions have also been running about 3% for the last decade.

The **prime rate**, or the rate that banks give to their most creditworthy customers, is always exactly 3% above the Federal Funds Rate. Of course, most commercial bank customers do not get the prime rate on their loans, but it is the benchmark against which commercial loans are priced. Most customers pay 1% to 2% above prime on their short-term loans.

Commercial Banks

Commercial banks accept deposits into checking and savings accounts. They use these deposits to make business, personal, and auto loans, as well as issue credit cards and mortgages. These banks also borrow money in the Commercial Paper Market and lend this out at higher rates. Commercial paper is short term loans, secured by promissory notes (essentially I.O.Us), with terms typically 30 to 180 days. There is a huge market for borrowing via commercial paper from banks. The current outstanding amount

of commercial paper in the U.S. is about $1.1 trillion. With an average term length of 30 days, banks must reborrow the money every 30 days.

Commercial banks receive a charter from the Federal Reserve Bank that gives them permission to operate. However, they must follow the rules of the Fed and remain solvent. The Fed audits commercial banks regularly and can revoke a charter if a bank is insolvent or engages in prohibited behavior. All deposits in commercial banks are insured by the Federal Deposit Insurance Corporation (FDIC) up to $250,000 per account. The FDIC is a government sponsored insurance company that charges premiums to commercial banks. If a bank becomes insolvent, the FDIC will usually sweep in on a Friday after close of business, seize the bank, fire the officers, and immediately call the customers to let them know their deposits are insured and therefore safe. Usually, the FDIC will then sell the assets to a solvent bank.

Savings Institutions

Savings institutions or savings banks accept deposits and provide personal and auto loans, as well as issue credit cards and mortgages. They tend to focus less on commercial loans than commercial banks. As with commercial banks, deposits are insured by the FDIC up to $250,000 per account.

Prior to 1980, savings institutions were legally limited to only offering checking and savings accounts, and their lending was restricted to mortgages. Following World War II, they paid 3% on deposits and lent mortgages at 6%. Then in 1979, Paul Volker, chair of the Federal Reserve Bank, raised short-term interest rates to 17% to control excessively high inflation. This rate stayed high for years, going up to 19% in 1980 and 1981. This caused disintermediation at the savings institutions, causing them to raise the rate to 8% on savings accounts in order to stay competitive. However, most of their money was already lent out at 6% for thirty-year mortgages. This was a recipe for bankruptcy.

The U.S. Government had to bail out the industry, costing taxpayers about $100 billion (though this now seems like a bargain compared to the massive bailout during The Great Recession). In 1980, there were more than 4,500 savings institutions insured through federal or state government programs. As of December 2017, FDIC data reveals that only 752 remained.

Credit Unions

Credit unions are non-profit institutions, and as a depositor, you are a part owner. Like a commercial bank, credit unions offer checking and savings accounts and certificates of deposit. They also offer auto and personal loans, and they issue credit cards and mortgages. Instead of the FDIC, your deposits are insured up to $250,000 per account by a similar organization, the National Credit Union Administration (NCUA). The NCUA is also responsible for issuing charters to credit unions.

As mentioned before, credit unions tend to have lower fees and better interest rates on savings accounts and loans since they do not have to generate profits. Most people use their local credit union for car purchases because the rate is normally lower than what is offered by dealers and commercial banks. Credit unions are also an excellent place to apply for a mortgage. Despite all of this, it is worth noting that commercial banks' mobile apps and online technology tend to be more advanced.

According to the NCUA, as of 2019, there were 5,335 federally insured credit unions with 117.3 million members. At the same time, there were 5,177 commercial banks and savings institutions. So, the number credit unions and the number of commercial banks in the U.S. are approximately equal. Almost half of all U.S. adults are members of a credit union.

Finance Companies

Finance companies are non-depository financial institutions that provide personal loans and financing, as well as issue credit cards. These companies lend to individuals who have trouble borrowing from sources such as banks and credit unions, thus they charge higher interest rates and are often ruthless in foreclosing on a defaulted loan. Because of this, you should avoid finance companies.

Securities Firms

Securities firms, such as Goldman Sachs, do Wall Street work. They sell new issues of stocks and bonds for companies that want to raise money. They also advise companies on mergers and acquisitions. For this work, they earn millions of dollars in fees.

Securities firms also provide stock brokerage services to individuals. In order to buy and sell stocks, you must hold a membership on the stock exchanges, so individuals need to go through brokers. Since there is so much competition for customers, securities

firms have reduced the cost for trading stocks to zero, leading to an explosion of amateur stock pickers. We will discuss investing at length in a later chapter.

Insurance Companies

Traditionally, insurance companies have sold automobile, homeowners, and health insurance, as well as annuities. However, about a decade ago, insurance companies entered personal wealth management, charging fees typically equal to 1% of the assets under management. Many insurance companies like Lincoln Financial and Prudential have aggressively sought this business since it is risk free and quite lucrative. We will discuss insurance in more depth in a later chapter.

Investment Companies

Investment companies, such as Vanguard and Fidelity Wealth Management, invest other peoples' money in mutual funds. We will discuss this more later, but Vanguard's invention of low cost mutual index funds has brought fees down dramatically. Historically, investment advisors charged fees of 1% of the value of your assets to manage your investments. Now, the average mutual fund fee at Vanguard (and others) is one-tenth of 1%.

Financial Conglomerates

Many financial institutions combine some or all services listed above. For example, Citicorp was created by the merger of Travelers Insurance Company and Citibank, so its activities include almost all of the above. Also, Goldman Sachs, a securities firm, is now entering retail banking.

Payday Lenders

Avoid payday lenders at all costs. Their main function is to advance money to people waiting for a paycheck. The fees they charge are exorbitant, and they usually prey on low-income people.

Banks Are Not Your Friends

Banks have shareholders and are motivated by profit. They run advertisements that implicitly say they will be your best friend and help you achieve your financial goals. However, this is just not true. Their interested in maximizing their profits, and this can come in conflict with your goals. Banks charge higher fees, pay lower interest on savings deposits, and charge higher interest rates on loans. Also, one of the biggest sources of income for banks is what they term in their financial statements as **non-interest income**. This income includes a number of charges, like ATM fees, overdraft fees, and late fees. ATM fees, for example, average $2.97 per transaction in the U.S. On top of that, if you go to an ATM not operated by your bank, you can be charged an additional fee, averaging $1.72 nationally.

Typically, overdraft fees are $35 or higher. In 2017, commercial banks charged $34 billion in overdraft fees. These fees came from only 9% of their customers, almost exclusively low-income. Additionally, if the overdraft is not corrected right away, the bank will continue to charge fees until the account balance runs down to zero; they will then will close the account. Since the bank is already earning profits from interest they charge on loans, the overdraft fees are pure profit.

Many commercial banks sell their mortgages to Fannie Mae and Freddie Mac, so they must conform exactly to the rules of these institutions. Your mortgage could end up being owned by anybody. A credit union might be a better choice. They will keep all or most of their mortgages, so they are more flexible on their requirements. If you do not have perfect credit, a credit union is more likely to give you a mortgage than a commercial bank.

Financial Services Offered by Banks and Credit Unions

Checking Accounts

Financial intermediaries all offer checking accounts. They typically do not pay interest on checking accounts, but some commercial banks charge a fee if the account does not hold a minimum amount of money or has no activity. Some commercial banks charge you $2.00 or more if you request a paper account summary each month. Commercial banks might also offer fee-free checking accounts for students, but as soon as you graduate, they put the standard fee structure in place. As a rule, credit unions do not charge you fees on checking accounts.

Ideally, you only need to keep money in your checking account to pay bills. Any extra money should be in a savings account. Arrange a “sweep” of your checking account at a certain time each month. A “sweep” is a banking term that means your financial institution will transfer any excess money from your checking account into your savings account, where it will earn interest.

Some securities firms, like Charles Schwab and Goldman Sachs, also offer checking accounts. These firms are insured by the FDIC for up to $250,000 per account. They often will pay interest on checking because they will invest your balance in money market funds. They both are insured by the FDIC up to $250,000 per account. The idea is to have one-stop shopping for banking and stock or mutual fund investing.

Saving Accounts

Savings accounts are where you should transfer any money that you do not need to cover daily expenses. Savings accounts pay interest, but the interest paid is very close to the federal funds rate. The federal funds rate is now 0% to .25%, so savings accounts pay about .5%. This is better than nothing. When you join a credit union, you automatically get a checking and a savings account. I have explained above how to use these to create a budgeting vehicle to nudge you to save each month.

Credit Cards

All financial intermediaries offer credit cards. They will be lending you their own funds but will contract with VISA or Mastercard to do the billing and collecting. I have an entire chapter on credit cards, so I refer you to that. However, allow me to repeat the cardinal rule for credit cards: only use credit for a purchase if you can pay it off completely at the end of each month.

Safety Deposit Boxes

Commercial banks and credit unions offer safety deposit boxes for rent at their branches. These offer security for important papers like auto titles and house deeds and valuable jewelry. They are completely confidential.

ATMs

Commercial banks and credit unions have automated teller machines at their branches for cash withdrawals. You need to be aware of what fees these charge. Commercial banks will charge a fee for withdrawing cash, but credit unions usually do not. In addition, if you withdraw money at an ATM at a convenience store, you will pay an additional fee on top of the bank’s fee. This could add up to $4.00 or more to withdraw cash. However, certain retailers like grocery stores will allow you to withdraw cash without fees.

Cashier’s Checks

Certain legal transactions, such as your payments at closing on a house, require a cashier’s check, also called a “bank check.” A cashier’s check is a guarantee to the receiver of the check that your account will have money to cash it. When you ask the financial intermediary to issue a cashier’s check for a certain amount (assuming you have the money in your account), the intermediary will put a hold on the corresponding amount and issue a check under the bank’s name.

Why Banks Want You to Sign Up for Electronic Bill Payment

About a decade ago, there was a huge push by commercial banks for all their customers to sign up for electronic bill pay. A study done by the Banking Trade Association found that if a customer signed up for electronic bill pay, it was so difficult to change all the data that 95% never left the bank. Thus, the bank could continue to charge higher fees and the customers would not leave. If you are currently at a commercial bank, do not sign up for electronic bill paying. Switch to a credit union right away. If or when you are at a credit union, it is a very good idea to sign up for electronic bill pay, since it is so convenient.

Who Regulates Banks and Credit Unions

The Federal Reserve Banks supervise and regulate commercial banks, and the FDIC insures their deposits. In certain states, old laws say that a Comptroller of the Currency regulates banks, but with all banks being insured by the FDIC, the same regulatory rules apply. The NCUA regulates and insures credit unions, ensuring that all credit unions have to abide by the same rules.

How Interest Rates on Deposits and Loans Are Determined

The federal funds rate is the rate that banks regulated by the Federal Reserve charge each other for overnight loans. The federal funds rate is set by the Fed as its principal tool of Monetary Policy, and it becomes the “wholesale cost of money” for commercial

banks. In 2020, due to the Pandemic Recession, the Federal Reserve reduced the funds rate to 0-.25%. This essentially means that commercial banks can borrow in the short-term money markets at 0% to .25%. It therefore causes savings rates offered by the commercial banks to be about the same. Commercial banks then will pay their depositors the same interest that other banks will charge them to borrow money.

Supply and Demand of Funds

The familiar law of supply and demand also applies to money and credit. If there is a lot of demand for money or credit relative to supply, interest rates rise and vice versa. However, the Federal Reserve Bank creates all the money, and it is their job to maintain moderate interest rates so economic actors can easily borrow money and keep the economy moving. In times of recessions or credit liquidity squeezes (not enough money supply to satisfy demand), the Fed injects money into the banking system to bring down interest rates. As I said above, in 2020, the Fed injected enough money to essentially bring interest rates down to 0%.

Bank Runs and Financial Crises

In economics, moral hazard can exist when a party to a contract can take risks without having to suffer consequences. It can also be characterized as cleaning up another's mistakes so they do not have to live with the negative consequences of their actions and so will make the same mistake over and over. As a perfect example, in the Great Recession, every major bank in the U.S. (with the exception of J.P Morgan) became insolvent. The Federal Reserve Bank bailed them all out. Since that bailout, the major banks know that they are "too big to fail," so they will continue to take big risks in the future. This is a prime example of moral hazard.

In the Great Depression, thousands of banks went bankrupt, and people lost their deposits. There were runs on the banks, but the money was gone. That is the reason the FDIC was established, to stop runs on the banks. It guarantees deposits up to $250,000 per account. Unfortunately, financial crises are cyclical and with the Fed bailouts essentially encouraging moral hazard, bank failures will be cyclical also. When there is a financial crisis, a higher number of borrowers default on loans, banks become insolvent, and the FDIC or the NCUA has to take them over and make the depositors whole.

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CHAPTER OVERVIEW

8: Consumer Strategies

This chapter discusses purchasing decisions, starting with recurring consumption, and then explores the details of a car purchase - a more significant and longer-term purchase both in terms of its use and financing.

8.1: Introduction

8.2: Consumer Purchases

8.3: A Major Purchase- Buying a Car

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8.1: Introduction

Learning Objectives

1. Trace the prepurchase, purchase, and postpurchase steps in consumer purchases.
2. Demonstrate the use of product-attribute scoring in identifying the product.
3. Compare and contrast features of different consumer markets.
4. Analyze financing choices and discuss their impact on purchasing decisions.
5. Discuss the advantages of consumer strategies using branding, timing, and transaction costs.
6. Identify common consumer scams, strategies, and remedies.

Consumer purchases refer to items used in daily living (e.g., clothing, food, electronics, appliances). They are the purchases that most intimately frame your life: you live with these items and use them every day. They are an expression and a reflection of you, your tastes, and your lifestyle choices. Your spending decisions reflect your priorities. Maybe you take pride in your car or your clothes or your kitchen appliances or your latest, coolest whatever. Or maybe you spend whatever you can on travel or on your passion for hiking. Those very personal tastes will frame your spending choices.

Consumer purchases should fit into your budget. By making an operating budget, you can plan to consume and to finance your consumption without creating extra costs of borrowing. You can plan to live within your income. At times, you may have unexpected changes (loss of a job or change in the family) that put your nondiscretionary needs temporarily beyond your means. Ideally, you would want to have a cushion to tide you over until you can adjust your spending to fit your income.

A budget can also show you just how fast some “small luxuries” can add up. Stopping for a latte on your way to work or school every day ($3.95) adds up to $20 per week, or about $1,000 per year. That money may be better used to finance a bigger ticket item that you then would not have to finance with debt. With the budget to help you put expenses into perspective, you can make better purchasing decisions.

Purchasing decisions are always limited by the income available, and that means making choices. Your choices of what, where, when, and even how to buy will affect the amount that you spend and the utility (the joy or regret) that you ultimately get out of your purchase.

Shopping is a process. You decide what you want, then have to make more specific decisions:

- Should you buy more (and pay more) but get a cheaper unit price?
- Should you buy locally or remotely, via catalogue or Internet?
- Should you pay more for a well-known brand, or buy the generic?
- Should you look for a guarantee or warranty or consider long-term repair costs?
- Should you consider resale value?
- Should you pay cash or use credit? If you pay through credit, is it store credit, your own credit card, or a loan?



Figure 8.1.1 . © 2010 Jupiterimages Corporation

Each of these decisions creates a trade-off. For example, it may be more convenient—and quicker—to shop locally, but there may be lower prices and a better selection of products online. Or you may find lower prices online but have a harder time getting repairs done if you haven't bought locally.

Some of your purchases involve few conscious decisions—for example, groceries—because you buy them repeatedly and often. Other purchases involve more decisions because they are made less often and involve costlier items such as a car. When you have to live with your decision for years instead of days, you tend to make it more carefully.

The decision process can be broken down into the following steps:

- Before you buy or "prepurchase,"
  - identify the product: compare attributes;
  - identify the market: compare price, delivery (return), convenience;
  - identify the financing.
- As you buy,
  - negotiate attributes: color, delivery, style;
  - negotiate price and purchase costs;
  - negotiate payment.
- After you buy, or "postpurchase," consider
  - maintenance;
  - how to address dissatisfaction.

Before You Buy: Identify the Product

What do you want? What do you want it to do for you? What do you want to gain by having it or using it or wearing it or eating it or playing with it or…? You buy things hoping to solve a need in your life. The more specifically you can define that need, the

more accurately you can identify something to fill it. If your purchase is inappropriate for your need, you will not be happy with it, no matter how good it is. And because your budget is limited, you want to minimize your opportunity cost and **buyer's remorse** or regret at not making a better purchase in order to use your limited income most efficiently.

Sometimes you can identify a need, but have no idea of the kinds of products that may fill it. This is especially true for infrequent needs or purchases. For example, you may decide you need to get away and take a long weekend. To do it cheaply, you decide to go hiking and camping. To make it more fun, you decide to go to an area where you've never been before. You may not be aware of the camping options available in that area, however, or of equally cheap alternatives such as hostels, bed and breakfasts, or other accommodations. When you find that you have a range of choices, you can compare them and choose one that offers the most satisfaction.

Once you have identified the product, you can compare the attributes of those products. What characteristics do you require or want? How are you going to use the product? For example, do you need cooking facilities, access to a shower, a safe but scenic location, opportunities to meet other hikers, and so on? What attributes are important to you and what are available?



Figure 8.1.2 . © 2010 Jupiterimages Corporation

Sig is looking for a new computer keyboard, a hot gaming keyboard that can also be comfortable for writing college papers. Sig begins to research keyboards and finds over five hundred models from over fifty brands with different designs, attributes, and functions offered at a range of prices. He decides to try to filter his choices by looking only at gaming keyboards, which narrows it down to about eighty models.

Noticing that most of the keyboards range in price from twenty-five to fifty dollars, he decides to look in the fifty to a hundred dollar range, figuring he'll get a slightly higher-end product, but not an outrageously expensive one. This narrows his search to about twenty-five models.

None of the models has all the attributes that Sig desires. It's a trade-off: he can have some features, but not others. He decides to try to organize his research by creating a table ranking the product attributes in order of importance, and then scoring each model on each attribute (on a scale of one to ten), eventually coming up with an overall score for each model. Figure 8.4 shows scoring for three models.

		VTK		TKG		GBY	
Attribute	**Weight (%)**						
backlit	25	8	2	10	2.5	9	2.25
wireless	25	9	2.25	10	2.5	0	0
programmable G-keys	25	2	0.5	10	2.5	5	1.25
game panel	8	7	0.56	1	0.08	5	0.4
touch	5	8	0.4	1	0.05	10	0.5
media controls	5	7	0.35	1	0.05	10	0.5
ergonomic design	5	7	0.35	1	0.05	10	0.5
warranty	2	0	0	0	0	10	0.2
Weighted Average Score	**100**		**6.34**		**7.72**		**5.55**

Figure 8.1.3 :Sig's Product-Attribute Scoring

Multiplying each attribute's weight by its score gives its weighted score, then adding up each weighted score gives the total score for the product. Based on this attribute analysis, Sig would choose TKG, which has the highest overall score.

In the case of an asset purchase, you may eventually think of reselling the item, so the ease and/or costs of doing so may figure into your prebuying evaluation. You may decide to go with a "better" product—a more recognizable or popular brand, for example—that may have a higher resale value. You also need to consider the market for used or preowned products: if there is one, how liquid the market is, or how easy it is to use. If the market is not very liquid, then the transaction costs of selling in the used product market may be significant, and you may be disappointed with the result.

The more choices you have, the better your chances of finding satisfaction. The more products there are to satisfy your need, and the more attributes those products offer, the more likely you are to find what "works" for you. Sometimes you need to be a bit creative in thinking about your alternatives, especially with limited resources.

Sources of product information include the manufacturer, retailer, and other consumers. Certain information must be provided for certain products by law. For example, food ingredients must be labeled, and perishable products dated. Appliances almost always come with operating and care instructions that can give you an idea of their ongoing maintenance costs as well as operating features.

The Internet has made it easy to research products online and to become a much better informed consumer. You can do lots of research online, even if you actually purchase locally. A feature of many online stores and consumer discussions is product reviews, where consumers give feedback on their satisfaction with the product. Such reviews can balance the information from the manufacturer and retailer, who want to inform consumers to encourage them to buy.

Other sources of information are magazines and trade journals (such as *Consumer Reports*, both in print and online), which have articles and ratings on products as well as ads. Your research may also involve actual or virtual window shopping, like going to stores to examine the products you are thinking of buying.

Before You Buy: Identify the Market

Your market may be local, national, or international, with advantages and disadvantages to each. Generally, a larger market (more vendors) will offer more variation and selection of product attributes.

As with any market, the real determinant of how your market works is competition. The more vendors there are, the more they compete for your business, and the more likely you will find options for purchasing convenience, product attributes, and price.

In markets where vendors are so plentiful that your problem is filtering rather than finding information, there are middlemen to provide that service. An example is the budget travel businesses with Web sites that make it convenient to research and buy flights, rental cars, and hotel accommodations. Middlemen or **brokers** exist in markets where they can add value to your purchasing process, either by providing information in the prepurchase stage or by providing convenience during the purchase. The more they can reduce the cost of a "bad" decision (e.g., a difficult flight schedule, an expensive car rental, an uncomfortable hotel accommodation), the more valuable they are. They can add more value in markets where you have too little or too much information or less familiarity with products or vendors. Generally, the more expensive the product or the less frequent the purchase, the more likely you will find a middleman to make it easier.

Some products have a "new" and a "used" market, such as durable goods and some consumer goods like textbooks, vintage clothing, and yard sale goods. Evaluating the quality of a used or preowned product can require more research, information, and expertise, because the effect of its past use on its future value can be hard to estimate. Used products are almost always priced less than new products, unless they have become "collectibles" that can store value. The trade-off is that used products offer less reliable or predictable future performance and may lack attributes of newer models.

Different kinds of stores often offer the same products at different prices. Convenience stores, for example, typically charge higher prices than grocery stores but may be in more convenient locations and open at more convenient hours. Smaller boutique stores cannot always realize the economies of scale in administrative costs or in inventory management that are available to a larger store or a chain of stores. For those reasons prices tend to be higher at a smaller store. Boutiques often offer more amenities and a higher level of customer service to be competitive. You may also shop at a specialty store when you need a certain level of expertise or assistance in making a purchase.

Cooperative stores are owned and managed collectively and may provide goods or services that would not otherwise be available. Shopping is usually open to anyone, but members are eligible for discounts, depending on their participation in the store's operations or management. The members own the store, so they can forgo corporate profits for consumer discounts.

Increasingly, merchandise of all kinds may be bought directly from the manufacturer, often through a catalogue or online. The shopping experience is very different (you can't try on the sweater or see how the keyboard feels), but if you are well informed about the product, you may be comfortable buying it. Internet shopping has become a great convenience to those who are too busy or too far away to visit stores.

Auctions are becoming increasingly popular, especially online auctions at eBay and similar sites. Auctions are open negotiations between buyers and sellers and offer dynamic pricing. They also offer uncertainty, as the price and even the eventual purchase are risky—you may lose the auction and not get the item. Auctions are used most often for resales and for assets such as homes, cars, antiques, art, and collectibles. The popularity of online auctions has led to more buyers, bringing more competition and thus higher prices.

Before You Buy: Identify the Financing

Most consumer purchases are for consumable goods or services and are budgeted from current income. You pay by using cash or a debit card or, if financed, by using a credit card for short-term financing. Such purchases—food, clothing, transportation, and so on—should be covered by recurring income because they are recurring expenses. You need to be able to afford them. As you read in Chapter 7, consumers who use debt to finance consumption can quickly run into trouble because they add the cost of debt to their recurring expenses, which are already greater than their recurring income.

Unless financed by savings, durable goods such as appliances, household wares, or electronics are often bought on credit, as they are costlier items infrequently purchased. Assets such as a car or a home may be financed using long-term debt such as a car loan or a mortgage, although they also require some down payment of cash.

The use of middlemen or brokers to find and buy an item also contributes to the cost of a purchase because of the fees you pay for the service.

Products and preferred financing sources are shown in Figure 8.5.



	Consumer Goods	Durable Goods	Assets
Cash, Debit, Income	✓	✓	
Savings		✓	✓
Credit		✓	
Debt			✓

Figure 8.1.4 :Products and Preferred Financing Sources

As You Buy: The Purchase

Having done your homework and made your choice, you are ready to purchase. In some cases, you may be able to make specific arrangements with vendors as to convenience, price, delivery, and even financing.

In Western cultures, prices for consumer goods are usually not negotiable; consumers expect to pay the price on the price tag. In other cultures, however, haggling over price is common and expected, which often surprises travelers abroad.

Durable goods and asset purchases typically offer more purchase options than consumer goods, usually as an incentive to buyers. Vendors may offer free delivery or free installation, product guarantees, or financing arrangements such as “no payments for six months” or “zero percent financing.” Offers may be enhanced periodically to “move the merchandise,” when prices may also be discounted. Sales, “special offers” or “low, low prices” may be used to sell merchandise that is about to be replaced by a newer model. If those product cycles are seasonal and predictable, you may be able to schedule your purchase to take advantage of discounts.

Or you may decide to wait and pay full price for the newer model to avoid purchasing a product that is about to become outdated.

The more the purchase process allows for negotiation, the more possibility there is for consumers to enhance satisfaction. However, the negotiation process can go the other way too: it allows more opportunity for the vendor to negotiate an advantage. The better-informed consumer is more likely to negotiate a more satisfying purchase, so it is important to be thorough in the prepurchase research.

A purchase may have transaction costs such as sales tax or delivery charges. For higher-priced products such as durables and assets, those transaction costs can add up, so you should figure them into your overall cost of the purchase.

Financing costs can also be significant if debt financing is used. Debt is long term and is a significant commitment as well. It may pay to compare financing rates and terms just as you would for the product itself, or you may be able to use financing costs as a negotiating chip in your price negotiations.

After You Buy

Now you can enjoy your purchase. Some products require maintenance and periodic repair to remain useful. You should research those additional costs before buying, because after the purchase you are committed to those activities.

If you are not satisfied due to a product defect, you can contact the retailer or manufacturer. If there is a warranty, the retailer or manufacturer will either fix the defect or replace the item. Many manufacturers and retailers will do so even if there is no warranty to maintain good customer relations and enhance their brand’s reputation. An Internet search will usually turn up contact information for a product’s customer service team.



Figure 8.1.6 . © 2010 Jupiterimages Corporation

There are also federal and state consumer protection laws that cover a seller's responsibilities after a sale. In the United States, the Federal Trade Commission (FTC) Bureau of Consumer Protection has the most direct responsibility for consumer issues. At the state level, the office of the attorney general usually has a consumer protection division. Locally, you can also contact your chamber of commerce or Better Business Bureau (BBB) for more information.

You can also resort to the judicial system for compensation. For limited claims, you can file in small claims court. Claim limits vary by state, but range between $500 and $10,000. Small claims court is a less formal and costly process than filing a suit. At the other end of the spectrum is the class-action suit in which many plaintiffs pursue the same complaint, sharing the costs and the awards of the lawsuit.

Consumer Strategies

The advertising industry is proof of the importance of "branding." Customer brand loyalty is a real phenomenon. In 2007, the top 100 biggest advertisers spent $107,635,000,000 on advertising worldwide, with the automotive, personal care, and food industries

leading the pack.Advertising Age, “Global Marketers: Top 100,” December 8, 2007, http://adage.com/images/random/datacenter/2008/globalmarketing2008.pdf (accessed April 1, 2009). Producers go to great expense to brand their products. When in doubt, consumers tend to choose a familiar brand. Once disappointed by a brand, consumers tend to avoid it. For some products, there are alternative private-label or store-label brands, applied to many products but sold by one store or chain. The store brand is usually a cheaper alternative and often, although not always, of comparable quality. This is a widespread practice in the food industry with grocery store brands. Shopping for the store brand can often yield significant savings.

Aiden’s purchase comes with a two-year manufacturer’s guarantee, but the salesperson is encouraging her to buy an extended warranty. She is already paying more than she wanted to for a high-quality machine, and the extended warranty adds nearly a hundred dollars to the purchase price. She decides to forgo the extra protection, reasoning that most repairs, if needed after two years, would cost less than that anyway.

An offer of a warranty with purchase can be valuable if it lowers the expected maintenance or repair costs of the product. Sometimes a product is offered with a warranty at a higher price; sometimes you can purchase an optional warranty for an additional cost. If the cost of a malfunction is low, then the warranty is probably not worth it.

Price advantage can sometimes come through timing. Seasonally updated products or models can force retailers to discount old inventory to get it off the shelves before the new inventory arrives. Automobiles, for example, have a one-year product cycle, as do many desktop computers and peripherals.

Some products are naturally dated, such as calendars or tax preparation software, and so may be discounted as they near their expiration date. However, that is because they have less and less usefulness and may not be worth buying at all.

Commodities prices can fluctuate depending on the season or the weather, and although you may not have a choice of buying home heating oil when you do, some products do offer you a choice. Tomatoes in January are more expensive than in August, for example; eating fresh foods seasonally can produce savings.

Price can also be affected by transaction costs, or the costs of making the purchase. They can be included in the price or may be listed separately. Larger and more expensive items tend to have more transaction costs such as delivery and storage. Sales tax, which is a percentage of the price, may be required, and the higher the item’s price, the more sales tax you will pay. Asset purchases also involve a legal transfer of ownership and often the costs of acquiring financing, which add to their costs. Sometimes, to entice a purchase, the seller may agree to bear some or all of the transaction costs.

Retailers change prices based on buyers’ needs. They practice **price discrimination**, or the practice of charging a different price for the same product, when different consumers have different need of a product. Airlines are a classic example, charging less for a ticket bought weeks in advance than for the same flight if the ticket is bought the day before. Someone who purchases weeks ahead is probably a leisure traveler, has more flexibility, and is more sensitive to price. Someone who books a day ahead is probably a business traveler, has little flexibility, and is not so sensitive to price. The business traveler, in this case, is willing to pay more, so the airline will charge that person more.

Retailers also offer discounts, sales, or “deals” to attract consumers who otherwise would not be shopping. Sometimes these are seasonal and predictable, such as in January, when sales follow the big holiday shopping season. Sometimes sales are not sales at all, but prices are “discounted” relative to new, higher, prices that will soon take effect. **Quantity discounts**, a lower unit price for a higher volume purchased, may be available for customers buying larger quantities, although sometimes the opposite is true, that is, the smaller package offers a smaller unit price. While it may be cheaper to buy a year’s worth of toilet paper at one time, you then create storage costs and sacrifice liquidity, which you should weigh against your cost savings.

In short, sellers want to sell and will use price to make products more attractive. As a buyer, you need to recognize when that attraction offers real value.

Scams: Caveat Emptor (Buyer Beware)

Unfortunately the world of commerce includes people with less-than-honorable intentions. You likely have been taken advantage of once or twice or have fallen victim to a **scam**, or a fraudulent business activity or swindle. Technology has made it easier for con artists to steal from more people, contacting them by telephone or by e-mail. The details of the scam vary, but the pattern is much

the same: the fraud sets up a scenario that requires the victim to send money or to divulge financial or personal information, such as bank account, Social Security (federal ID), or credit card numbers, which can then be used to access accounts.

Here are some typical scams reported by *Consumer Reports*, the magazine of the nonprofit Consumers Union, an advocacy group for consumers:Consumer Reports, "Sneakiest Consumer Scams," September 2007, http://www.consumerreports.org (accessed April 1, 2009).



Figure 8.1.6 . © 2010 Jupiterimages Corporation

- This car's a cream puff.
- You've just won.…
- There's a problem with your bank account.
- This stock is at 50 cents, and it's going to 5 or 6 bucks this week. Buy now!
- You don't need a physical to qualify for this low-cost health insurance!
- I'll be back sometime soon to finish your roof.
- This investment provides the guaranteed high returns and low risk that seniors like you need.
- We move u 4 less.
- I'm a political refugee. Help me move millions out of my former country into your bank account.
- I wouldn't go on vacation without this car repair.

The best way to protect yourself from scams is to be as informed as possible. Do your homework. If you feel like you are in over your head, call on a friend or family member to help you or to speak for you in negotiations. There are a number of nonprofit and government agencies that you can ask about the legitimacy of an idea or an arrangement. There are also some proven ways to try to protect yourself:

- Never give anyone personal and/or financial information when solicited by telephone or Internet. Legitimate business interests do not do that. When in doubt, contact the organization to verify their identity.
- Get a second opinion, especially when advised to do costly repairs.
- Check the credentials of prospective workers or service providers; most are certified, licensed, or recognized by a professional organization or trade group (e.g., auto mechanics may be endorsed by the American Automobile Association [AAA]).
- If you have doubts about a professional's credentials, such as an accountant, doctor, or architect, call the local professional society or trade group and ask about previous complaints lodged against him or her.
- Get a written estimate, specifying the work to be done, the materials to be used, the estimated labor costs, the estimated completion date, and the estimated total price. Ask the vendor to provide proof of insurance.

If you do get "scammed," it is your civic duty to complain to your state's consumer division in the attorney general's office and, if advised, to federal regulators at the Federal Trade Commission (FTC). That is the only way to stop and expose such frauds and to keep others from becoming victims. As the saying goes, "If it sounds too good to be true, it probably is."

KEY TAKEAWAYS

- The consumer purchase process involves
  - Prepurchase
    - Identifying the product
    - Identifying the market
    - Identifying the financing
  - Purchase
    - Negotiating the purchase price and terms of sale
  - Postpurchase
    - Ensuring satisfaction.
- Attribute scoring can be used to help identify the product.
- A product may be sold in different markets that may affect the cost of the purchase.
- Financing choices can affect the cost of the purchase.
- Strategies such as maximizing the advantages of branding, timing, and transaction costs can benefit consumers.
- There are common features of scams and also legal protections and remedies.

Exercises

1. Identify the last three items (consumer goods and durable goods) you purchased. Alternatively, select any three items you purchased during the last two months. Choose diverse items and analyze each item in terms of the following factors:
   1. Why did you buy that item? How did you decide what to get?
   2. What attributes proved most important in narrowing your choices? Create an attribute analysis chart for each item (see Figure 8.4).
   3. Where did you get your information about the item?
   4. Where did you go to buy the item?
   5. In what kind of market did you make your purchase?
   6. Where did the money come from for your purchase?
   7. How much did you pay for the item, and how did you pay for it?
   8. How would you rate your satisfaction with your purchase?
   9. If or when you purchase that type of item again, what might you do differently?
2. In My Notes or your personal finance journal, record your favorite strategies for making purchases. Include a specific recent example of how you used each strategy. Your strategies may relate to bargain shopping, high-end shopping, warranties, store brands, coupons, discounts, rebates, seasonal shopping, expiry shopping, bulk buying, cooperative buying, special sales, or other practices. Share your consumer success stories with classmates and add at least one new idea to your list.
3. Have you ever been the victim of a consumer scam? What scams have you been exposed to that you managed to avoid? Describe your experiences in My Notes or your personal finance journal. Find out how many complaints of fraud the Federal Trade Commission received from consumers in its most recent reporting year (e.g., see http://www.ftc.gov/opa/2008/02/fraud.shtm). What were the most common fraud complaints?
4. How informed are you about your rights as a consumer in your state and as a citizen of the United States? For example, what are your rights in returning unwanted purchases and recalled items? In moving your house? In buying food? In having access to electricity? Research a topic relevant to your personal situation from the comprehensive list at the Federal Trade Commission's Consumer Guides and Protections for Citizens: www.usa.gov/Citizen/Topics/Co...r_Safety.shtml. How will what you learn guide you in your next related purchase or in taking some other action? Visit the following Web sites to learn more about the information and protections available to you as a consumer. What services do the organizations and agencies provide? What should you do if you have a complaint as a consumer or suspect you are being scammed?
   1. Better Business Bureau (http://www.bbb.org)
   2. Federal Trade Commission (http://www.ftc.gov)

3. Consumer protection laws about making purchases (http://www.ftc.gov/bcp/menus/consumer/shop.shtm)

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8.2: Consumer Purchases

Learning Objectives

1. Show how the purchasing process (e.g., identifying the product, the market, and the financing) may be applied to a car purchase.
2. Explain the advantages (and disadvantages) of leasing versus borrowing as a form of financing.
3. Analyze all the costs associated with car ownership.
4. Define “lemon laws.”

Many adults will buy a car several times during their lifetimes. A car is a major purchase. Its price can be as much as or more than one year’s disposable income. Its annual operating costs can be substantial, including the cost of fuel, legally mandated insurance premiums, and registration fees, as well as maintenance and perhaps repairs and storage (parking). A car is not only a significant purchase, but also an ongoing commitment.



Figure 8.2.1 . © 2010 Jupiterimages Corporation

In the United States, people spend a considerable amount of time in their cars, commuting to work, driving their children to school and various activities, driving to entertainment and recreational activities, and so on. Most people want their car to provide not only transportation, but also comforts and conveniences. You can apply the purchasing model, described in this chapter, to the car purchase.

First, you identify the need: What is your goal in owning a car? What needs will it fulfill? Here are some further questions to consider:

- What kind of driving will you use the car for? Will you depend on it to get you to work, or will you use it primarily for weekend getaways?
- Do you need carrying capacity (for passengers or “stuff”) or hauling capacity?
- Do you live in a metropolitan area where you will be driving shorter distances at lower speeds and often idling in traffic?
- Do you live in a more rural area where you will be driving longer distances at faster speeds?
- Do you live in a climate where winter or a rainy season would make traction and storage an issue?
- How much time will you spend in the car every day?
- How many miles will you drive each year?
- How long do you expect to keep the car?
- Do you expect to resell or trade in the car?

Your answers to these questions will help you identify the product you want.

Identify the Product

Answering these questions can help identify the attributes you value in a car, based on how you will use it. Cars have many features to compare. The most critical (in no particular order) are shown in Figure 8.9.

Automobile Attribute	Relevance
Fuel or Energy Efficiency	Determines the costs and convenience of operating the car, a major component of your annual operating expense. Energy efficiency may also relate to growing demand for "green" cars or hybrids. An environmentally friendly car may in itself be an attribute you care about when deciding to buy a car.
Size and "Horsepower"	Determined by your need to carry passengers and "stuff." Size may also refer to engine size, which affects fuel or energy efficiency.
Condition	New, floor model, or used. Physical condition and odometer readings on trade-ins are major attributes in the used car market.
Performance Quality	Usually described in terms of the car's acceleration (0 to 60 miles per hour in *x* seconds), but also in terms of the availability of four-wheel drive and the quality of the steering system, braking system, suspension, and transmission—all of which affect the ease and utility of driving the car and its expected maintenance and repair costs.
Entertainment Features	As more people spend more time in their cars, features such as DVD players and monitors have joined radios, CD players, and cup holders as desirable features. Plug-in capacity for cell phones and laptops has also become a critical feature for many consumers.
Navigation Features	Innovations such as real-time GPS systems with digital road maps are rapidly becoming standard.
Safety Features	Many safety features are mandated, but distinctive safety features are offered, including, for example, electronic locking systems, built-in security alarms, built-in child restraints, and reverse sonar.
Appearance and Comfort	For some buyers the color, shape, and fittings of a car and its interior are important attributes.
Reliability	Reliability refers to expected mileage and performance over time in all conditions, as well as to future maintenance and repair costs.
Make	Some buyers prefer particular brands or styles of car and remain loyal to them.

Figure 8.2.2 :Automobile Attributes and Relevance

All these attributes affect price, and you may think of others. Product attribution scoring can help you identify the models that most closely fit your goals.

Mary lives on a dirt road in a rural area; she drives about 18,000 miles per year, commuting to her job as an accountant at the corporate headquarters of an auto parts chain and taking her kids to school. She is also a pretty good car mechanic and does basic maintenance herself.

John lives in the city; he walks or takes a bus to his job as a market researcher for an ad agency, but keeps a car to visit his parents in the suburbs. He drives about 5,000 miles per year, often crawling in traffic. All John knows about a car is that the key goes in the ignition and the fuel goes in the tank.

John and Mary would rate these attributes very differently, and their scoring of the same models would have very different results.

Mary may value fuel efficiency more, as she drives more (and so purchases more fuel). Driving often and with her children, she may rank size, safety, and entertainment features higher than John would, who is in his car less frequently and alone. Mary relies on the car to get to work, so reliability would be more important for her than for John, who drives only for recreational visits. But Mary also knows that she can maintain and repair some things herself, which makes that less of a factor.

Car attributes are widely publicized by car dealers and manufacturers, who are among the top advertisers globally year after year.Advertising Age, "Global Marketers: Top 100," December 8, 2007,

http://adage.com/images/random/datacenter/2008/globalmarketing2008.pdf (accessed April 1, 2009). You can visit dealerships in your area or manufacturers' Web sites. Using the Internet is a more efficient way of narrowing your search. Specialized print and online magazines, such as *Car and Driver*, *Road and Track*, and Edmunds.com, offer detailed discussions of model attributes and their actual performance. *Consumer Reports* also offers ratings and reviews and also provides data on frequency of repairs and annual maintenance costs.

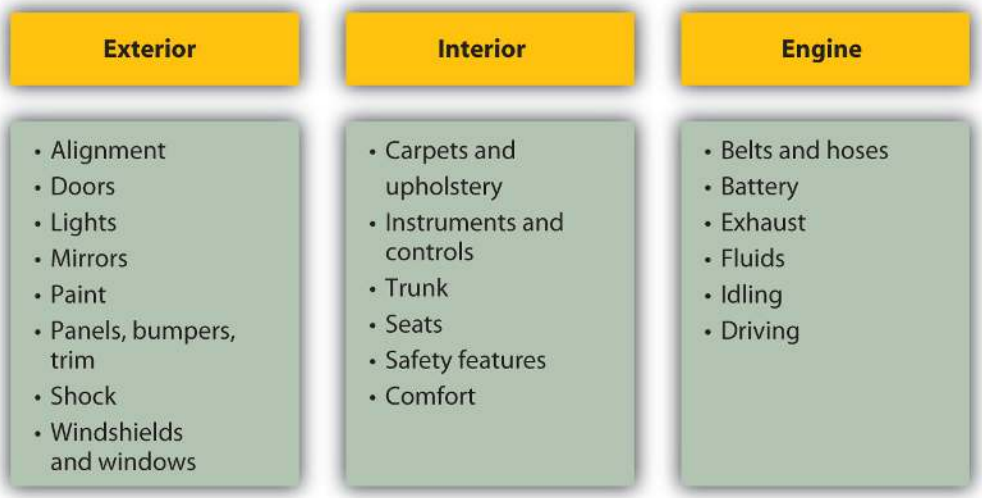
You want to be sure to consider not only the price of buying the car, but also the costs of operating it. Fuel, maintenance, repair, insurance, property taxes, and registration may all be affected by the car's attributes, so you should consider operating costs when choosing the product. For example, routine repairs and maintenance are more expensive for some cars. A more fuel-efficient car can significantly lower your fuel costs. A more valuable car will cost more to insure and will mean higher property (or excise) taxes. Moreover, the costs of fuel, maintenance, insurance, registration, and perhaps property tax on the car will be ongoing expenses—you want to buy a car you can afford *and* afford to drive.

If you are buying a new car, you know its condition, and so you can predict annual maintenance and repair costs and the car's longevity by the history for that model. Depending on how long you expect to own the car, you may also be concerned with its predicted resale value.

Used cars are generally less expensive than new. A used car has fewer miles left in it. Its condition is less certain: you may not know how it has been driven or its repair and maintenance history. This makes it harder to predict annual maintenance and repair costs. Typically, since it is already used when you buy it, you expect little or no resale value. You can gain a significant price savings in the used car market, and there are good used cars for sale. You may just have to look a bit harder to find one.

The National Automobile Dealers Association (NADA) offers a checklist for used vehicle inspection when buying a used car. The NADA also publishes guidebooks on used car book values (see Figure 8.10.

Figure 8.2.3 Used Car Buyer's ChecklistNational Automobile Dealers Association, www.nadaguides.com (accessed November 23, 2009).



The condition of exterior and interior features can indicate past accidents, repairs, or lack of maintenance that may increase future operating expenses, or just driving habits that have left a less attractive or less comfortable vehicle.

Services like Carfax (http://www.carfax.com) provide research on a vehicle's history based on its VIN (vehicle identification number), including any incidence of accidents, flooding, frame damage, or airbag deployment, the number and type of owners (was it a rental or commercial vehicle?), and the mileage. All these events affect your expectations of the vehicle's longevity, maintenance and repair costs, resale value, and operating costs, which can help you calculate its value and usefulness.

Unless you are an expert yourself, you should always have a trained mechanic inspect a used vehicle before you buy it. With cars, as with any item, the better informed you are, the better you can do as a consumer. Given the cost of a car and its annual expense, there is enough at stake with this purchase to make you cautious.

Identify the Market

New cars are sold through car dealerships. The dealer has a contract with the manufacturer to sell its cars in the retail market. Dealers may also offer repair and maintenance services as well as parts and accessories made especially for the models it sells.

New car dealers may also resell cars that they get as trade-ins, especially of the same models they sell new. Used car dealers typically buy cars through auctions of corporate, rental, or government cars.



Figure 8.2.4 . © 2010 Jupiterimages Corporation

Individuals selling a used car can also do so through networking—in an online auction such as eBay, a virtual bulletin board such as Craig's List, or the bulletin board in the local college snack bar. Dealers will have more information about the market, especially about the supply of cars and price levels for them.

Some people prefer a new car, with its more advanced features and more certain quality, but a used car may be a viable substitute for many purchasers. Many people buy used cars while their incomes are lower, especially in the earlier stages of their adult (working) life. As income rises and concern for convenience, reliability, and safety increases with age and family size, consumers may move into the new car market.

While they are two very different markets, the markets for new and used cars are related. Supply of and demand for new cars affect price levels in the new car market, but also in the used car market. For example, when new car prices are high, more buyers seek out used cars and when low, used car buyers may turn to the new car market.

Demand for cars is affected by macroeconomic factors such as business cycles and inflation. If there is a recession and a rise in unemployment, incomes drop. Demand for new cars will fall. Many people will decide to keep driving their current vehicle until things pick up, unwilling to purchase a long-term asset when they are uncertain about their job and paycheck. That slowing of demand may lower car prices, but will also lower the resale or trade-in value of the current vehicle. For first-time car buyers, that may be a good time to buy.

If there is inflation, it will push up interest rates because the price of borrowing money rises with other prices. Since many people borrow when purchasing a car, that will make the borrowing, and so the purchase, more costly, which will discourage demand.

When the economy is expanding, on the other hand, and inflation and interest rates are low, demand for new cars rises, pushing up prices. In turn, prices are kept in check by competition. As demand for new cars rises, demand for used cars may fall, causing the supply of used cars to rise as more people trade in their cars to buy a new one. They trade them in earlier in the car's life, so the quality of the used cars on the market rises. This may be a good time to buy a used car.

Identify the Financing: Loans and Leases

The cost of a car is significant. Car purchases usually require financing through a loan or a lease. Each may require a down payment, which you would take out of your savings. That creates an opportunity cost of losing the return you could have earned on your savings. You also lose liquidity: you are taking cash, a liquid asset, and trading it for a car, a not-so-liquid asset.

Your opportunity cost and the cost of decreasing your liquidity are costs of buying the car. You can reduce those costs by borrowing more (and putting less money down), but the more you borrow, the higher your costs of borrowing. If you trade in a vehicle, dealers will often use the trade-in value as the down payment and will sell the car to you with "no money down."

Car loans are available from banks, credit unions, consumer finance companies, and the manufacturers themselves. Be sure to shop around for the best deal, as rates, maturity, and terms can vary. If you shop for the loan before shopping for the car, then the loan negotiation is separate from the car purchase negotiation. Both may be complex deals, and there are many trade-offs to be made. The more separate—and simplified—each negotiation is, the more likely you will be happy with the outcome.

Loans differ by interest rate or annual percentage rate (APR) and by the time to maturity. Both will affect your monthly payments. A loan with a higher APR is costing you more and, all things being equal, will have a higher monthly payment. A loan with a longer maturity will reduce your monthly payment, but if the APR is higher, it is actually costing you more. Loan maturities may range from one to five years; the longer the loan, the more you risk ending up with a loan that's worth more than your car.

Rebecca buys a used Saturn for $6,000, with $1,000 cash down from savings and a GMAC-financed loan at 7.2 APR, on which she pays $115 a month for forty-eight months. She could have gotten a twenty-four-month loan, but wanted to have smaller monthly payments. After only twenty-five months, she totals her car in a chain collision but luckily escapes injury. Now she needs another car. The Saturn has no trade-in value, her insurance benefit won't be enough to cover the cost of another car, and she still has to pay off her loan regardless. Rebecca is out of luck, because her debt outlived her asset. If your debt outlives your asset, your ability to get financing when you go to replace that vehicle will be limited, because you still have the old debt to pay off and now are looking to add a new debt—and its payments—to your budget. Rebecca will have to use more savings and may have to pay more for a second loan, if she can get one, increasing her monthly payments or extending her debt over a longer period of time.

An alternative to getting a car loan is leasing a car. Leases are a common way of financing a car purchase. A **lease** is a long-term rental agreement with a **buyout option** at maturity. Typically, at the end of the lease, usually three or four years, you can buy the car outright for a certain amount, or you can give it back (and buy or lease another car), which removes the risk of having an asset that outlives its financing. Leases specify an annual mileage limit, that is, the number of miles that you can drive the car in a year before incurring additional costs. Leases also specify the monthly payment and requirements for routine maintenance that will preserve the car's value.

So, lease or borrow? The price of the car should be the same regardless of how it is financed—the car should be worth what it's worth, no matter how it is paid for. The cost of borrowing, in percentage terms, is the interest rate or APR of the loan. The costs of leasing, in dollars, are the down payment, the lease payments, and the buyout. Since the price of the car itself is the same in either case, the present value of all the lease costs should be the same as the price of the car. You can use what you know about the time value of money to calculate the discount rate that produces that price; that is the equivalent annual cost of the lease, in percentage terms.

For example, you want to buy a car with a price of $19,000. You can get a car loan with an APR of 6.5 percent from your bank. You are offered a lease requiring a down payment of $2,999, monthly payments of $359 for three years, and a final buyout of $5,000. The APR of the lease is actually 5.93 percent, which would make it the cheaper financing alternative.

In general, the longer you intend to keep the car, the less sense it makes to lease. If you typically drive a car "into the ground," until it costs more to repair than replace it, then you are better off borrowing and spreading the costs of financing over a longer period. On the other hand, if you intend to keep the car only for the term of the lease and not to exercise the buyout option, then it is usually more cost effective to lease. You also need to consider whether or not you are likely to stay within the mileage limits of the lease, as the mileage penalties can add significantly to your costs.

Some people will say that they like to borrow and then "own" in order to have an asset that can store value or "build equity." Given the unpredictable nature of the used car market, however, a car is really not an asset that can be counted on to store value. Thinking of a car as something that you will use up (although over several years) rather than as an asset you can preserve or save will help you make better financial decisions.



Figure 8.2.5 . © 2010 Jupiterimages Corporation

When you are buying a car, you want to minimize the cost of both the car and the financing. If you are purchasing both the car and the financing from the same dealer, you should be careful to discuss them separately. Car dealers, who offer loans and leases as well as cars, often combine the three discussions, offering a break on the financing to make the car more affordable, or offering a break on the car to make the financing more affordable. To complicate matters further, they may also offer a rebate on a certain model or with a certain lease. The more clearly you can separate which costs belongs to which—the car or the financing—the more clearly you can understand and minimize your costs.

Purchase and Postpurchase

A car purchase requires significant prepurchase activities. Once you have identified and compared appropriate car attributes, a seller, and financing options, all you have to do is drive away, right? Not quite.

Car purchases are one instance where the buyer is expected to haggle over price. The sticker price is the **manufacturer's suggested retail price (MSRP)** for that vehicle model with those features. Dealers negotiate many of the factors that ultimately determine the value of the purchase: the optional features of the car, the warranty terms, service discounts on routine maintenance, financing terms, rebates, trade-in value for you old car, and so on.

As more of these factors are discussed at once, the negotiation becomes more and more complex. You can help yourself by keeping the negotiations as simple as possible: negotiate one thing at a time, settle on that, and then negotiate the next factor. Keep track of what has been agreed to as you go along. When each factor has been negotiated, you will have the package deal.

Your ability to get a satisfying deal rests on your abilities as a negotiator. For this reason, many people who find that process distasteful or suspect that their skills are lacking find the car purchasing process distasteful. Dealers know this, and some will try to attract customers by being more transparent about their own costs and about prices. Some even promise the "no-dicker sticker" sale with no haggling over price at all.

As with any product in any market, the more information you have, the better you can negotiate. The more thorough your prepurchase activities, the more satisfying your purchase will be.

While you own the car, you will maximize the benefits enjoyed by operating the vehicle safely and by keeping it in good condition. Routine maintenance (e.g., replacing fluids, rotating tires) can ensure the quality and longevity of your vehicle. New cars come with owner's manuals that detail a schedule of service requirements and good driving practices for your vehicle. You will be required to keep the car legally insured and registered with the state where you reside, and you must maintain a valid license to drive.



Figure 8.2.6 . © 2010 Jupiterimages Corporation

New cars, and some used cars, are sold with a **warranty**, which is a promise about the quality of the product, made for a certain period of time. The terms and covered repair costs may vary. You should understand the terms of the warranty, especially if something covered should need servicing, so that you know what repairs you may be charged for. The manufacturer, and sometimes the seller, issues the warranty. If you have questions about the warranty after purchasing, it may be best to contact the manufacturer directly.

If you are dissatisfied with your purchase (and the fault seems to be with the car), your first step should be a conversation with your dealer. If the problem is not addressed, you can contact the automobile company directly; its Web site will provide you with a customer service contact. If the dealer and the manufacturer refuse to make good, you should contact your state's consumer affairs division in the attorney general's office. In some states, there are entire state agencies or departments devoted to auto purchases.

For his first car Ray bought a ten-year-old coupe with only 60,000 miles on it for a price that seemed too good to be true. The seller said the good price was in exchange for getting payment in full in cash. The car broke down right away, however, and within two weeks died of a cracked block. When Ray complained, the seller claimed he didn't know about the cracked block and pointed out that there was no warranty on the car, so Ray was out of luck. Fortunately, Ray had read that a defective car, referred to as a "lemon," is covered under laws that protect consumers who unknowingly purchase a car that proves to be defective. **Lemon laws** regulate sales terms, purchase cancellation conditions, and warranty requirements. These laws are enforced on both the federal and state level in the United States. Other consumer protection laws apply specifically to motor vehicles and vary by state. Ray learned that laws in his state include used cars as well as new ones, and when he told the seller, he was able to get most of his cash back.

KEY TAKEAWAYS

- The purchase process may be applied to a car purchase.
- Attribute scoring may be helpful to identify the product.
- Common car financing is through a loan or a lease.
- A warranty guarantees minimal satisfaction with performance attributes.
- Laws protect consumers who are dissatisfied with their car purchases or unknowingly buy defective cars.

Exercises

1. Perform an attribute analysis for your next new or used car. Go online to research cars with the attributes you have prioritized, and find where you could buy what you want locally. Then research the dealership, including a quick check at the Better Business Bureau Web site or your local chamber of commerce to learn if there have been many consumer complaints. After researching the product, the market, and the price, visit a dealership, preferably with a classmate or partner, for the experience of getting information and practicing your negotiation skills (but without making any commitments, unless you really are in the market for a car at this time).
2. How will you finance a car? Play with the Car Loan Calculator at www.edmunds.com/apps/calc/CalculatorController. First identify a sample of new or used cars you would like to own, and for each choice calculate what your down payment, monthly loan payments, and term of payment would be. How much would you need to buy a car and where would that money come from? How much could you afford to pay each month and for how long? How could you modify your budget to accommodate car payments?
3. For a car you would like to drive, calculate and compare what it would cost you to buy it and to lease it. Use the Lease versus Buy Calculator at http://www.leaseguide.com/leasevsbuy.htm. What would be the advantages of owning the car? What would be the advantages of leasing it? For your lifestyle, needs, and uses of a vehicle, should you buy or lease?
4. View a 2009 Money Talks video on “Buying Cars in a Credit Crunch” at http://articles.moneycentral.msn.com/video/defau ab1-4e25-b446- 30e313aa3796%26tab=Money %20Talks%20News. What sources of financing does the video identify for times when national banks and finance companies are not forthcoming with car loans because of downturns in the economy?
5. Check the lemon laws in your state at Lemon Law America’s Web site: http://www.lemonlawamerica.com/. Click on your state on the map. What conditions do your state lemon laws cover? Some states do not cover used or leased cars under lemon laws. Under federal laws, if you buy a used car “as is,” do you still retain rights under the lemon laws? Under federal lemon laws, in what situations, when the seller does not divulge the information, may you be able to get your money back on a car?

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8.3: A Major Purchase- Buying a Car

Learning Objectives

1. Show how the purchasing process (e.g., identifying the product, the market, and the financing) may be applied to a car purchase.
2. Explain the advantages (and disadvantages) of leasing versus borrowing as a form of financing.
3. Analyze all the costs associated with car ownership.
4. Define “lemon laws.”

Many adults will buy a car several times during their lifetimes. A car is a major purchase. Its price can be as much as or more than one year’s disposable income. Its annual operating costs can be substantial, including the cost of fuel, legally mandated insurance premiums, and registration fees, as well as maintenance and perhaps repairs and storage (parking). A car is not only a significant purchase, but also an ongoing commitment.



Figure 8.2.1 . © 2010 Jupiterimages Corporation

In the United States, people spend a considerable amount of time in their cars, commuting to work, driving their children to school and various activities, driving to entertainment and recreational activities, and so on. Most people want their car to provide not only transportation, but also comforts and conveniences. You can apply the purchasing model, described in this chapter, to the car purchase.

First, you identify the need: What is your goal in owning a car? What needs will it fulfill? Here are some further questions to consider:

- What kind of driving will you use the car for? Will you depend on it to get you to work, or will you use it primarily for weekend getaways?
- Do you need carrying capacity (for passengers or “stuff”) or hauling capacity?
- Do you live in a metropolitan area where you will be driving shorter distances at lower speeds and often idling in traffic?
- Do you live in a more rural area where you will be driving longer distances at faster speeds?
- Do you live in a climate where winter or a rainy season would make traction and storage an issue?
- How much time will you spend in the car every day?
- How many miles will you drive each year?
- How long do you expect to keep the car?
- Do you expect to resell or trade in the car?

Your answers to these questions will help you identify the product you want.

Identify the Product

Answering these questions can help identify the attributes you value in a car, based on how you will use it. Cars have many features to compare. The most critical (in no particular order) are shown in Figure 8.9.

Automobile Attribute	Relevance
Fuel or Energy Efficiency	Determines the costs and convenience of operating the car, a major component of your annual operating expense. Energy efficiency may also relate to growing demand for "green" cars or hybrids. An environmentally friendly car may in itself be an attribute you care about when deciding to buy a car.
Size and "Horsepower"	Determined by your need to carry passengers and "stuff." Size may also refer to engine size, which affects fuel or energy efficiency.
Condition	New, floor model, or used. Physical condition and odometer readings on trade-ins are major attributes in the used car market.
Performance Quality	Usually described in terms of the car's acceleration (0 to 60 miles per hour in *x* seconds), but also in terms of the availability of four-wheel drive and the quality of the steering system, braking system, suspension, and transmission—all of which affect the ease and utility of driving the car and its expected maintenance and repair costs.
Entertainment Features	As more people spend more time in their cars, features such as DVD players and monitors have joined radios, CD players, and cup holders as desirable features. Plug-in capacity for cell phones and laptops has also become a critical feature for many consumers.
Navigation Features	Innovations such as real-time GPS systems with digital road maps are rapidly becoming standard.
Safety Features	Many safety features are mandated, but distinctive safety features are offered, including, for example, electronic locking systems, built-in security alarms, built-in child restraints, and reverse sonar.
Appearance and Comfort	For some buyers the color, shape, and fittings of a car and its interior are important attributes.
Reliability	Reliability refers to expected mileage and performance over time in all conditions, as well as to future maintenance and repair costs.
Make	Some buyers prefer particular brands or styles of car and remain loyal to them.

Figure 8.2.2 :Automobile Attributes and Relevance

All these attributes affect price, and you may think of others. Product attribution scoring can help you identify the models that most closely fit your goals.

Mary lives on a dirt road in a rural area; she drives about 18,000 miles per year, commuting to her job as an accountant at the corporate headquarters of an auto parts chain and taking her kids to school. She is also a pretty good car mechanic and does basic maintenance herself.

John lives in the city; he walks or takes a bus to his job as a market researcher for an ad agency, but keeps a car to visit his parents in the suburbs. He drives about 5,000 miles per year, often crawling in traffic. All John knows about a car is that the key goes in the ignition and the fuel goes in the tank.

John and Mary would rate these attributes very differently, and their scoring of the same models would have very different results.

Mary may value fuel efficiency more, as she drives more (and so purchases more fuel). Driving often and with her children, she may rank size, safety, and entertainment features higher than John would, who is in his car less frequently and alone. Mary relies on the car to get to work, so reliability would be more important for her than for John, who drives only for recreational visits. But Mary also knows that she can maintain and repair some things herself, which makes that less of a factor.

Car attributes are widely publicized by car dealers and manufacturers, who are among the top advertisers globally year after year.Advertising Age, "Global Marketers: Top 100," December 8, 2007,

http://adage.com/images/random/datacenter/2008/globalmarketing2008.pdf (accessed April 1, 2009). You can visit dealerships in your area or manufacturers' Web sites. Using the Internet is a more efficient way of narrowing your search. Specialized print and online magazines, such as *Car and Driver*, *Road and Track*, and Edmunds.com, offer detailed discussions of model attributes and their actual performance. *Consumer Reports* also offers ratings and reviews and also provides data on frequency of repairs and annual maintenance costs.

You want to be sure to consider not only the price of buying the car, but also the costs of operating it. Fuel, maintenance, repair, insurance, property taxes, and registration may all be affected by the car's attributes, so you should consider operating costs when choosing the product. For example, routine repairs and maintenance are more expensive for some cars. A more fuel-efficient car can significantly lower your fuel costs. A more valuable car will cost more to insure and will mean higher property (or excise) taxes. Moreover, the costs of fuel, maintenance, insurance, registration, and perhaps property tax on the car will be ongoing expenses—you want to buy a car you can afford *and* afford to drive.

If you are buying a new car, you know its condition, and so you can predict annual maintenance and repair costs and the car's longevity by the history for that model. Depending on how long you expect to own the car, you may also be concerned with its predicted resale value.

Used cars are generally less expensive than new. A used car has fewer miles left in it. Its condition is less certain: you may not know how it has been driven or its repair and maintenance history. This makes it harder to predict annual maintenance and repair costs. Typically, since it is already used when you buy it, you expect little or no resale value. You can gain a significant price savings in the used car market, and there are good used cars for sale. You may just have to look a bit harder to find one.

The National Automobile Dealers Association (NADA) offers a checklist for used vehicle inspection when buying a used car. The NADA also publishes guidebooks on used car book values (see Figure 8.10.

Figure 8.2.3 Used Car Buyer's ChecklistNational Automobile Dealers Association, www.nadaguides.com (accessed November 23, 2009).

The condition of exterior and interior features can indicate past accidents, repairs, or lack of maintenance that may increase future operating expenses, or just driving habits that have left a less attractive or less comfortable vehicle.

Services like Carfax (http://www.carfax.com) provide research on a vehicle's history based on its VIN (vehicle identification number), including any incidence of accidents, flooding, frame damage, or airbag deployment, the number and type of owners (was it a rental or commercial vehicle?), and the mileage. All these events affect your expectations of the vehicle's longevity, maintenance and repair costs, resale value, and operating costs, which can help you calculate its value and usefulness.

Unless you are an expert yourself, you should always have a trained mechanic inspect a used vehicle before you buy it. With cars, as with any item, the better informed you are, the better you can do as a consumer. Given the cost of a car and its annual expense, there is enough at stake with this purchase to make you cautious.

Identify the Market

New cars are sold through car dealerships. The dealer has a contract with the manufacturer to sell its cars in the retail market. Dealers may also offer repair and maintenance services as well as parts and accessories made especially for the models it sells.

New car dealers may also resell cars that they get as trade-ins, especially of the same models they sell new. Used car dealers typically buy cars through auctions of corporate, rental, or government cars.



Figure 8.2.4 . © 2010 Jupiterimages Corporation

Individuals selling a used car can also do so through networking—in an online auction such as eBay, a virtual bulletin board such as Craig's List, or the bulletin board in the local college snack bar. Dealers will have more information about the market, especially about the supply of cars and price levels for them.

Some people prefer a new car, with its more advanced features and more certain quality, but a used car may be a viable substitute for many purchasers. Many people buy used cars while their incomes are lower, especially in the earlier stages of their adult (working) life. As income rises and concern for convenience, reliability, and safety increases with age and family size, consumers may move into the new car market.

While they are two very different markets, the markets for new and used cars are related. Supply of and demand for new cars affect price levels in the new car market, but also in the used car market. For example, when new car prices are high, more buyers seek out used cars and when low, used car buyers may turn to the new car market.

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Figure 8.2.6 . © 2010 Jupiterimages Corporation

New cars, and some used cars, are sold with a **warranty**, which is a promise about the quality of the product, made for a certain period of time. The terms and covered repair costs may vary. You should understand the terms of the warranty, especially if something covered should need servicing, so that you know what repairs you may be charged for. The manufacturer, and sometimes the seller, issues the warranty. If you have questions about the warranty after purchasing, it may be best to contact the manufacturer directly.

If you are dissatisfied with your purchase (and the fault seems to be with the car), your first step should be a conversation with your dealer. If the problem is not addressed, you can contact the automobile company directly; its Web site will provide you with a customer service contact. If the dealer and the manufacturer refuse to make good, you should contact your state's consumer affairs division in the attorney general's office. In some states, there are entire state agencies or departments devoted to auto purchases.

For his first car Ray bought a ten-year-old coupe with only 60,000 miles on it for a price that seemed too good to be true. The seller said the good price was in exchange for getting payment in full in cash. The car broke down right away, however, and within two weeks died of a cracked block. When Ray complained, the seller claimed he didn't know about the cracked block and pointed out that there was no warranty on the car, so Ray was out of luck. Fortunately, Ray had read that a defective car, referred to as a "lemon," is covered under laws that protect consumers who unknowingly purchase a car that proves to be defective. **Lemon laws** regulate sales terms, purchase cancellation conditions, and warranty requirements. These laws are enforced on both the federal and state level in the United States. Other consumer protection laws apply specifically to motor vehicles and vary by state. Ray learned that laws in his state include used cars as well as new ones, and when he told the seller, he was able to get most of his cash back.

KEY TAKEAWAYS

- The purchase process may be applied to a car purchase.
- Attribute scoring may be helpful to identify the product.
- Common car financing is through a loan or a lease.
- A warranty guarantees minimal satisfaction with performance attributes.
- Laws protect consumers who are dissatisfied with their car purchases or unknowingly buy defective cars.

Exercises

1. Perform an attribute analysis for your next new or used car. Go online to research cars with the attributes you have prioritized, and find where you could buy what you want locally. Then research the dealership, including a quick check at the Better Business Bureau Web site or your local chamber of commerce to learn if there have been many consumer complaints. After researching the product, the market, and the price, visit a dealership, preferably with a classmate or partner, for the experience of getting information and practicing your negotiation skills (but without making any commitments, unless you really are in the market for a car at this time).
2. How will you finance a car? Play with the Car Loan Calculator at www.edmunds.com/apps/calc/CalculatorController. First identify a sample of new or used cars you would like to own, and for each choice calculate what your down payment, monthly loan payments, and term of payment would be. How much would you need to buy a car and where would that money come from? How much could you afford to pay each month and for how long? How could you modify your budget to accommodate car payments?
3. For a car you would like to drive, calculate and compare what it would cost you to buy it and to lease it. Use the Lease versus Buy Calculator at http://www.leaseguide.com/leasevsbuy.htm. What would be the advantages of owning the car? What would be the advantages of leasing it? For your lifestyle, needs, and uses of a vehicle, should you buy or lease?
4. View a 2009 Money Talks video on “Buying Cars in a Credit Crunch” at http://articles.moneycentral.msn.com/video/defau ab1-4e25-b446- 30e313aa3796%26tab=Money %20Talks%20News. What sources of financing does the video identify for times when national banks and finance companies are not forthcoming with car loans because of downturns in the economy?
5. Check the lemon laws in your state at Lemon Law America’s Web site: http://www.lemonlawamerica.com/. Click on your state on the map. What conditions do your state lemon laws cover? Some states do not cover used or leased cars under lemon laws. Under federal laws, if you buy a used car “as is,” do you still retain rights under the lemon laws? Under federal lemon laws, in what situations, when the seller does not divulge the information, may you be able to get your money back on a car?

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CHAPTER OVERVIEW

9: Buying a Home

This chapter applies the ideas developed in the previous chapter to what, for most people, will be their most significant purchase: a home. The chapter discusses its role both as a living expense and an investment, as well as the financing and financial consequences of the purchase.

- 9.1: Introduction
- 9.2: Identify the Product and the Market
- 9.3: Identify the Financing
- 9.4: Purchasing and Owning Your Home
- 9.5: Alternate Perspectives
  - 9.5.1: Buying a Home
  - 9.5.2: Housing
    - 9.5.2.1: Buying a Home
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  - 9.5.3: Vehicles
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9.1: Introduction

Be it ever so humble, the “biggest” purchase you ever make may be your home. Unlike most other consumer purchases, a home is expected to be more than just a living space; it is also an asset that stores and generally appreciates (increases) in value. The house serves a dual financial purpose, acting as both a home and an investment.

Home ownership comes with substantial annual operating expenses for repairs and maintenance, insurance, and property taxes. Maintenance preserves a home’s value, insurance protects that value, and taxes for community services both enhance and secure value.

A home purchase is typically financed with secured debt that creates a significant monthly expense - the mortgage payment - in your budget. A mortgage is a long-term debt that obligates your cash flows for an extended period, potentially limiting your career choices and mobility.

Your choice of home reflects personal factors in your life. These factors include your tastes, age, stage of life, family size and circumstances, health, and career choices. These factors are reflected in your decision to own a home, as well as in the location, size, and use of your home.

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9.2: Identify the Product and the Market

Learning Objectives

1. Describe the different building structures for residential dwellings.
2. Describe the different ownership structures for residential dwellings.
3. Identify the factors lenders use to evaluate borrowers for mortgage credit.
4. Identify the components of the mortgage affordability calculation and calculate estimated mortgage affordability.
5. Identify the components of a buyer's inspection checklist.
6. Explain the potential effects of business cycles, unemployment, and inflation on the housing market.
7. Analyze the effects of the demand for housing financing on the housing market.

Renting a Home

If you have already decided on a goal of home ownership, you have probably already compared the costs and benefits of the alternative: renting. Renting requires relatively few initial legal or financial commitments. The renter signs a lease that outlines the terms of the rental agreement, including the term, rent, payment terms and fees, restrictions (such as pets or smoking), and charges for damages. A renter is usually required to provide the landlord with a security deposit to cover the landlord's costs for repairs or cleaning, as necessary, when the tenant moves out. If the deposit is unused, it is returned to the departing tenant (although typically without any interest earned).

Some general advantages and disadvantages of renting and owning are shown in Table 9.2.1 (Renting) and Table 9.2.2 (Owning).

Table 9.2.1 : Advantages and Disadvantages of Renting

Advantage	Disadvantage
Limited financial obligation	No equity growth or store of value
Limited maintenance expenses	Lifestyle limitations (e.g., pets, smoking)
More liquidity	Decorating/renovating limitations
More mobility	Less predictable housing expense

Table 9.2.2 : Advantages and Disadvantages of Home Ownership

Advantage	Disadvantage
Store of value and possible equity growth	Substantial financial obligation
Lifestyle choices	Significant annual expenses
Decorating/renovating choices	Less liquidity
Pride of ownership	Less mobility
Tax deduction for mortgage interest	
More predictable housing expenses	

The decision of whether to rent or own typically follows the pattern of life stages. People often rent early in their adult lives because they typically have fewer financial resources and place a higher value on mobility, which allows for greater career flexibility. When adults first begin their careers, their incomes are generally lower, and the tax advantages of homeownership don't provide much benefit.

As family size grows, the quality of life for dependents typically takes precedence, and a family seeks the added space and comfort of a home, as well as its benefits as an investment. This is the mid-adult stage of accumulating assets and building wealth. As income rises, the tax benefit may become increasingly valuable as well.

With both income and family size smaller in retirement, older adults will often downsize to an apartment, reducing responsibilities and financial commitments.

Homeownership decisions vary: Some people do not want the responsibilities of ownership, while others want a place of their own.

Finding an apartment is much like finding a home in terms of assessing its attributes, comparing choices, and making a choice. Property owners, property managers, and agents all rent properties and use various media to advertise available space. Since the rent for an apartment is a regular expense, financed from current income (not long-term debt), you only need to find an apartment, not the financing, which simplifies the process considerably.

Assessing Attributes

Once you decide to own your home, you must choose the one that is right for you, considering the different types of homes and forms of home ownership.

There are single- and multiple-unit dwellings, for example. A **multiple-unit dwelling** can be used to create rental income or to house extended family members. Still, this choice imposes the responsibilities of being a property owner and also limits privacy.

There are previously owned, new, and custom-built homes. Previously owned homes may require some renovation to make them comfortably modern and convenient. New and custom-built homes typically have more modern features and conveniences and require less maintenance and repair expense. Custom-built homes are built to the homeowners' specifications.

Sales of existing single-family homes far outnumber sales of new and custom homes. In September 2023, for example, 3.96 million existing homes[1] were sold compared to 759,000 sales of new homes[2]. The average price of a new house in the United States in June 2023 was $416,000. [3]

Mobile homes can be fitted with utility connections, installed with trailers on permanent sites, and used as residences. A mobile home may also be situated in a trailer park or mobile home community where the owner rents a lot. Mobile homes are often referred to as manufactured homes. Other examples of manufactured homes include prefabricated or modular homes, which are transported to a foundation site by trailer and then assembled.

In a **condominium** (condo), the homeowner owns a unit in a multiple-unit dwelling, but the common areas of the building are owned and managed by the condominium owners' association. Condo owners pay a monthly fee to cover the costs of overall building maintenance and operating expenses for common areas.

Cooperative housing refers to a unit in a building or complex that is owned by a nonprofit association or corporation for the exclusive use of its residents. Residents do not own the units; instead, they own shares in the cooperative association, which entitles them to the right to reside in its housing units.

Personal factors such as your age, family size, health, and career help you to answer some of the following key questions:

- How large should the house be? How many bedrooms and bathrooms?
- Which rooms are most important: the kitchen, the family room, or the home office?
- Do you need a parking space or a garage?
- Do you need storage space?
- Do you need disability accommodation?
- Do you want outside space, such as a yard, patio, or deck?
- How important is privacy?
- How important are energy efficiency and other "green" features?
- How important are design features and appearance?
- How important are the location and environmental factors?
- What is the proximity to work? Schools? Shopping? Family and friends?

After ranking the importance of such attributes, you can use an attribute-scoring matrix to score your choices. Once you understand exactly what you are looking for in a home, you should also consider how much house you can afford.

Assessing Affordability

Before looking for a house that offers what you want, you need to identify a price range that you can afford. Most people use financing to purchase a home, so your ability to access financing or get a loan will determine the price range of the house you can buy.

For example, Eva and Mateo are both twenty-five years old, newly married, and hoping to buy their first home. Both work and earn good incomes. The real estate market is strong, especially with mortgage rates relatively low. They buy a two-bedroom condo in a new development as a starter home.

Fast-forward five years. Eva is expecting their second child. While the couple is happy about the new baby, neither Eva nor Mateo can imagine how they will all fit in their already cramped space. They would love to sell the condo and purchase a larger home with a yard for the kids, but the real estate market has slowed, mortgage rates have risen, and a plant closing last year has driven up unemployment in their area. Eva hasn't worked outside the home since their first child was born two years ago. They are barely getting by on one salary, and a new baby will increase their expenses, making it even more challenging to consider financing a larger home.

A lender will look at your income, your current debts, and your credit history to assess your ability to assume a mortgage. As discussed in Chapter 7, your credit score is a crucial tool for lenders, who may also request verification of employment and income from your employer.

Lenders do their calculations of how much debt you can afford, based on a reasonable percentage - usually about 33 percent - of your monthly gross income that should go toward your monthly housing costs, or **principal, interest, taxes, and insurance (PITI)**. If you have other debts, your PITI plus your other debt repayments should be no more than about 38 percent of your gross income. Those percentages will be adjusted for income level, credit score, and the amount of the down payment.

Say the lender assumes that 38 percent of your monthly gross income (annual gross income divided by twelve) should cover your PITI, plus any other debt payments. Subtracting your other debt payments and estimated cost of taxes and insurance leaves you with a figure for affordable monthly mortgage payments. Dividing that figure by the mortgage factor for your mortgage's maturity and mortgage rate shows the mortgage that is affordable overall. Once you know what percentage your mortgage will be of the home's purchase price, you can calculate the maximum purchase price of the home you can afford. That affordable home purchase price is based on your gross income, other debts, taxes, insurance, mortgage rate, mortgage maturity, and down payment.

Table 9.2.3 shows an example of this calculation for a thirty-year, 6.5 percent mortgage.

Table 9.2.3 : Mortgage Affordability Calculation

1. Gross Annual Income	$ 60,000
3. PITI + Other Debt Payments	$ 1,900 = 38% of $ 5,000
4. Other Debt Payments	$ 200 = your estimate
5. Affordable Monthly PITI	$ 1,700 = (3) - (4)
6. Monthly Taxes + Insurance	$ 700 = your estimate
7. Affordable Monthly Mortgage Payment	$ 1,000 = (5) - (6)
8. Mortgage Factor	6.32 = mortgage factor
9. Affordable Mortgage	$ 158,228 = (7) / (8) x 1000
10. Down Payment as % of Purchase Price	20% = your estimate
11. Mortgage as % of Purchase Price	80% = 1 - (10)
12. Affordable Purchase Price	$ 197,785 = (9) / (11)

You and your lender will have a clearer idea of how much house you can afford once you make these calculations. You may want to sit down and discuss this with a potential lender before you do any serious house hunting. That way, you have a price range in mind

before you shop. Mortgage affordability calculators are also available online.

Searching for a Home

Once you understand exactly what you are looking for in a home and what you can afford, you can organize your efforts and begin your search.

Typically, buyers use a **real estate agent** and real estate listings to identify homes for sale. A real estate broker can add value to your search by providing information about the house and property, the neighborhood and its schools, recreational and cultural opportunities, and the cost of living.

However, remember that although the broker or their agent may be helping you gather information and assess your choices, they are working for the sellers and will be compensated by the seller when a sale is made. Consider hiring a buyer's agent, a fee-based real estate broker who works on behalf of the buyer to help identify their best options. The industry is regulated by state and federal laws, as well as self-regulatory bodies, and real estate agents are required to be licensed to operate.

Increasingly, sellers are marketing their homes directly to save the cost of using a broker. Buyers and sellers of real estate negotiate with real estate agents on the amount of the commission they will pay on the sale/purchase of a home. For-sale-by-owner (FSBO) sites online can make the exchange of housing information easier and more convenient for both buyers and sellers. However, keep in mind that sellers acting as their own brokers and agents are not licensed or regulated, and may not be knowledgeable about federal and state laws governing real estate transactions. This will potentially increase financial and legal risks.

After you narrow your search and choose a prospective home within your price range, you will have the home inspected to assess its condition and estimate the cost of any necessary repairs or renovations. Many states require a home inspection before signing a purchase agreement or as a condition of the agreement. A standard home inspection checklist, based on information from the National Association of Certified Home Inspectors, is shown in Table 9.2.4 .

Table 9.2.4 : Standard Home Inspection Checklist

Structural Elements	Foundation, floors, walls, ceilings, roofs
Exterior Elements	Sliding, fascia, trim, windows, doors, elevation, drainage, landscaping, pool, driveways, sidewalks
Roof and Attic	Framing, ventilation, flashing, gutters
Plumbing	Pipes: potable, drain, waste, vent, toilets, showers, sinks, faucets, traps
Electrical	Main panel, circuit breakers, wiring, fixtures
Systems	Furnace, water heater, air conditioner, ducts, chimney, sprinklers
Outdoor Buildings	Garage, tool shed, pool house

When purchasing a car, it's a good idea to have a trusted mechanic inspect the vehicle. When buying a house, buyers or their agents must ask a professional (structural engineer, contractor, or licensed home inspector) to perform a thorough home inspection. See the American Association of Home Inspectors (www.homeinspector.org) for detailed information. Not only will a professional be able to spot potential problems, but they will also identify evidence of past issues that may have been improperly addressed or that may recur, such as water in the basement or leaks in the roof. If there are problems, you will need an estimate of repair costs. If an inspection finds any significant need for repairs or renovations, especially those requiring immediate attention, a buyer or their agent can try to reduce the purchase price by those costs. You don't want any surprises after you buy a house, especially costly ones.

Your lender will require a title search to verify that no **liens** or claims are outstanding against the property. For example, the previous owners may have had a dispute with a contractor and never paid his bill. The contractor may have filed a mechanics lien or a claim against the property, which must be resolved before the property can be transferred. There are several other kinds of liens; for example, a tax lien is imposed to secure payment of overdue taxes, such as property taxes or federal income tax.

A lawyer or a title search company can do the search, which involves checking the county or city records where a lien would be filed. A title search will also reveal if previous owners have deeded any rights, such as development rights, water rights, or mineral rights. Grants of right-of-way across the property may diminish its value, so be aware of these as well.

Identifying the Market

Housing costs are determined by the price of the house and the interest rate or other costs associated with financing the house. House prices are determined by forces of supply and demand, which, in turn, are determined by macroeconomic circumstances.

When the economy is contracting and incomes are decreasing, especially if unemployment rises and incomes become uncertain, buyers are hesitant to take on the significant financial responsibility of new debt. They tend to continue with their present arrangements or may try to move into cheaper housing, such as downsizing to a smaller house, an apartment, or a condo, to decrease operating expenses. On the other hand, when the economy is expanding, expectations of rising incomes may encourage buyers to be more confident in their purchasing decisions.

Housing markets are local, however. If the local economy is dominated by a single industry or a large employer, the housing market will be susceptible to the fate of that industry or employer. If a location has value independent of the local economy, such as being a preferred vacation or retirement location, that value can offset local concerns. In that case, housing prices may be less sensitive to local economic conditions.

Acquiring a home relies on a buyer's ability to finance the purchase, provide a down payment, and secure a loan to cover the balance. That ability is determined by the buyer's personal situation (e.g., stability of employment or income, credit history) and by macroeconomic events such as interest rate levels, expected inflation, and liquidity in the credit markets. If interest rates and inflation are low and there is liquidity in the credit markets, it will be easier for buyers to borrow. If inflation and interest rates are high and the credit market is illiquid, it becomes harder for buyers to borrow. Demand for housing thus relies on the availability of credit for the housing market.

Summary

- Different building structures are
  - single-unit or multiple-unit dwellings or mobile homes
  - previously owned, new, or custom-built
- Different ownership structures include
  - conventional ownership
  - condominium
  - cooperative housing
- Lenders assess income, current debts, and credit history to determine the creditworthiness of borrowers
- A mortgage affordability estimate uses an estimate of PITI and other debt payments as a percentage of gross monthly income and of the down payment as a percentage of the purchase price
- The buyer's inspection checklist includes
  - structural elements
  - exterior elements
  - systems for plumbing, electrical, heating/cooling
  - outdoor buildings and features
- Housing prices may be affected by business cycles, as they affect
  - unemployment and income levels
  - inflation, which affects not only the cost of houses, but also interest rates and the cost of home financing
- Housing prices are affected by the availability of home financing, which in turn depends on
  - interest rates and inflation
  - liquidity in the credit markets

Exercises

1. Perform an analysis of your projected wants and needs as a homeowner. Begin by prioritizing the following personal and microeconomic factors in terms of their importance to you in deciding when to buy a home.
   - How large should the house be? How many bedrooms and bathrooms?
   - Which rooms are most important: the kitchen, the family room, or the home office?
   - Do you need a parking space or a garage?
   - Do you need storage space?
   - Do you need disability accommodation?
   - Do you want outside space, such as a yard, patio, or deck?
   - How important is privacy?
   - How important is energy efficiency or other "green" features?
   - How important are design features and appearance?
   - How important are location and environmental factors?
   - Proximity to work? Schools? Shopping? Family and friends?
2. In your financial journal, describe the first or next home you would like to own, including its location and environment. Predict how much you think it might cost in your state. Then look through real estate sites to find the asking prices for homes or housing units similar to the one you described. How accurate is your prediction?
3. Are you a renter and likely to remain one for a few years? Read legal tips about renting (www.nolo.com/legal-encyclopedia/ten-tips-tenants-29446.html) housing. How does that advice compare with the information in this chapter about buying a house? What advice, if any, would you add? Discuss with classmates the advantages and disadvantages of being a tenant and being a landlord. Develop a comparison chart that outlines the benefits, drawbacks, and risks.
4. Do you live in a dorm or at home with parents or other relatives? What needs to happen for you to have a place of your own? Research websites that aid students in finding independent housing, such as this article (www.collegiateparent.com/housing-residential-life/housing-search-tips-to-share-with-your-student) from *CollegiateParent*. Develop a flexible plan and timetable for finding and financing your own place, and record it in your personal finance journal.
5. Investigate the local real estate market. How do local housing availability and pricing differ from those of other cities, towns, counties, and states? Use online resources to find this information. Housing Predictor (www.housingpredictor.com) provides independent real estate market forecasts for local housing markets for all fifty U.S. states; Realty Times (www.realtytimes.com) analyzes local real estate markets nationwide. How stable or volatile is the real estate market? Is it a buyer's or seller's market, and what does that mean? To what local factors do you attribute the differences you find?
6. Identify and analyze the macroeconomic factors affecting your local real estate market. In what ways or to what extent does your local economy reflect macroeconomic factors in the national economy? According to the National Association of Realtors (www.nar.realtor), what are the most important present trends in the real estate market? If you were shopping for a new or existing home today or were planning to build, how would each macroeconomic factor or trend affect your choices? Record your answers in your personal finance journal.
7. Watch House Hunting Tips for First-Time Home Buyers (www.youtube.com/watch?v=iwz3eJyiWlk) (2:24 minutes). How do you determine the best location to look for a home? How do you find a real estate agent? Consider watching the Bank of America First-Time Home Buying series (www.youtube.com/playlist?list=PL4yQRNEEv-VnK-39hw4GQn86zQj2tAEoj) with Kristy and Desmond. The five short videos, each three to four minutes long, take you through their home-buying experience.

[1] Mutikani, Lucia. "US Existing Home Sales Drop to 13-Year Low in September." *Reuters*, October 19, 2023. https://www.reuters.com/markets/us/u...-2023-10-19. www.reuters.com/markets/us/us-existing-home-sales-drop-13-year-low-september-2023-10-19/.

[2] Mutikani, Lucia. "US New Home Sales Scale 19-Month High as Median Price Drops." *Reuters*, October 25, 2023. https://www.reuters.com/markets/us/u...-2023-10-25. www.reuters.com/markets/us/us-new-home-sales-accelerate-september-2023-10-25/.

[3] Phillips, Matt. “Old Houses Now Cost as Much as New Houses.” Axios, July 23, 2023. https://www.axios.com/2023/07/21/new...-home-prices. www.axios.com/2023/07/21/new-existing-home-prices.

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9.3: Identify the Financing

Learning Objectives

1. Define the effects of the down payment on other housing costs.
2. Calculate the monthly mortgage payment, given its interest rate, maturity, and principal balance.
3. Distinguish between a fixed-rate and an adjustable-rate mortgage, and explain their effects on the monthly payment and interest rate.
4. Distinguish between a rate cap and a payment cap, and explain their uses and risks.
5. Determine the effect of points on the monthly mortgage payment.
6. Identify potential closing costs.

Just as your house may be your most significant purchase, your mortgage may be your most significant debt. The principal is likely far more than your short-term disposable income. It may need to be paid over a period of fifteen to thirty years. The house secures the loan, so if you default or miss payments, the lender may **foreclose** on your house or claim ownership of the property, evict you, and resell the house to recover what you owe. You may lose not only your house but also your home.

Banks, credit unions, finance companies, and mortgage finance companies sell mortgages. They profit by lending and competing for borrowers. It makes sense to shop around for a mortgage, as rates and terms (i.e., the borrower's costs and conditions) may vary widely. The Internet has made it easy to compare; a quick search for "mortgage rates" yields many websites that provide national and state averages, lenders in your area, comparable rates and terms, and free mortgage calculators.

You may feel more comfortable obtaining your mortgage through your local bank, which may process the loan and then sell it to a larger financial institution. The local bank typically continues to service the loan and collect payments. Still, these cash flows are then passed through to the financial institution (usually a much larger bank) that has purchased the mortgage. This secondary mortgage market enables your local bank to have more liquidity and reduced risk, as it is repaid promptly, allowing it to make more loans. As long as you continue to make your payments, your only interaction is with the bank that services the loan. Alternatively, local banks may earmark a percentage of mortgages to keep "in-house" rather than sell.

The U.S. government assists some groups, such as Native Americans, Americans with disabilities, and veterans, in obtaining home loans. Veterans can find resources at the U.S. Department of Veterans Affairs (VA) Home Loans (www.benefits.va.gov/homeloans/).

Please note that the costs discussed in this chapter, which are associated with various types of mortgages, are subject to change. The real estate market, government housing policies, and government regulation of the mortgage financing market may change. When shopping for a mortgage, it is essential to stay informed about the latest developments.

Down Payment

Mortgages typically require a **down payment**, which is a percentage of the purchase price paid in cash at the time of purchase. Most buyers fund the down payment with money from savings, another home sale, an inheritance, a windfall like lottery winnings, or a family gift.

The size of the down payment does not directly affect the price of the house, but it can impact the cost of financing. For a certain house price, the larger the down payment, the smaller the mortgage and, all things being equal, the lower the monthly payments. An example of a thirty-year mortgage is shown in Table 9.3.1 .

Table 9.3.1 : Down Payment and Monthly Payment

Purchase Price	% Down	Mortgage	Mortgage Rate	Mortgage Payment
$ 250,000	5.00%	$ 237,500	5.00%	$ 1,274.95
$ 250,000	10.00%	$ 225,000	5.00%	$ 1,207.85
$ 250,000	20.00%	$ 200,000	5.00%	$ 1,073.64
$ 250,000	30.00%	$ 175,000	5.00%	$ 939.44
$ 250,000	40.00%	$ 150,000	5.00%	$ 805.23
$ 250,000	50.00%	$ 125,000	5.00%	$ 671.03

Typically, if the down payment is less than 20 percent of the property's sale price, the borrower is required to pay for **private mortgage insurance (PMI)**. If a borrower defaults on a mortgage that includes PMI, the lender is insured against loss. A larger down payment generally eliminates the need for PMI, saving the borrower that expense.

A larger down payment can offset the annual cost of the financing, but it may create opportunity costs and decrease liquidity. Cash will also be required for the **closing costs** (transaction costs) of this purchase, as well as for any immediate renovations or repairs. Those needs will have to be weighed against your available cash to determine the amount of your down payment.

Monthly Payment

The monthly payment is the ongoing cash flow obligation to the loan. If you fail to make this payment, you will default on the loan and may eventually lose the house, with no compensation for the money you have already invested in it. Your ability to make the monthly payment determines your ability to keep the house.

The interest rate and the maturity (lifetime of the mortgage) determine the monthly payment amount. With a **fixed-rate mortgage**, the interest rate remains constant throughout the entire mortgage term, and so does the monthly payment. Conventional mortgages are fixed-rate mortgages for thirty, twenty, or fifteen years.

The longer the term, the greater the interest rate, because the lender faces more risk the longer it takes for the loan to be repaid.

A fixed-rate mortgage is structured as an annuity: regular periodic payments of equal amounts. Some of the payment is repayment of the principal, and some is for interest expense. As you make a payment, your balance gets smaller, so the interest portion of your next payment is smaller, and the principal payment is larger. In other words, as you continue making payments, you are paying off the loan balance faster and paying less interest.

An example of a **mortgage amortization**, or a schedule of interest and principal payments over the life of the loan, is shown in Table 9.3.2 . The mortgage is a thirty-year, fixed-rate mortgage. Only year one is shown, but the spreadsheet extends to show the amortization over the term of the mortgage.

Table 9.3.2 : A Mortgage Amortization: Year One of a Thirty-Year, Fixed-Rate 6.5 Percent Mortgage

End of Month	Payment	Interest Expense	Principle Paid	Balance
				$ 200,000.00
1	$ 1,264.14	$ 1,083.33	$ 180.80	$ 199,819.20
2	$ 1,264.14	$ 1,082.35	$ 181.78	$ 199,637.42
3	$ 1,264.14	$ 1,081.37	$ 182.77	$ 199,454.65
4	$ 1,264.14	$ 1,080.38	$ 183.76	$ 199,270.89
5	$ 1,264.14	$ 1,079.38	$ 184.75	$ 199,086.14
6	$ 1,264.14	$ 1,078.38	$ 185.75	$ 198,900.39
7	$ 1,264.14	$ 1,077.38	$ 186.76	$ 198,713.63
8	$ 1,264.14	$ 1,076.37	$ 187.77	$ 198,525.86
9	$ 1,264.14	$ 1,075.35	$ 188.79	$ 198,377.07
10	$ 1,264.14	$ 1,074.33	$ 189.81	$ 198,147.26
11	$ 1,264.14	$ 1,073.30	$ 190.84	$ 197,956.42
12	$ 1,264.14	$ 1,072.26	$ 191.87	$ 197,764.55

In the early years of the mortgage, your payments are mostly interest, while in the final years, they are mostly principal. It is essential to distinguish between them because the mortgage interest is generally tax-deductible. That tax benefit is greater in the earlier years of the mortgage, when the interest expense is larger.

Monthly mortgage payments can be estimated using the **mortgage factor**. The mortgage factor is a calculation of the payment per $1,000 of the mortgage loan, given the interest rate and the mortgage maturity. Mortgage factors for 30-, 20-, and 15-year mortgages are shown in Table 9.3.3 .

Table 9.3.3 : Mortgage Factors for Various Mortgage Rates

	Mortgage Amount	Mortgage Rate	30-Year Mortgage Factor	20-Year Mortgage Factor	15-Year Mortgage Factor
t	$ 1,000	4.00%	4.77	6.06	7.40
t	$ 1,000	4.50%	5.07	6.33	7.65
t	$ 1,000	5.00%	5.37	6.60	7.91
t	$ 1,000	5.50%	5.68	6.88	8.17
t	$ 1,000	6.00%	6.00	7.16	8.44
t	$ 1,000	6.50%	6.32	7.46	8.71
t	$ 1,000	7.00%	6.65	7.75	8.99
t	$ 1,000	7.50%	6.99	8.06	9.27
t	$ 1,000	8.00%	7.34	8.36	9.56
t	$ 1,000	8.50%	7.69	8.68	9.85
t	$ 1,000	9.00%	8.05	9.00	10.14

The monthly payment can be calculated as

$$\text{mortgage} \;\; \text{factor} \times (\text{principal} \div 1,000)$$

If you purchase a house for $250,000 with a $50,000 down payment and finance the remaining $200,000 with a 30-year, 6.5 percent mortgage, your monthly mortgage payment would be 6.32 × ($200,000 ÷ 1,000) = $1,264. If you choose a 15-year mortgage, your monthly payment would be 8.71 × ($200,000 ÷ 1,000) = $1,742. If you opt for a 30-year mortgage at a 6 percent rate, your monthly payment would be $1,200.

Potential lenders and many websites provide mortgage calculators to do these calculations. You can estimate your monthly payments for a fixed-rate mortgage if you know the mortgage rate, the term to maturity, and the principal borrowed.

Mortgage Designs

So far, the discussion has focused on fixed-rate mortgages, which are mortgages with fixed or constant interest rates and payments that remain unchanged until maturity. With an **adjustable-rate mortgage (ARM)**, the interest rate and the monthly payment can change. If interest rates rise, the monthly payment will increase; if rates fall, the monthly payment will decrease. By federal law, adjustable interest rates cannot increase by more than 2 percent at a time; however, even with this **rate cap**, homeowners with adjustable rates risk unexpected payment increases. Borrowers can mitigate this interest rate risk by implementing a payment cap; however, this introduces another risk.

A **payment cap** limits the amount that payments can increase or decrease. That sounds like it would protect the borrower, but if the payment is capped and the interest rate rises, more of the payment goes toward the interest expense and less toward the principal payment, so the balance is paid down more slowly. If interest rates are high enough, the payment may be too small to cover all the interest expense, and any unpaid interest will be added to the mortgage principal balance.

In other words, instead of paying off the mortgage, your payments may increase your debt, and you could end up owing more money than you borrowed, even if you make all your required payments on time. This is called negative amortization. If you have this type of loan, you can voluntarily increase your monthly payment amount to avoid the negative effects of a payment cap.

Adjustable-rate mortgages are risky for borrowers. However, these mortgages are usually offered at lower rates than fixed-rate mortgages and may be more affordable. Borrowers who expect an increase in their disposable income (which would offset the risk of a higher payment) or who expect a decrease in interest rates may prefer an adjustable-rate mortgage, which can have a maturity of up to forty years. Otherwise, a fixed-rate mortgage is generally the better option.

Some mortgages combine fixed and variable rates; these mortgages offer a fixed rate for a specified period, followed by an adjustable rate. Another type of mortgage is a **balloon mortgage**; these offer fixed monthly payments for a specified period - usually three, five, or seven years - and then a final repayment of the outstanding principal (the balloon payment). An **Option Adjustable Rate Mortgage** allows the borrower to pay either interest-only or principal and interest for the first few years of the loan. This helps make homeownership more affordable for many buyers. However, although you may save money at first by paying interest only, you are not accumulating stored value, known as equity, in your investment.

As an asset, a house may be used to secure other types of loans. A **home equity loan** or a second mortgage allows homeowners to borrow against the equity in their home. A home improvement loan is a type of home equity loan. A **home equity line of credit (HELOC)** enables homeowners to secure a line of credit, or a loan that is borrowed and repaid as needed, with interest paid only on the outstanding balance. A **reverse mortgage** provides homeowners with long-term equity in their property a monthly income in the form of a loan. A reverse mortgage is a loan against your home that you do not have to repay as long as you live there. To be eligible for most reverse mortgages, you must own your home and be 62 or older. You or your estate repays the loan when you decide to sell the house or if you pass away and the house is sold.

Points

Points are another possible financing cost. One point is equivalent to one percent of the mortgage amount. When the mortgage originates, points can be paid to the lender as prepaid interest. Points are used to decrease the mortgage rate. In other words, paying points is a way of buying a lower mortgage rate.

To decide whether or not it is worth paying points, consider the difference the lower mortgage rate will make to your monthly payment and how long you will be paying this mortgage. When will the points pay for themselves in reduced monthly payments? For example, suppose you have the following choices for a 30-year, fixed-rate, $200,000 mortgage: a mortgage rate of 6.5 percent with no points or a rate of 6 percent with two points.

First, calculate the difference in your monthly payments for each situation. Using the mortgage factor for a 30-year mortgage, the monthly payments in each case would be the mortgage factor × $200,000 ÷ 1,000 or

Points	Mortgage rate	Mortgage factor	Monthly payment
0	6.50%	6.32	1,264
2	6.00%	6.00	1,200

Paying the two points allows you to enjoy a lower monthly payment and saves you $64 per month. The two points cost $4,000 (2% of $200,000). At the rate of $64 per month, it will take 62.5 months ($4,000 ÷ 64) or a little over five years for those points to pay for themselves. If you do not plan on keeping this mortgage for a long time, paying the points is not worth it. Paying points has liquidity and opportunity costs up front that must be weighed against its benefits. Points are part of the closing costs, but borrowers do not have to pay them if they are willing to pay a higher interest rate.

Closing Costs

Another cost of a home purchase is transaction costs, which are the expenses incurred to facilitate the transaction that are not directly related to the home or financing. These are referred to as closing costs, because they are paid at the closing, the meeting between buyer and seller where ownership and loan documents are signed and property is legally transferred. Buyers pay closing costs, which include the appraisal fee, title insurance, and filing fee to record the deed with the county recorder.

The lender will require an independent **appraisal** of the home's value to guarantee the mortgage amount is reasonable given the value of the house it secures. The lender will also require a **title search** and contract for **title insurance**. The title company will research any claims or liens on the deed. The purchase cannot go forward if the deed cannot be freely transferred. Over the mortgage term, title insurance protects against defects not revealed in the original title and any claims that may arise. The buyer also pays a fee to file the property deed with the township, municipality, or county. Some states may also have a **property transfer tax** that is the buyer's responsibility.

Closings may occur in an escrow office (a neutral third-party office) or a title company office. Closings may also happen in the lender's space, such as a bank or legal office, if the buyer and seller's attorneys are involved in mediation. Real estate attorneys ensure that all legal requirements are met and all filings of legal documents are completed. For example, homebuyers have the right to review a U.S. Department of Housing and Urban Development (HUD) Settlement Statement twenty-four hours before signing at closing. This document, along with a Truth-in-Lending disclosure statement, outlines and explains all the terms of the transaction, including the costs of buying the house and all closing costs. The buyer and seller must both sign the HUD document and are legally bound by it.

Summary

- The percentage of the purchase price paid upfront as the down payment will determine the amount borrowed. That principal balance on the mortgage, in turn, determines the monthly mortgage payment
- A larger down payment may make the monthly payment smaller, but it creates the opportunity cost of losing liquidity
- A fixed-rate mortgage is structured as an annuity; the monthly mortgage payment can be calculated from the mortgage rate, the maturity, and the principal balance on the mortgage
- A fixed-rate mortgage has a fixed mortgage rate and fixed monthly payments
- An Adjustable-Rate Mortgage may have an adjustable rate and/or adjustable payments
- A rate cap or a payment cap may be used to offset the effects of an ARM on monthly payments
- Points are borrowing costs paid upfront (rather than over the maturity of the mortgage)
- Closing costs are transaction costs such as an appraisal fee, title search and title insurance, filing fees for legal documents, transfer taxes, and sometimes agent real estate commissions

Exercises

1. You are considering purchasing an existing single-family house for $500,000 with a 20 percent down payment and a 30-year fixed-rate mortgage at 6 percent.
   - What would be your monthly mortgage payment?
   - If you decided to buy two points for a rate of 5.5 percent, how much would you save in monthly payments? Would it be worth it to buy the points? Why, or why not?
2. Review the explanation of adjustable-rate mortgages consumer guide (www.federalreserve.gov/pubs/arms/arms_english.htm) written by the U.S. Federal Reserve (the Fed). According to the Fed, why should you be cautious about adjustable-rate mortgages?
3. Do you presently rent or own your home or condo? What are your housing costs? What percent of your income is taken up by housing costs? If housing costs you more than a third of your income, what could you do to reduce that cost? Record your alternatives in your personal finance journal.
4. As a prospective homeowner, what would be your estimated PITI? Would a bank consider you qualified for a mortgage loan at this time? Why or why not? What criteria do lenders use to determine your eligibility for a home mortgage?
5. Can you afford a mortgage now? How much of a mortgage could you afford? Answer these questions using online mortgage affordability calculators. If you cannot afford a mortgage now, how would your situation and/or your budget need to change to make that possible? Establish home affordability as a goal in your financial planning. When do you expect to reach that goal? Write an estimated date in your journal.
6. Read 12 Steps of a Real Estate Closing (www.investopedia.com/articles/mortgages-real-estate/10/closing-home-process.asp). According to *Investopedia*, who attends the closing? What legal documents are processed at the closing?
7. Review affordable local real estate, condo, or apartment listings. Choose a home you'd like to own and do some research for your personal finance journal.

- Record the purchase price
- Determine the down payment you would make
- Calculate the mortgage amount you would seek
- Determine the current interest rates on a mortgage loan for fixed- and adjustable-rate mortgages for various periods or maturities
- Select the type of mortgage you would prefer
- Determine the rate and maturity you would seek
- Determine the points you would buy (if any)
- Calculate the number of monthly mortgage payments you would expect to make
- Select the names of lenders you would consider approaching for a loan

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9.4: Purchasing and Owning Your Home

Learning Objectives

1. Identify the components of a purchase and sale agreement.
2. Explain the importance of a capital budget in determining capital spending priorities.
3. Identify the financing events you may encounter during the maturity of a mortgage.
4. Define the borrower's and the lender's responsibilities to the mortgage.
5. Explain the consequences of default and foreclosure.

The Purchase Process

Now that you've chosen your home and figured out the financing, all that's left to do is sign the papers, right? Not quite. You are off to a good start, but the purchase process will also include offers, negotiations, agreements, and a deposit.

Once you have found a house, you will make an offer to the seller, who will then accept or reject your offer. If the offer is rejected, you may try to negotiate with the seller or decide to forgo the purchase. If your offer is accepted, you and the seller will sign a formal agreement, known as a **purchase and sale agreement**, which specifies the terms of the sale. You will be required to pay a non-refundable deposit or **earnest money** upon signing the purchase and sale agreement. That money will be held in **escrow** or a restricted account and then applied toward the closing costs at settlement.

The purchase and sale agreement will include the following terms and conditions:

- A legal description of the property, including boundaries, with a site survey contingency
- The sale price and deposit amount
- A mortgage contingency, stating that the sale is contingent on the final approval of your financing
- The closing date and location are mutually agreed upon by the buyer and seller
- **Conveyances** or any agreements made as part of the offer; for example, an agreement as to whether the kitchen appliances are sold with the house
- A home inspection contingency specifying the consequences of a home inspection and any problems that it may find, if not already completed and included in the price negotiation
- Possession date, usually the closing date
- A description of the property insurance policy that will cover the home until the closing date

Legally, problems with the property must be disclosed, but specifics vary by state; however, lead-paint disclosure is a federal mandate for any housing built before 1978.

After the **Purchase and Sale Agreement** is signed, all specified conditions must be fulfilled before the closing date. If those conditions are the seller's responsibility, you will want to check that they have been fulfilled before closing. Read all documents carefully before signing them and obtain copies of everything you sign. Do not hesitate to ask questions. You will probably live in your home and be responsible for mortgage payments for a long time. Be sure you understand the process.

Capital Expenditures

A house and property need care; even a new home will have repair and maintenance costs. These costs are now part of your living expenses or operating budget.

If you have purchased a home that requires renovation or repair, you will decide how much of the work you can do immediately and how much can be done on an annual basis. A capital budget helps project these expenditures and plan for income or savings to finance them. You can prioritize these costs by urgency and by the method of completion.

For example, Mai and Quan just closed on an older home and are planning renovations. During the home inspection, they discovered that the old stone foundation required some repair work. They would like to install more energy-efficient windows, paint the walls, and strip and refinish the old wooden floors.

The home's foundation should be the number one priority. The windows should be next on the list, as they will provide comfort and reduce heating and cooling expenses. Cosmetic repairs, such as painting and refinishing, can be done later. The walls should be addressed before the floors are refinished. You don't want paint spots!

Renovations should increase the resale value of your home. It is tempting to customize renovations to suit your tastes and needs. Still, excessive customization can make it more difficult to recoup the value of those renovations when it comes time to sell. You will have a better chance of selling at a higher price if the renovations appeal to as many buyers as possible. The more customized or quirky the renovations are, the less broad their appeal.

Early Payment

Two financing decisions may come up during the life of a mortgage: **early payment** and **refinancing**. Some mortgages have an **early payment penalty** that fines the borrower for repaying the loan before it is due, but most do not. If your mortgage does not, you may be able to pay it off early (before maturity) either with a lump sum or by paying more than your required monthly payment and having the excess payment applied to your principal balance.

Suppose you are considering paying off your mortgage with a lump sum. In that case, you are weighing the value of your liquidity, the opportunity cost of forgoing cash, against the cost of the remaining interest payments. The cost of giving up your cash is the loss of any investment return you would have otherwise earned from it. You would compare that to the cost of your mortgage, or your mortgage rate, less the tax benefit that it provides.

For example, suppose you can invest cash in a Money Market Mutual Fund (MMMF) that earns 7 percent. Your mortgage rate is 6 percent, and your tax rate is 25 percent. Your mortgage costs you 6 percent per year, but saves you 25 percent of that in taxes. Therefore, your mortgage ultimately costs you 4.5 percent, which is 75 percent of 6 percent. After taxes, your money market mutual fund earns 5.25 percent, which is 75 percent of 7 percent. Since your cash is worth more to you as a money market investment, which nets 5.25 percent, than it costs you in mortgage interest (4.5 percent), you should leave it in the mutual fund and pay your mortgage incrementally as planned.

On the other hand, if your money market mutual fund earns 5 percent, but your mortgage rate is 8 percent and you are in the 25 percent tax bracket, then the real cost of your mortgage is 6 percent, which is more than your cash can earn. You would be better off using the cash to pay off your mortgage and eliminate that 6 percent interest cost.

You also need to weigh the use of your cash to pay off the mortgage versus other uses of that cash. For example, suppose you have some money saved. It is earning less than your after-tax mortgage interest, so you are thinking of paying down the mortgage. However, you also know that you will need a new car in two years. If you use that money to pay down the mortgage now, you won't have it to pay for the car two years from now. You could consider getting a car loan to purchase the vehicle, but the interest rate on that loan would likely be higher than the rate on your mortgage, and the interest on the car loan is not tax-deductible. If paying off your mortgage debt forces you to use more expensive debt, then it is not worth it.

One way to pay down a mortgage early without sacrificing liquidity is by making a larger monthly payment. The excess over the required amount will be applied to your principal balance, which then decreases faster. Since you pay interest on the principal balance, reducing it more quickly would save you some interest expense. If you have experienced an increase in income, you may be able to do this relatively painlessly; however, there may be a better use for your increased income.

Over a mortgage as long as thirty years, that interest expense can be substantial, possibly more than the original balance on the mortgage. However, that choice must be made in the context of the value of your alternatives.

Refinancing

You can consider refinancing your mortgage if better rates are available. Refinancing means borrowing new money, typically by acquiring a new mortgage to repay an existing one. It also involves closing costs: The lender will want an updated appraisal, a title search, and title insurance. It is valuable to refinance only if the mortgage rate is significantly lower than your current rate, resulting in a substantial reduction in your monthly payment. That, in turn, depends on the size of your mortgage balance.

You may be able to refinance and increase the principal balance on the new mortgage without increasing the monthly payment over your old monthly payment. If interest rates are low and your home has appreciated in value, your home equity may increase. You

can withdraw equity from your house, but doing so means you are not allowing it to function as an investment. You are not storing your wealth.

Using gains from the house and investing them may be a good choice. But if you take gains from the house and use them for consumption, you reduce the investment returns on your home. You are also using non-recurring income to finance recurring expenses, which is unsustainable. There is also a danger that property values will decrease, and you will be left with a mortgage worth more than your home is worth.

Default, Foreclosure, and Fraud

If you have a change of circumstances (you lose your job in an economic downturn or you have unexpected health care costs), you may be unable to meet your mortgage obligations as planned. You may become unable to make payments. A mortgage is secured by the property it finances. If you miss payments and default on your mortgage, the lender can foreclose on your property, evict you, take possession of your home, and then sell it or lease it to recover their investment. Under normal circumstances, lenders incur a cost in repossessing a house, and usually lose money in its resale. It may be possible to renegotiate the terms of your mortgage to forestall foreclosure. You may want to consult with a legal representative or contact federal and/or state agencies for assistance.

You may believe you are having trouble meeting your mortgage obligations because they are not what you thought they would be. Lenders profit by lending. When borrowing, it is essential to understand the terms of your loan. If those terms adjust under certain conditions, you must understand what could happen to your payments and the value of your home. It is your responsibility to understand these conditions. However, according to federal and state laws, the lender is required to disclose the lending arrangement and all associated costs. Some rules may vary from state to state, but if you believe that all conditions and terms of your mortgage were not fairly disclosed, you should contact your state banking regulator or the U.S. Department of Housing and Urban Development (HUD). Consumer advocacy groups can also help clarify laws and explore any available legal recourse.

Just as your lender has a legal obligation to be forthcoming and transparent with you, you must be truthful. If you have misrepresented or omitted facts on your mortgage application, you can be held liable for mortgage fraud. For example, if you have overstated your income, misled the lender about your employment or your intention to live in the house, or have understated your debts, you may be prosecuted for **mortgage fraud**. Some forms of mortgage fraud are more elaborate, such as inflating an appraisal. Whether the errors are intentional or accidental, you are responsible for providing the lender with accurate information.

Summary

- The purchase and sale agreement details the conditions of the sale
- Conditions of the purchase and sale agreement must be met before the closing
- A capital budget can help you prioritize and budget for capital expenditures
- Early payment is the trade-off of interest expense versus the opportunity cost of losing liquidity
- Refinancing is the trade-off between lower monthly payments and closing costs
- Both borrowers and lenders have a responsibility to understand the terms of the mortgage
- Buyers, sellers, lenders, and brokers must be alert to real estate scams and possible cases of mortgage fraud
- Default may result in the lender foreclosing on the property and evicting the former homeowner

Exercises

1. Read what the National Association of Realtors has to say about real estate purchase agreements (www.nar.realtor/closing/real-estate-purchase-agreement), and view a sample California residential purchase agreement (www.eforms.com/purchase-agreements/ca/). For comparison, find a sample purchase and sale agreement for your state.
2. According to this chapter, what information is included in a purchase and sale agreement?
3. Use this mortgage refinancing calculator (www.bankrate.com/mortgages/refinance-calculator/) to find out if you would save money by refinancing your real or hypothetical mortgage at this time. What factors should you take into consideration when deciding to refinance?

4. Read about mortgage fraud (www.investopedia.com/terms/m/mortgage-fraud.asp) as defined by *Investopedia*. What constitutes mortgage fraud? What common ways do home buyers become involved either directly or indirectly in mortgage or real estate fraud?
5. Explore the ways to avoid foreclosure (www.usa.gov/avoid-foreclosure) at USA.gov. What steps should people take to avoid foreclosure?

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9.5.1: Buying a Home

Reasons to Rent or Own a Home

Owning a home has always been the American Dream. In fact, the rate of American home ownership has always been greater than in most European countries. Historically, the homeownership rate in the U.S. has ranged from 63% to 65%, going back to 1970. It rose to 69% just before the Great Recession, but then in 2015, as homes were foreclosed, it dropped all the way back down to 63%. Still, it remains a dream of most people to own their own home.

There are two main factors to consider when trying to decide whether to buy or rent: how long you will be in a location and what your current financial situation is. You need to own a house at least three years to recover your transaction costs, and you should consider whether you can afford the down payment and the monthly mortgage costs. Also, be sure to check if you would be eligible for tax benefits. You can deduct the annual interest of your mortgage plus local real estate taxes. Generally, young people rent while in college, then rent in a downtown area after they get their first job, and then buy a home after they become a couple (especially if they have children). People under 25 tend to rent, as they are not yet locationally stable and because the mortgage interest tax deduction does not help them much. Between the ages of 25 to 55, people tend to buy. At any age, however, low-income people tend to rent due to economic barriers.

You Are Buying a Location, Not Just a Physical Structure

When buying a home, you are buying into a school district, a government, and a neighborhood. Depending on the district, school quality (and associated taxes) can vary significantly and can be a major expense in owning a home. The government in your city or township may or not be interested in actively maintaining the infrastructure of the municipality, which can have an effect on road conditions and municipal taxes. Finally, you want a friendly neighborhood, and if you buy a house when you have children, you want other children for your kids to play with. When you have narrowed down your property choices, it pays to knock on a few doors to introduce yourself and ask about the neighborhood.

When either renting or owning, you consume **housing services**. This is easy to understand with renting but might be a little harder to grasp when it comes to owning. A house is a durable good, or a good that lasts more than three years. A house provides you with housing services that you then pay for. The correct price for a **durable good** is not its purchase price but what is called its annual user cost: your annual out of pocket expenses. For a home, the user cost includes:

- Mortgage payments
- Real estate and other taxes
- Home insurance
- Utilities (electricity, gas or oil, water, sewage)
- Trash collection
- Home and yard maintenance

This probably sounds like it would be more expensive than if you were renting, but really, it is not. Your landlord incurred these same expenses to own the property, and your rent has these expenses taken into account; instead of paying various municipalities, people and companies, you paid your landlord.

Calculate What You Can Afford

There are constraints established by financial institutions on the size of a mortgage you are allowed to take out. The size of the mortgage, of course, will dictate the price of the house you can afford. The Consumer Financial Protection Bureau is a government agency whose job it is to make sure that financial institutions treat consumers fairly. According to the CFPB, your debt payments can be no more than 43% of your gross income:

> *The 43 percent debt-to-income ratio is important because, in most cases, that is the highest ratio a borrower can have and still get a Qualified Mortgage. Evidence from studies of mortgage loans suggest that borrowers with a higher debt-to-income ratio are more likely to run into trouble making monthly payments.*

Here is what makes a qualified mortgage:

> *A Qualified Mortgage is a loan a borrower should be able to repay. Beginning on January 10, 2014, lenders making virtually any residential mortgage loan will have to assess a borrower's ability to repay the loan. A Qualified Mortgage is presumed to meet this requirement. A Qualified Mortgage is a loan that avoids risky features and meets other requirements general, the borrower also must have a total monthly debt-to-income ratio including mortgage payments of 43% or less.*

Your debt-to-income ratio is all your monthly debt payments divided by your gross monthly income. This ratio is one way that lenders measure your ability to manage your monthly loan payments. For example, let's say your monthly debt payments look like this:

- $1500 for your mortgage
- $100 for an auto loan
- $400 for the rest of your debts

This means your monthly debt payments total $2,000. If your gross monthly income is $6,000, then your debt-to-income ratio is 33 percent ($2,000 is 33% of $6,000). Remember that your student loans must be included in this calculation, so student loans can be a drag on buying your first home.

These regulations are the direct result of the housing and mortgage crisis that lead to the Great Recession. Immediately prior to the housing bust, mortgage companies were committing vast fraud in the initiation and documentation of mortgages and then selling these mortgages to investors. Investors then lost their money in these fraudulent mortgages, and many people lost their houses because they could not make the mortgage payments.

But where did the magic number 43% come from? As I will detail below, the government sponsored (and now government owned) companies, Fannie Mae and Freddie Mac either own or guarantee about 60% of the residential mortgages in the United States. From an analysis of the mortgages they hold (including defaulted mortgages), Fannie Mae and Freddie Mac have determined that 43% is a safe ratio for a household.

Difficulties of First-Time Home Buyers

The biggest difficulty for first-time home buyers is saving up the down payment. As we said above, you can usually put only 10% down on a house and often only 5% down. For the 2019 median house price in the U.S., a 10% down payment would be $23,000. Saving this amount is difficult, so you might do what many young people do: go to your relatives for help. Remember, though, that you cannot borrow the down payment, but anyone can give you a gift of some or all of the cost.

The second biggest difficulty for first-time home buyers is getting a mortgage. As I mentioned earlier, in order to get a qualified mortgage your debt payments to gross income ratio cannot be more than 43%. This includes auto loan, credit card, and student loan payments. Recently, student loans have surpassed the $1.5 trillion mark and exceeded the amount of credit card debt owed by all the households in America ($970 billion in 2018). The amount of student debt that young people have is negatively affecting the economy, slowing down consumer spending and home purchases. There has been talk in Washington, D.C. about figuring out a way to alleviate this debt, but no effective action has been taken yet.

Another difficulty for first-time buyers is that no one is really building a lot of starter homes' for first-time buyers. This is like a vicious cycle. Many first-time buyers cannot qualify for homes at today's prices, so builders are not building as many, so the choices for those first-time buyers who do qualify are limited.

Finally, after a big rush to the cities, the price of housing in hip neighborhoods is getting too expensive, leading millennials to flock to the suburbs. In a 2019 article in the The Wall Street Journal entitled "American Suburbs Swell Again as a New Generation Escapes the City" Valerie Bauerlein discusses this phenomenon:

> *Millennials, the generation now ages 23 to 38, are no longer as rooted as they were after the economic downturn. Many are belatedly getting married and heading to the suburbs,*

> *just as their parents and grandparents did.*

Millennials are trying to find small towns that give the feel of a community, instead of a big sprawling suburb with big houses. This means a longer commute to work but better schools and environment for the whole family.

House as Nest or House as Investment

No doubt you have been told that a house is a great investment, and this is generally true. For most people nearing retirement, their work retirement fund and their home equity are the only assets they have to depend on. However, I will point out that a house is both a **nest** and an **investment**. As a nest, you consume housing services from the physical structure you own. You therefore want to be conservative in the type of mortgage you select, and I recommend a simple 30-year fixed rate mortgage. As an investment, a house is an asset that pays you a return either in a dividend or in the appreciation of its value. More than that, owning a house also offers some income tax relief.

Rate of Return on Houses as Investments

Prior to The Great Recession, houses were a great investment. From 1964 to 2009, the average growth rate of housing prices was 5.4% (Freddie Mac). In order to fully understand the rate of return on home ownership, we need to analyze how **leverage** (that is, borrowing part of your investment capital) impacts your investment. Let's say you buy a home at $230,000, the median national (Zillow, 2019). You then put down 20% of this, or $46,000. The return must be calculated on your actual cash investment of $46,000 and not the total house price. If the house goes up in value by 10%, it is now worth $253,000 for an increase of $23,000. If you had not taken out a mortgage but paid all cash for the home, your return on investment would have been 10%. However, since you only invested $46,000 cash into the home, your return on investment is: $23,000/$46,000 = 50%. Note, however, that I did not take into account the transaction costs of buying and selling the home and all the costs while owning it.

Finding a Real Estate Agent

Just like finding a contractor to work on your home, finding a good real estate agent requires research. Since the seller pays the commission to the realtors, it costs you nothing to hire your own real estate agent. Here are some tips for finding a good agent.

First, since housing is a local market, you want to find an agent that has a lot of local experience. A local agent will know the home prices in the market and, through their contacts with other agents, know about homes that will be coming on the market soon. This latter information is valuable in a hot real estate market.

Second, it is best to get a referral from friends or acquaintances. A good agent will be loyal and focused on your needs, not just looking to make a commission. A good agent will also know competent home inspection services and mortgage and title insurance companies to help with your purchase.

Finally, you should sit down and interview the referred agent. Ask what they know about the school districts and municipalities in the areas in which you are interested. Ask them to show you recent comparable sales in those areas and ask them what they think you will need to pay. Talk to them about pre-qualifying for a mortgage so you know if you can afford the houses in that area. You need to spend some time talking to the agent about the school districts and the types of houses you like. A good agent will be patient with you to make sure you get a house you can afford and love.

Home Prices

The price of housing, like almost everything else, is determined by supply and demand. The more buyers and the fewer sellers in a local market, the faster housing prices rise. Conversely, more sellers and fewer buyers, the slower housing prices rise. Prior to the Great Recession, however, people actually believed that housing prices never went down. Sadly, that was not to be the case.

The American Association of Realtors' general rule is that if there is a six months' supply of houses, the market is in equilibrium; that is, housing prices neither move up or down. However, if there is less than a six months' supply, house prices tend to rise, and vice versa.

The first thing your real estate agent will do before they meet with you is to look up **comparables**. Comparables are houses that were sold or are for sale in your neighborhood or in the neighborhood you are considering. In order to be comparable, it should

have approximately the same square feet as your house or the house you can afford, have the same number of bedrooms and bathrooms, and share other traits in common.

Zillow and Redfin are two good sources for house prices. They can give you fairly accurate estimates of average home prices in the area you are considering. When you look at prices, only look at **sales prices**, not the **listing price**. Only a sold house will give you the correct price that a willing seller and a willing buyer will agree upon.

The Down Payment and Private Mortgage Insurance

Conventional wisdom says that you need 20% as a down payment on a house. However, home buyers can usually put 5% or even 3.5% down if they arrange a U.S. Federal Housing Administration (FHA) loan on a 30-year fixed-rate home mortgage. Note that 3.5% FHA down payments are usually capped at $417,000 for home mortgage loans, although there are exceptions to that rule depending on location. Many bank loans also often approve loans up to $417,000 with 5% down. If the loan is larger than that, lenders will usually ask for another 5% down.

Regular 30-Year Fixed Mortgage

Traditional mortgages, like a 30-year fixed rate mortgage, usually require at least a 5% down payment. For example, if you are buying a home for $200,000, you will need $10,000 to secure a home loan.

FHA Mortgage

For a government-backed mortgage like a FHA, the minimum down payment is 3.5%. For a home that costs $200,000, you will need to save $7,000 to get a loan.

VA Loans

A U.S. Veteran's Affairs (VA) loan offers military members and veterans home loans with zero money down approvals. The U.S. Department of Agriculture (USDA) also has a zero-down loan guarantee program for specific rural areas.

In 2016, the average home down payment was 11% according to the National Association of Realtors. Home buyers age 35 and under on average put down 8% in the same time period. When you are figuring out how much to save for a down payment, know that, while you are not allowed to borrow the money for the down payment, it's perfectly acceptable to use any cash gifts from friends, family, or business partners. Setting aside any workplace bonuses or financial windfalls (like an inheritance) can also curb the impact of having to save. Many young people (including myself) got help with the down payment on their first house by their parents, grandparents, or other relatives; there is no need to be prideful about it. Accept with gratitude any help you get, and be sure to send them a thank you letter.

If you take out a traditional mortgage and do not make a 20% down payment, your financial institution will likely make you purchase **Private Mortgage Insurance** (PMI). PMI is arranged by the lender and provided by private insurance companies to insure the financial institution against loss of money if they foreclose on your house and sell it. A buyer usually would be required to put down 20%, and the financial institution would put a mortgage of 80% of the purchase price. If the buyer defaults, and the lender forecloses on the home, the lender only has to sell the house for 80% of what you paid for it to be made whole on its mortgage. The 20% down payment gives the lender a cushion to recover its loan, even if home values have declined since the borrower bought the house.

If the buyer puts down less than 20%, this means that the lender's **Loan-to-Value ratio** (the percent of the purchase price the lender finances) is higher than 80%. This increases the risk that the financial institution will not recover its loan if the buyer defaults. PMI essentially insures the recovery of the difference between a 5% down payment and a 20% down payment. Let's say you buy a home for $300,000. Whereas people used to put down 20% ($60,000.00), you only put down 5% ($15,000.00). The lender is now financing 95% of the purchase price ($ 285,000.00). In order to cover the increased loan exposure, the lender will arrange for PMI and make you pay for this insurance. It costs somewhere between 0.5% and 1% of the total outstanding mortgage. For the example above, a 0.5% premium of the PMI on a mortgage of $285,000 would cost you $1,425.00 per year, or an additional monthly payment of $119.00.

You should buy a home as soon as you have at least a 5% down payment and go ahead and pay the PMI premium. It is hard enough to save money for a down payment (or ask your parents for the down payment) when you are beginning your career. In addition to

that, the Consumer Financial Protection Bureau states that when the amount outstanding on your mortgage becomes 78% or less of the value of your home, then by law, your lender must cancel the PMI (and you stop paying the premium). In practice, you can often get your lender to remove the PMI when your mortgage is 80% or less of the home's value. In both cases, you want to alert your lender of the Loan-to-Value and ask that the PMI be cancelled. The lender will likely not do it automatically.

Qualifying to remove the PMI happens reasonably quick because your home value will appreciate at least 3% per year. Your lender will not pay attention to the home values in your area so will not volunteer to remove your PMI. You have to ask your lender to do it. Stay informed about the property values of comparable homes in your neighborhood. The bank may ask you to pay for another appraisal ($300 to $500) but it is worth the money to save the PMI premium each month.

Where to Get a Mortgage

Many financial institutions say they can arrange a home mortgage for you, including commercial banks (e.g., Wells Fargo, Bank of America) and mortgage brokers (e.g., Rocket Mortgage and Ditech.com). Some will charge higher fees than others. However, the best place to get a mortgage is a credit union. As we discussed earlier, a credit union is essentially a non-profit entity, as it is owned by its members and, unlike a commercial bank, does not need to make a profit to pass on to stockholders. Therefore, a credit union will charge a lower interest rate and fewer fees than either a mortgage broker or a commercial bank.

If you are not currently a member of a credit union, you can easily join one. State laws differ slightly on credit unions, but you can now join almost any credit union by opening a checking and savings account and depositing $5.00. Go visit the credit union office that is most convenient to you and open an account. You can then apply for a mortgage. Credit unions are in the business of lending money, so if your credit history is good, they will be happy to work with you.

Pre-Qualifying for a Mortgage

If you are ready to buy a house, it is important to pre-qualify for a mortgage. You do this by going to your financial institution and submitting all the paperwork they require before you make an offer on a house. You can do this while you are still house hunting. The lender will give you a letter saying you qualify for a mortgage of a certain amount, addressed either to you or to your real estate agent. A lender can easily determine the maximum mortgage that you qualify for. As we said before, your total monthly debt payments plus the mortgage payment cannot exceed 43% of your gross monthly income. If your credit score is acceptable, the lender will give you a letter testifying to the maximum mortgage you qualify for.

A credit score of 700 or above is ideal. A credit score from 600 to 700 may affect the interest rate you will be charged on the mortgage and may affect the maximum amount you can borrow. However, this usually will still allow you to get a mortgage close to the 43% maximum mortgage guideline. A credit score under 600 will be a problem in securing a mortgage but not impossible. If you have a credit score under 600, you should first try your credit union or an online mortgage broker like Rocket Mortgage or Ditech.com.

Pre-qualifying for a mortgage is an important competitive edge in winning a bid on a house, especially if several people are interested in the same house as you. The sales contract that you will sign will have a **contingency clause** which states that your offer is dependent on securing a mortgage. If you already have a letter from your lender saying they have pre-approved you for a mortgage, then the seller can feel comfortable that you will be able to close the deal.

It is common practice to get pre-approved for a mortgage now, so if you do not, you will be at a competitive disadvantage. This is especially true when there is a **seller's market** (more demand for than supply of houses) as opposed to a **buyer's market.**

Types of Mortgages

There are many different flavors of mortgages in the marketplace. These are the three most common:

- A fixed rate 30-year mortgage
- A fixed rate 15-year mortgage
- A three-year adjustable rate mortgage

The **thirty-year-fixed rate mortgage** is by far the most common type, and I recommend this for your principal residence. In this case, be conservative. Take out a conventional or FHA fixed-rate thirty year mortgage loan when you buy your house. A thirty-year fixed rate mortgage has a consistent monthly payment. This gives you a specific amount you need to budget each month. Also, the

longer the term of the loan, the lower the amount of principle that must be paid back (or **amortized**) every month; that means a smaller monthly payment. As with any loan, the interest you pay is on the outstanding principle. But if the outstanding principal changes every month (along with the interest) as you pay down the loan, how do you end up with a consistent monthly payment? Simply put, the paydown of the principle of the loan changes every month. Here is a typical relationship of interest to principal each month in a thirty-year fixed rate constant payment mortgage:

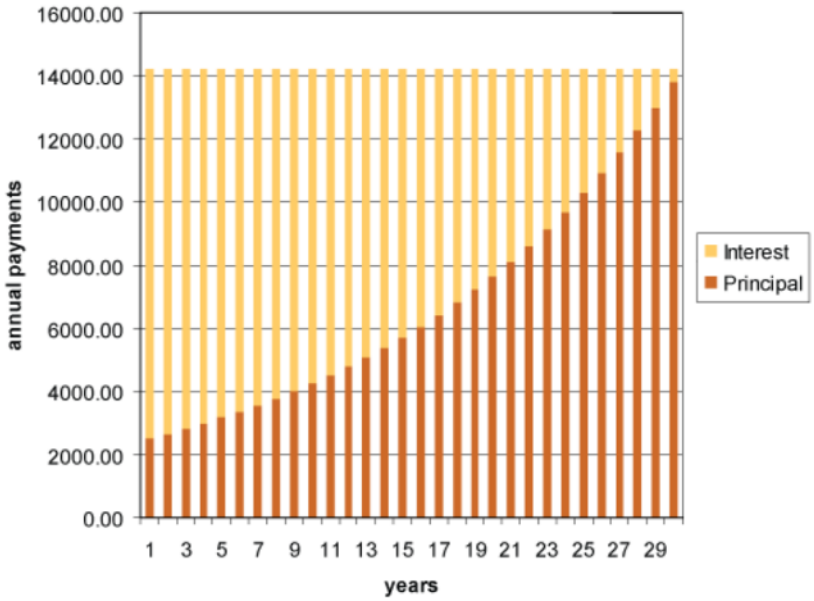


Figure 9.5.1.1: Amortization of a $200,000 loan for 30 years at 5.9% by The Federal Reserve Board is in the public domain.

A **fifteen-year fixed rate mortgage** is similar to a thirty-year fixed rate mortgage, but you repay the principle over fifteen years instead of thirty. The only major advantage of a fifteen-year loan is that you pay off the principal sooner, which, in addition to being satisfying, saves a lot of interest. However, the monthly payment is larger. Below, you can see an example of how much interest you can save. The loan amount in each case is $200,000, and the interest payments are shown in orange on the chart.

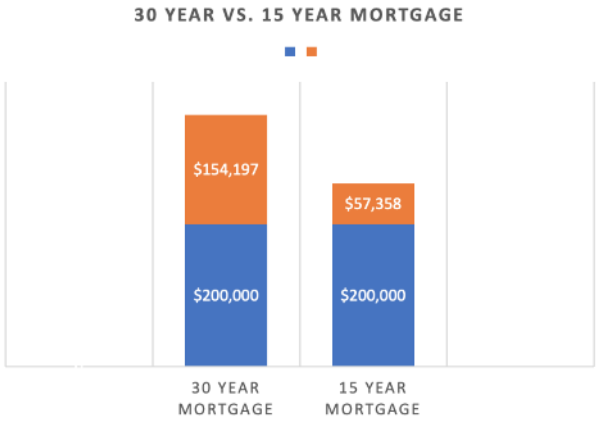


Figure 9.5.1.2: Mortgage Total Cost 15 year v. 30 year

Now let's compare payments between a thirty-year and a fifteen-year fixed rate mortgage. Here is a 95% Loan-to-Value loan for a thirty-year and a fifteen-year fixed rate mortgage on the median home price in the United States:

- Median home price: $227,000
- Down payment (5%): $11,350
- Closing costs (2%-3%): $4,900
- Mortgage amount: $222,450

For a $222,450 mortgage, here is what your monthly payment would be:

Monthly mortgage payment for 3(0)-year loan at $6\% =$

$$\$1.292 + \mathrm{P\backslash Il}(0.5\% = \$18.5/\mathrm{mo}) = \$1.477 \quad (9.5.1.1)$$

Monthly mortgage parment for 15 -year loan at $6\% =$

$$\$1.819 + \mathrm{P\backslash\ II}\ (0.5\% = \$18.5/\mathrm{mo}) = \$2.004 \quad (9.5.1.2)$$

Since rates and home prices vary, you can use an online calculator to calculate a mortgage. Generally, younger people buying their first or second house cannot afford the higher payment on a fifteen-year mortgage, so they choose the thirty-year instead. My advice is to go with the thirty-year mortgage with the lower monthly payment. This will help your cash flow.

A **three-year adjustable rate mortgage** (ARM) has an interest rate that is adjusted upward (or downward) based on a certain designated financial index after three years or to a predetermined rate. The principal payment is usually based on a thirty-year amortization. The advantage of this loan is that the interest rate is lower at the beginning. For example, on September 17, 2019, the rate on a five-year ARM ranged from 3.00% to 3.25% while the rate on a thirty-year fixed rate mortgage was 3.97%. However, when the interest rate is adjusted the payment often is higher, and this can create a cash flow problem for the borrower.

There are many different types of adjustable-rate mortgages, but they all have common elements. For example, if the mortgage is a five-year ARM, it will be tied to some index of interest rates, such as the five-year U.S. Treasury Note. Then, after the first five years, the interest rate will be changed once a year in accordance with any changes in the five-year Treasury Note. This also means that the monthly payment will change (up or down) as the interest rate of the index changes. The lender will also specify how much above the index interest rate your mortgage interest rate will be. This is called the **margin** or **mark up**. As an individual, you cannot borrow money at the same rate as the U.S. government, as you represent a higher risk for the lender. The higher risk is reflected in the higher rate. If we look at the rates in the previous paragraph, we see that the five-year ARM mortgage has a margin or risk premium of 1.4% over the five-year U.S. Treasury Note (3.00% 5yr ARM – 1.6% 5yr Treasury = 1.4% risk premium).

The likelihood is that once the first five years is over, the rate will increase and, as a result, your monthly payment will increase. The assumption here is that five years from now your salary will have increased, and you can afford a higher monthly payment. However, the ARM interest rate will have what is known as **caps** on it. Caps are limits on how much the ARM interest can rise in any one year or over the life of the loan. Here is a hypothetical example:

- 5-year Adjustable Rate Mortgage: 5.25% will not adjust more than +/- 0.5% in first 5 years then adjusts to market rate at the time
- Constant monthly payment: $1,190
- Principle amortization based on 30-year amortization: 30-year amortization
- Rate for five years: 5.25%

After five years, the rate will adjust every year on the anniversary of the loan to a rate that is 2.00% above the rate of the five-year U.S. Treasury Note.

- Annual cap: Upon adjustment, the rate will not go up (or down) more than 0.25% each year it is adjusted or go up more than 1% total for the life of the loan.

With an adjustable rate mortgage, you may end up doing a partial amortization or a negative amortization of your principal. Partial amortization or zero amortization in a mortgage will occur if you take out an interest-only mortgage. If you are paying only the interest on the loan, it reduces the monthly payment. However, the downside is that the principal does not decrease and must be paid off if you sell the house or refinance the loan. If you are paying only the interest on your home mortgage plus a little bit of the principal (in order to reduce the monthly payment) the amount of the loan paid off will not decrease as rapidly as it will with a thirty-year or fifteen-year home loan.

If you take out an adjustable rate mortgage, you may also end up with negative amortization of the principal of your home loan. A negative amortization loan is one in which you are not even paying the market interest on your home loan. Any interest above the market interest is added to the balance of unpaid principal. Negative amortizations can be offered with certain types of mortgage products. Although negative amortization can help provide more flexibility to borrowers by reducing the monthly payment, it can also increase their exposure to interest rate risk and actually increases the amount they owe.

Fannie Mae and Freddie Mac

Fannie Mae, or FNMA, is shorthand for the Federal National Mortgage Association. **Freddie Mac**, or FHLMC, refers to the Federal Home Loan Mortgage Corporation. The main difference between Fannie and Freddie comes down to who they buy mortgages from. Fannie Mae mostly buys mortgage loans from commercial banks, while Freddie Mac mostly buys them from smaller banks that are often called **thrift banks**.

Fannie Mae and Freddie Mac were created by Congress to perform an important role in the nation's housing finance system: to provide liquidity, stability, and affordability to the mortgage market. They provide **liquidity** (ready access to funds on reasonable terms) to the thousands of banks, savings and loans, and mortgage companies that make loans to finance housing.

It may not seem like it, but the banking business model, especially in mortgage lending, is a very unstable business model. Banks borrow **short** (that is, borrow money from depositors or from 90-day Commercial Paper lenders) and lend it **long** through multi-year credit cards, one year lines of credit, three year auto loans and, in the case of the mortgage market, three to thirty year mortgages. Depositors can demand their money back at any time, and the 90-day Commercial Paper loans must be renewed every 90 days. If a large portion of the depositors demanded their money back at once or if the banks were not able to roll over the Commercial Paper, the bank would be illiquid and would likely have to close. Fannie Mae and Freddie Mac buy the three-to-thirty-year mortgages and give the banks a profit for originating them. The banks get their money back and can lend it out again.

As to affordability, Fannie Mae and Freddie Mac bundle the mortgages and attach a guarantee to the bonds they buy. Since the market considers this a "quasi-guarantee" by the U.S. government, the interest rate that FNMA and FHLMC must pay on these bonds approaches the low interests on U.S. Treasury bonds. This translates to low interest rates on mortgages that qualify for purchase by these two institutions. They are very powerful in the mortgage market, owning or having guaranteed over 60% of all U.S. mortgages.

Fannie Mae and Freddie Mac buy mortgages from lenders and either hold these mortgages in their portfolios or package the loans into **mortgage-backed securities** (MBS) that may be sold. Lenders use the cash raised by selling mortgages to the enterprises to engage in further lending. The enterprises' purchases help ensure that individuals and families that buy homes and investors that purchase apartment buildings and other multifamily dwellings have a continuous, stable supply of mortgage money. These institutions also set the rates and the conditions for the mortgages they will buy (called **prime mortgages**). Fannie Mae and Freddie Mac also help stabilize mortgage markets and protect housing during extraordinary periods of stress in the broader financial system.

Fannie Mae was first chartered by the U.S. government in 1938 and was a company whose stock was sold to the public, and Freddie Mac was chartered by Congress in 1970 as a private company, whose stock was also sold to the public. During the Great Recession, both Fannie Mae and Freddie Mac went bankrupt and were taken over by the U.S. Treasury Department. They are still in what is called conservatorship and pay their profits to the U.S. Treasury.

The Home Mortgage Crisis of 2006 to 2009 and the Great Recession

The following graph shows median home prices in the U.S. before, during, and after the mortgage crisis of 2006 to 200 (Case/Shiller, 2009). The Case/Shiller Index is one of the most respected indices of home prices. Note that home prices for the 10 largest U.S. cities (the Composite 10) and the 20 largest U.S. cities (the Composite 20) along with the National Index began dropping in early 2006 and continued to drop until sometime in the year 2009.

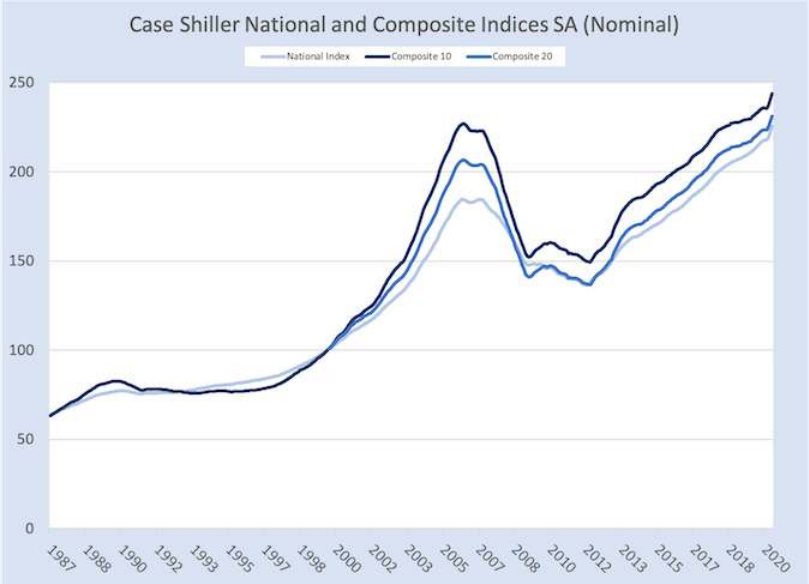


Figure 9.5.1.3: Case Shiller Index by Fred Rowland is used under a CC BY-NC 4.0 License. Source: Federal Reserve Economic Data [FRED] (12/2020).

As Akerloff and Shiller (both Nobel Prize laureates in Economics) contend in their book, Animal Spirits, most recessions begin with a financial crisis (2009). The Great Recession was no exception. Fannie Mae and Freddie Mac were not owned by the government but instead private organizations that offered stock to the public. Fannie Mae and Freddie Mac were very profitable and became the envy of the Wall Street banks. In fact, as of now, they own or guarantee 60% of the mortgages in the United States!

They became so profitable by purchasing mortgages from banks and mortgage brokers (called the **originators**) and assembling them into bonds they then sold. Fannie Mae's and Freddie Mac' guarantees were seen by investors as being equivalent to an implicit guarantee by the U.S. government. Therefore, Fannie Mae and Freddie Mac were able to pay very low interest rates on the bonds, allowing them to make large profits on the difference between the interest rates they were receiving on the mortgages they purchased and the low rates they were borrowing their money at by selling bonds.

Wall Street banks wanted to get in on the action. The problem was that even the biggest banks could not match the implicit government guarantee that backed the Fannie Mae and Freddie Mac bonds. Instead, they came up with the idea of paying for default insurance on the bonds they wanted to issue to buy mortgages. The banks went to AIG, the largest insurance company in the world, and convinced them to issue default insurance. With this AIG guarantee, the banks were able to get the highest credit rating on their bonds and to borrow money almost as cheaply as Fannie Mae and Freddie Mac.

Like all screwy schemes, things went well (and profitably) for a while (from 2000 to 2003), but then the banks got greedy. As they started to run out of very credit-worthy mortgages to buy (the prime mortgages), the Wall Street banks bought less credit-worthy mortgages (known as **subprime mortgages**). These subprime mortgages were structured in a dizzying array of new types of loans or even loans where the income and assets of the home buyer were self-reported and not verified (called **liar loans**). These subprime mortgages were all bundled into bonds with some prime mortgages and the AIG guarantee the bonds the highest credit rating.

In 2006, subprime mortgage holders began to default—not just a few, but millions. This caused a total halt to the bond market for Wall Street banks. According to the **Generally Accepted Accounting Practices** rules (GAAP), if there is no market for an asset you own, you must write its value down to zero in your financial statements. The Wall Street banks had to write down the mortgage-backed bonds they held to zero, and as a result every major bank in the United States became insolvent (except for J.P. Morgan, who did not participate as much in this bond party). They all had to be bailed out in 2008 by the Federal Reserve Bank.

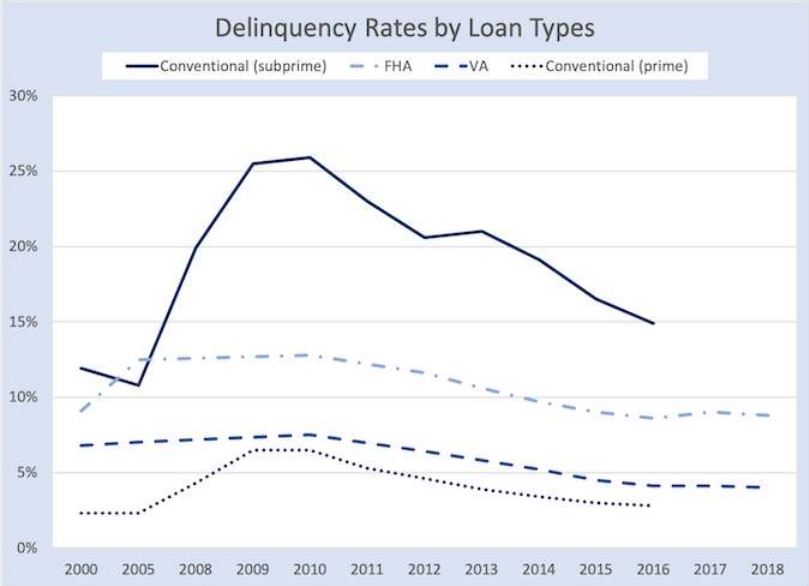


Figure 9.5.1.4: Delinquency Rates by Loan Types by Fred Rowland is used under a CC BY-NC 4.0 License. Source: Statistical Abstract of the United States data (2020).

The dominoes began to fall. The availability of cheap and easy money to buy houses had caused a spike in housing prices from 2000 to 2005. The mortgage defaults and the resulting disappearance of this easy money then caused housing prices to drop precipitously. Millions had bought homes at elevated prices and borrowed mortgages on those elevated prices. When home prices fell, the value of their homes was less than the mortgage amount they owed on their home (called being underwater). Ultimately, three million people lost their homes to foreclosure in 2008, and it is estimated that as many as ten million people lost their homes to foreclosure in the Great Recession. The financial crisis and the ensuing drop in home prices and foreclosures were one of the major causes, if not the major cause, of the Great Recession. Eight and a half million people lost their jobs in this recession. The value of stocks in the U.S. stock market dropped 38% to 40% during the recession.

Since then, housing prices have recovered in the United States (and internationally). Even further, some cities can be classified as unaffordable for middle class people. Here is data on the most unaffordable cities, when we compare home prices to income:



Figure 9.5.1.5: Where it is Hardest to Afford a Home by Statista is used under a CC BY-ND 3.0 License.

Transaction Costs of Purchasing a Home

Here is an estimate of the closing costs on a 95% Loan-to-Value loan and a thirty-year fixed rate mortgage on the median home price in the United States:

- Median home price: $227,000
- Down payment (5%): $11,350
- Closing costs (2%-3%): $4,900
- Mortgage amount: $222,450

The closing costs will be quite substantial, and these will likely include the following:

Table 9.5.1.1: Closing Costs

Item	Comments	
Mortgage Points	1% of Mortgage	$2,200
Origination Fee		$700
Appraisal Fee		$300
Application Fee		$200
Attorney Fee (Deed Preparation)		$500
Inspection Fee (Termites or Radon)		$300
Title Insurance		$500
Other Fees		$200
TOTAL		$4,900

You may also be asked to pay for some other items at closing:

- Reimbursement of Oil: If your purchased home has oil heat, you will likely be asked to reimburse the seller for oil left in the oil tank.
- Prepayment of Insurance: The bank giving you the mortgage may ask you to pay at settlement the first six months of homeowners insurance, so they know, at least initially, that the home is insured.
- Reimbursement of Real Estate Taxes: If the seller has already paid all the real estate taxes for the year and there are, e.g., six months left in the tax year, you will have to reimburse the seller for six months of real estate taxes.
- State Transfer Tax: Some states have real estate transfer taxes, which are charged on home sales. As an example, the state of Pennsylvania has a 2% transfer tax on all home sales. One percent of this is paid by the buyer and 1% is paid by the seller.

You are entitled to a full good faith estimate of the closing costs at least a few days prior to closing on the house and closing on the mortgage. If you do not get one, ask for it.

How to Calculate the Monthly Payment

Start with the approximate sales prices of recently sold houses in the neighborhood. Next, figure out what amount of money you have for the down payment. This will most likely need to be a 5% down payment. If you do not have 5%, often you can put only 3% down. Next, realize your closing costs will be 2 % to 3% of the purchase price (depending on any real estate transfer tax in your state). Then calculate the mortgage you will need by taking the home price and deducting the 5% down payment and adding the closing costs. Finally, use a mortgage calculator online.

Tax Consequences of Home Ownership

There are significant income tax benefits to owning a home. The Internal Revenue Code allows you to deduct all interest you pay on your mortgage from your personal income. The tax savings you receive will be in line with the rate of federal income taxes you pay on your income. For example, if you pay a tax rate of 20% in income taxes, you will save 20% of the annual interest you pay on your mortgage. Let's say the total interest you pay annually on your mortgage is $9,600, and your average tax rate is 20%. That means you will save $9,600 X 0.20 = $1,920. Also, you do not have to wait until you file your taxes to get a refund of that money. You can adjust the IRS Form W-4 with your employer at any time. You will add additional deductions on the W-4 so that less income tax is withheld every pay period. This improves your cash flow and helps with the monthly mortgage payment. The ability to deduct the interest on your mortgage payments is a significant subsidy for American homeowners. This tax savings does not exist in many other countries.

Annual Costs of Home Ownership

If you purchase a brand new house, you will likely not have any major maintenance expenses for a couple years. However, for previously owned homes, the annual average for repairs and maintenance (painting, driveway resealing, etc.) is estimated to be from 2% to 4% of the value of the home per year, depending on how old the home is. Zillow estimates homeowners can spend over $9,000 a year on average.

Common Mistakes in Taking Out a Mortgage

The biggest mistake people make in buying a home is to buy a more expensive house than they can afford. This, of course, means that they will take out a bigger mortgage than they can afford. The mortgage payment on the house is the gauge of how expensive a house you can qualify for. A qualified loan is one where the total debt payments-to-total income ratio is no more than 43%. However, just because you qualify for a certain loan size does not mean you should buy the most expensive house you can. There are maintenance expenses on the house and other expenses you need to consider. Seriously review your household budget and include the mortgage payment and expenses. Then decide what monthly mortgage payment you are comfortable with. Do not forget to consider the tax savings on the mortgage interest in your budget.

When to Refinance

Historically, common wisdom said that you should refinance if you can reduce your mortgage interest rate by 2%. However, many people refinance if they can lower their interest rate by 1%. You should definitely refinance an adjustable rate mortgage to a fixed rate thirty-year or fifteen-year mortgage to protect yourself against interest rate increases. Essentially, the decision to refinance should be based on a cost/benefit analysis. What will it cost you to refinance, and how much will you save per month? Calculate

how many months it will take you to get back the fees you paid to refinance from the savings. Bankrate.com has a refinancing calculator to show you how much you can save and how long it will take you to get your fees back. The fees to refinance are similar to the fees to take out the original mortgage:

- Origination fee
- Appraisal fee
- Application fee
- Attorney fee (deed preparation)
- Inspection fee (termites or radon)
- Title insurance
- Other fees (PMI insurance)

These could total up to 2% of the new financed amount. Always ask the bank early on what the fees for refinancing add up to. This will enable you to do an informed cost/benefit analysis.

Table 9.5.1.1. Refinancing Example

	Example	Your numbers
1. Your current monthly mortgage payment	$1,199	
2. Subtract your new monthly payment	– $1,073	
3. This equals your monthly savings	$126	
4. Subtract your tax rate from 1 (e.g. 1 – 0.28 = 0.72)	0.72	
5. Multiply your monthly savings (#3) by your after-tax rate (#4)	$126 x 0.72	
6. This equals your after-tax savings	$91	
7. Total of your new loans' fees and closing costs	$2,500	
8. Divide total costs by your monthly after-tax savings (from #6)	$2,500 / 91	
9. This is the number of months it will take you to recover your financing costs	27 months	

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SECTION OVERVIEW

9.5.2: Housing

9.5.2.1: Buying a Home

9.5.2.2: Mortgages

9.5.2.3: Housing-Related Complaints

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9.5.2.1: Buying a Home

Thinking about buying a home? We have information that can help! Got questions? Talk to one of our housing counselors!

1. Figure out how much you can afford

What you can afford depends on your income, credit rating, current monthly expenses, downpayment and the interest rate.

- Home Economics
- Homebuying programs in your state

2. Know your rights

- Fair Housing: Equal Opportunity for All – brochure
- Real Estate Settlement Procedures Act (RESPA)
- Borrower's rights
- Predatory lending

3. Shop for a loan

- Looking for the best mortgage: shop, compare, negotiate – brochure
- Let FHA help you
- Learn about interest only loans

4. Learn about homebuying programs

- Homebuying programs in your state
- Let FHA help you (FHA loan programs offer lower downpayments and are a good option for first-time homebuyers!)
- HUD's special homebuying programs
  - Good Neighbor Next Door (formerly known as Teacher/Officer/Firefighter Next Door)
  - Homeownership for public housing residents
  - Indian Home Loan Guarantee Program (Section 184)

5. Shop for a home

- Wish list – what features do you want?
- Home-shopping checklist? take this list with you when comparing homes
- Homes for sale (including HUD homes)
- "Fixer-Uppers – home purchase and repair programs
- Manufactured (mobile) homes
- Shopping for a Home FAQ's

6. Make an offer

- Making an offer

7. Get a home inspection

- For Your Protection Get a Home Inspection

8. Shop for homeowners insurance

- Homeowners insurance
- 12 ways to lower your homeowners insurance costs

9. Sign papers

You're finally ready to go to "settlement" or "closing." Be sure to read everything before you sign!

- Getting ready to close

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9.5.2.2: Mortgages

Learn some of the basics about mortgages.

What's on This Page

- Mortgage Refinancing
- Predatory Loans
- Reverse Mortgages

Mortgage Refinancing

Refinancing refers to satisfying a debt by making another loan on new terms. The most common consumer refinancing is for a home mortgage, which generally involves paying off your existing mortgage and taking out a new mortgage.

The following resources provide further information:

- A Consumer's Guide to Mortgage Refinancings
- Buying Your Home: Settlement Costs Booklet (PDF, Download Adobe Reader)
- Interest Rate Reduction Refinancing Loans (IRRRL) – For Veterans

Making Home Affordable Program

The Making Home Affordable Program offers opportunities to modify or refinance your mortgage to make your monthly payments more affordable. It also includes the Home Affordable Foreclosure Alternatives Program for homeowners who are interested in a short sale or deed-in-lieu of foreclosure. Call 1-888-995-4673 for more information.

Please note: New Federal Reserve rules require mortgage companies to notify homeowners when their loans are transferred to another company. The company that takes over your loan must send you a notice within 30 days of acquiring it. Even with a new loan owner, the company that "services" or handles your loan might not change and you might continue to send your payments to the same address. If that loan servicer changes, you will receive a separate notice.

For more information about servicing companies, read the Federal Trade Commission's publication "Mortgage Servicing: Making Sure Your Payments Count."

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Predatory Loans

Most mortgage professionals are trustworthy and provide a valuable service, helping you to buy or refinance your home. But dishonest or "predatory" lenders do exist and engage in practices that increase the chances of borrowers losing their homes to foreclosure. To avoid becoming a victim of predatory lending, you need to understand the process to buy a home and be a smart consumer.

What Is Predatory Lending?

Predatory lenders, appraisers, mortgage brokers and home improvement contractors could use any of these tactics to take away your home or investments:

- Sell properties for much more than they are worth using false appraisals
- Encourage borrowers to lie about their income, expenses, or cash available for down payments in order to get a loan
- Knowingly lend more money than a borrower can afford to repay
- Charge high interest rates to borrowers based on their race or national origin and not on their credit history
- Charge fees for unnecessary or nonexistent products and services

Avoid Predatory Loans by Being a Smart Consumer

Follow these guidelines to avoid becoming a victim of predatory lending:

- Before you buy a home, attend a homeownership education course offered by a U.S. Department of Housing and Urban Development (HUD)-approved, non-profit counseling agency.

- Interview several real estate professionals (agents), and ask for and check references before you select one to help you buy or sell a home.
- Get information about the prices of other homes in the neighborhood. Don't be fooled into paying too much.
- Hire a qualified and licensed home inspector to carefully inspect the property before you are obligated to buy. Determine whether you or the seller will be responsible for paying for the repairs.
- Shop for a lender and compare costs. Be suspicious if anyone tries to steer you to just one lender.

The HUD Office of Housing Counseling has a list of federal, state, and local resources to protect you from predatory lending.

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Reverse Mortgages

A reverse mortgage is a home loan that you do not have to pay back for as long as you live in your home. You only repay the loan when you die, sell your home, or permanently move away. Homeowners who are at least 62 years old are eligible. These mortgages allow older homeowners to convert part of the equity in their homes into cash without having to sell their homes or take on additional monthly bills.

Read more information about reverse mortgages.

Types of reverse mortgages include:

- Federally insured Reverse Mortgages – Known as Home Equity Conversion Mortgages (HECM)
- Proprietary Reverse Mortgages
- Single Purpose Reverse Mortgages

Be sure to watch for aggressive lending practices, advertisements that refer to the loan as "free money," or those that fail to disclose fees or terms of the loan. To be a savvy consumer and help protect yourself, remember:

- Do not respond to unsolicited advertisements
- Be suspicious of anyone claiming that you can own a home with no down payment
- Seek out your own reverse mortgage counselor
- Never sign anything you do not fully understand
- Make sure the loan is federally insured

Reporting Fraud or Abuse

If you suspect fraud or abuse, let the counselor, lender, or loan servicer know. You may also file a complaint:

- Federal Trade Commission (FTC)
- State Attorney General's office
- State banking authority

If you have questions, contact your local Homeownership Center for advice.

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9.5.2.3: Housing-Related Complaints

Find out what to do if you have one of these complaints when buying or renting a home.

What's on This Page

- Complaints About Mortgage Companies
- Identify and Complain about Housing Discrimination
- Landlord and Tenant Disputes

Complaints About Mortgage Companies

If you feel that you have been the victim of a discriminatory lending transaction, you can contact the Federal Trade Commission (FTC) or file a complaint using their Online Complaint Assistant. The FTC has enforcement authority in the case of mortgage companies for the following laws:

- Equal Credit Opportunity Act (ECOA)
- Truth in Lending Act
- Fair Credit Reporting Act

You may also file consumer complaints using the following resources:

- Consumer Financial Protection Bureau (CFPB)
- State/local consumer protection agencies

Foreclosure Scams

If you feel you are the victim of a foreclosure scam, you may contact the HOPE NOW Alliance at 1-888-995-HOPE (1-888-995-4673) or (TTY 1-877-304-9709), for more information on how to lodge your complaint.

Predatory Lending

Getting the right mortgage can be difficult. For instance, consumers can become victims of predatory lending, which is the practice of convincing borrowers to agree to unfair and/or unprincipled loan terms. Federal and state governments enact many laws to prevent predatory lending. Find information on predatory lending, including resources to help protect you against it.

Please note: You are legally obligated to make your mortgage payments by the date specified each month, whether or not you are provided with a bill, the mortgage company or loan service agency has properly credited your previous payments, and/or the escrow has been properly handled. Never withhold your mortgage payments for any reason.

Identify and Complain about Housing Discrimination

Housing discrimination happens when a housing provider acts in a way that blocks someone from renting or buying housing because of their

- Race or color
- Religion
- Sex
- National origin
- Familial status (such as having children)
- Disability

A housing provider that discriminates against someone could be a landlord or a real estate management company. It could also be a lending institution like a bank or other organization that is an important part of acquiring a home.

Housing discrimination is prohibited by the Fair Housing Act. Discrimination covered by the Act can take many different forms beyond just raising prices or lying about availability. For example, the Act addresses wheelchair access in some newer properties. Learn what the Fair Housing Act covers, how to complain, and how the investigation process works.

File a Housing Discrimination Complaint

If you think you are a victim of housing discrimination,

- Complete and submit a Housing Discrimination Complaint Form or
- Contact your regional HUD office

Discrimination Against LGBT People

The Fair Housing Act does not specifically prohibit discrimination based on sexual orientation or gender identity. But discrimination against someone who is lesbian, gay, bisexual, or transgender (LGBT) may still be in violation of the Act or other state or local regulations. If you think you've been discriminated against for these reasons, file a complaint as described above, or email HUD at LGBTFairhousing@hud.gov with general questions about LGBT housing issues.

Landlord and Tenant Disputes

If you are someone who pays to rent a home or an apartment (a tenant), you may at some point have a dispute with the person who owns the building or management company that represents the owner (the landlord). Often disputes are about the conditions of the building, essential services, rent increases, or your right to stay. It is best to come to an agreement directly with the landlord or manager. Make sure that you get everything in writing. If a landlord and tenant cannot come to an agreement, a tenant might turn to outside help.

Getting Help for a Dispute with a Landlord

Laws about the rights of tenants and landlords are almost always handled at the state level. Find help from your state in a directory of state-level agencies and resources of interest to tenants. Results differ for each state, but you may find:

- State agencies that address tenant rights.
- Agencies that handle complaints.
- Resources for legal assistance.

You may eventually decide that you need help from a lawyer. People with very low-income might qualify for free legal aid from a non-profit organization.

Complaints about housing discrimination or landlords who receive assistance from the federal government should be directed to the U.S. Department of Housing and Urban Development.

Before There's a Problem

Of course, it's best to avoid a dispute in the first place if possible.

- Understand your lease completely.
- Keep all correspondence between you and your landlord.
- Communicate problems early on and in writing, noting date and time of phone calls.
- Keep proof of rent and deposits paid.
- Know the landlord-tenant laws in your state.

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SECTION OVERVIEW

9.5.3: Vehicles

9.5.3.1: Buying a Car

9.5.3.2: Buying a New Car

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9.5.3.1: Buying a Car

Learn what to do before buying, leasing, or renting a car.

Buy a New Car

Whether you are buying or leasing a new car, consider these tips to get the best deal and avoid problems:

- Compare car makes and models. Visit the websites of car manufacturers to review the models that interest you.
- Research the dealer's price (or wholesale price) for the car and options. This information can help you negotiating the final price.
- Find out if the manufacturer is offering rebates that will lower the cost.
- Read car advertisements closely. Ads may over promise on the deals, or only apply to a small group of buyers.
- Get price quotes from several dealers. Find out if the amounts quoted are the prices before or after rebates are deducted.
- Research financing options. Be mindful of "loan packing.", where a lender presses you to add features and services to your car to increase the amount of your loan.
- Avoid low-value extras such as credit insurance, auto club memberships, extended warranties, rust proofing, and upholstery finishes.
- Get estimates for how much your auto insurance would cost for each model you are considering.

Buy a Used Car

Consider these factor If you are buying a used car from a dealership.

- Contact your state or local consumer protection office to learn your rights when buying a used car.
- Find out from your state motor vehicle department what paperwork you will need to register a vehicle.
- Check prices of similar models with used car guides that you can find online or at your local library.
- Research the vehicle's history. Ask the seller for details concerning past owners, use, and maintenance. You can also find out whether the car has been damaged in a flood, involved in a crash, had its odometer rolled back, or been labeled a "lemon." Get the car's unique vehicle information number (VIN), usually found on the car's lower left dashboard.
- Research the car's title history with your state motor vehicle department.
- Find out if the car has any recalls, investigations or complaints searchable online database.
- Verify that mileage disclosures match the car's odometer reading.
- Check with the manufacturer to verify if the manufacturer's warranty is still in effect.
- Get and read the seller's return policy in writing.
- Have the car inspected by your mechanic. Talk to the seller and agree in advance that you'll pay for the examination if the car passes inspection, but the seller will pay if the mechanic discovers significant problems. A qualified mechanic should check the vehicle's frame, tires, air bags, and undercarriage, as well as the engine.
- Examine dealer documents carefully. Make sure you are buying—not leasing—the vehicle. Leases use terms such as "balloon payment" and "base mileage" disclosures.

Buying a Car from a Private Owner

You may choose to buy a car directly from an individual, instead of a dealer. The purchase price is often lower and easier to negotiate if you buy a car from a private owner. You should still take the same steps as if you bought the car from a dealership. There are more factors to consider if you buy from a private owner.

A private owner sells the car "as is." If the car has defects when you buy it, the seller isn't required to repair them before you purchase it. Also, federal protections and rules, such as FTC's Buyer's Guide don't apply. If the seller is fraudulent, it can be more difficult to resolve the problem. You can't complain to your local consumer protection office about the seller.

If you choose to purchase a car from a private seller:

- Ask to get service records from the owner.
- Verify that the seller actually owns the car and that the title and registration are in their name.
- Verify that there are no liens against the car, or if it is still under a finance agreement.

- Contact the manufacturer to determine if the manufacturer warranty, or other warranty protection, transfer to you.
- Meet the seller in a public place or busy area, especially if the seller is a someone you don't know.

Vehicle Financing

Learn about the options available for paying for a vehicle.

A link to an interactive elements can be found at the bottom of this page.

Lease a Car

When you lease, you pay to drive a vehicle owned by a automobile dealership or leasing company. Monthly lease payments may be lower than loan payments, but at the end of the lease you have no ownership or equity in the car. To get the best deal, follow the advice below.

- Compare leasing versus owning. The Consumer Leasing Act requires leasing companies to give you information so that you can compare monthly payments and other charges.
- Compare lease offers from multiple dealers. Consider buying from an independent agent rather than a car dealership
- Find out what the down payment, or capitalized cost reduction, is for the lease.
- Calculate the total cost over the life of the lease, and include the down payment. A lease with a higher down payment and low monthly payments may be a better deal for you.
- Ask for details on wear and tear limits. Damages that you regard as normal wear and tear could be billed as significant damage at the end of your lease.
- Find out how many miles you can drive in a year. Most leases allow 12,000 to 15,000 miles a year. Expect a charge of 10 to 25 cents for each additional mile driven.
- Check the manufacturer's warranty. It should cover the entire lease term and the number of miles you are likely to drive.
- Ask the dealer what happens if you give up the car before the end of your lease. You could be responsible for termination fees if you end the lease early.
- Ask what happens if the car is involved in an accident.
- Get all the terms in writing. Everything included with the car should be listed on the lease to avoid being charged for "missing" equipment later.

Get more tips to help you understand the differences between a buying or leasing a car.

Car Safety Information

Car Safety Tests

These organizations conduct automobile safety crash tests:

- The National Highway Traffic Safety Administration (NHTSA):
  - Conducts new vehicle crash tests to determine the protection level for drivers and passengers during front and side-impact crashes.
  - Evaluates vehicle restraints such as air bags and safety belts.
  - Determines the likelihood of a vehicle rolling over if involved in a single-vehicle crash.
- The Insurance Institute for Highway Safety performs a different test that uses offset-frontal car crashes to assess the protection provided by a vehicle's structure.

Safety Performance Reporting

These organizations report on or provide automobile safety information:

- SaferCar.gov:
  - Provides information on how to file a complaint about child safety seats, tires, equipment, and vehicles

  - Lists vehicle and equipment defects and recalls – If a vehicle has been recalled, ask your car dealer for proof that the defect has been repaired. Used vehicles should also have a current safety inspection sticker if your state requires one.
  - Lists vehicles equipped with Electronic Stability Control (ESC)
- The National Motor Vehicle Title Information System provides information about a vehicle's history and condition, including information about its title, odometer reading, and, in some cases, theft.
- Consumer Reports' car issue rates vehicles in terms of overall safety. Its safety score combines crash test results with a vehicle's accident avoidance factors, such as emergency handling, braking, acceleration, and driver comfort.

Car Rental and Car Sharing Services

Even if you don't own a car, there are times when you may need one. When you rent a car, you're using a company's vehicle for a short period of time. Use these tips before signing the rental agreement to help you avoid unexpected problems and charges:

- **Fees:** What is the total cost, after all fees are included? Will there be an airport surcharge or fees for car drop-off, insurance, fuel, mileage, taxes, additional drivers, an underage driver, or equipment rental (for items such as ski racks and car seats)?
- **Driving record:** Ask whether the rental company checks customers' driving records when they arrive at the service counter. If there are problems with your driving record, the rental company could turn you away, even if you have a confirmed reservation.
- **Insurance:** Be sure that you aren't duplicating coverage. You might have coverage through your personal auto insurance policy, a motor club membership, the credit card you used to reserve the rental, or your employer, if you're traveling on business.
- **Damages:** Before driving off, inspect the vehicle for dents, scratches, and marks and check the tires. Report any pre-existing problems and ask the company to note them on your rental agreement. Try to return the car during regular business hours so you and the rental staff can look at the car together to verify that you didn't damage it.
- **Fuel:** Some rental companies, particularly at airports, may require you to refuel within a 10 mile radius of the airport or show a fuel receipt when you return the car.
- **Payment method:** Pay with a credit card rather than a debit card to avoid holds on other funds in your checking account.
- **Rental deposit:** Does the rental company require a deposit? If so, ask for a clear explanation of the deposit refund procedures.

Some state laws cover short-term car and truck rentals. Contact your state or local consumer protection office for information or to file a complaint.

Car Sharing

If you'd rather rent a car on an hourly basis and have greater flexibility in where and when you can pick up a vehicle, you can join a car sharing service. You get the convenience of a car when you need one, without the costs of ownership.

- **Fees:** What fees does the company charge (annual fees, application fee)? Are they refundable, even if you cancel or are denied membership?
- **Availability of cars:** Are there cars available at times that you need one? How far in advance do you need to reserve a vehicle?
- **Attendants:** Are there on-site staff present when you check out your car and return it? This can be very helpful when you need to verify that the car is returned in the same condition as when you borrowed it.
- **Fuel:** Do you have to pay for gas out of your own pocket or does the company pay for it?
- **Extension of time:** How easy is it to extend the length of your rental? Is it done through an app or is there a dedicated customer service hotline?
- **Cancellation:** How far in advance must you give notice to cancel a reservation or your membership? And can the company cancel your membership without notification?
- **Damages:** Are you responsible for damages, even if they were not your fault or they happened after you returned the car? This is especially important if you return the car to a lot that does not have on-site staff.
- **Insurance:** Is insurance included? You may be insured by a personal policy or the credit card that you use to pay for this service.

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9.5.3.2: Buying a New Car

A new car is second only to a home as the most expensive purchase many consumers make. According to the National Automobile Dealers Association, the average price of a new car sold in the United States is about $30,000. That's why it's important to know how to make a smart deal.

A link to an interactive elements can be found at the bottom of this page.

- Buying Your New Car
- Learning the Terms
- Financing Your New Car
- Trading in Your Old Car
- Considering a Service Contract

Buying Your New Car

Think about what car model and options you want and how much you're willing to spend. Do some research. You'll be less likely to feel pressured into making a hasty or expensive decision at the showroom and more likely to get a better deal.

Consider these suggestions:

- Check publications and websites that discuss new car features and prices. These may provide information on the dealer's costs for specific models and options.
- Shop around to get the best possible price by comparing models and prices in ads and at dealer showrooms. You also may want to contact car-buying services and broker-buying services to make comparisons.
- Plan to negotiate on price. Dealers may be willing to bargain on their profit margin, often between 10 and 20 percent. Usually, this is the difference between the manufacturer's suggested retail price (MSRP) and the invoice price.
- Because the price is a factor in the dealer's calculations regardless of whether you pay cash or finance your car — and also affects your monthly payments — negotiating the price can save you money.
- Consider ordering your new car if you don't see what you want on the dealer's lot. This may involve a delay, but cars on the lot may have options you don't want — and that can raise the price. However, dealers often want to sell their current inventory quickly, so you may be able to negotiate a good deal if an in-stock car meets your needs.

Learning the Terms

Negotiations often have a vocabulary of their own. Here are some terms you may hear when you're talking price.

- Invoice Price is the manufacturer's initial charge to the dealer. This usually is higher than the dealer's final cost because dealers receive rebates, allowances, discounts, and incentive awards. Generally, the invoice price should include freight (also known as destination and delivery). If you're buying a car based on the invoice price (for example, "at invoice," "$100 below invoice," "two percent above invoice") and if freight is already included, make sure freight isn't added again to the sales contract.
- Base Price is the cost of the car without options, but includes standard equipment and factory warranty. This price is printed on the Monroney sticker.
- Monroney Sticker Price (MSRP) shows the base price, the manufacturer's installed options with the manufacturer's suggested retail price, the manufac-turer's transportation charge, and the fuel economy (mileage). Affixed to the car window, this label is required by federal law, and may be removed only by the purchaser.
- Dealer Sticker Price, usually on a supplemental sticker, is the Monroney sticker price plus the suggested retail price of dealer-installed options, such as additional dealer markup (ADM) or additional dealer profit (ADP), dealer preparation, and undercoating.

Financing Your New Car

If you decide to finance your car, be aware that the financing obtained by the dealer, even if the dealer contacts lenders on your behalf, may not be the best deal you can get. Contact lenders directly. Compare the financing they offer you with the financing the dealer offers you. Because offers vary, shop around for the best deal, comparing the annual percentage rate (APR) and the length of

the loan. When negotiating to finance a car, be wary of focusing only on the monthly payment. The total amount you will pay depends on the price of the car you negotiate, the APR, and the length of the loan.

Sometimes, dealers offer very low financing rates for specific cars or models, but may not be willing to negotiate on the price of these cars. To qualify for the special rates, you may be required to make a large down payment. With these conditions, you may find that it's sometimes more affordable to pay higher financing charges on a car that is lower in price or to buy a car that requires a smaller down payment.

Before you sign a contract to purchase or finance the car, consider the terms of the financing and evaluate whether it is affordable. Before you drive off the lot, be sure to have a copy of the contract that both you and the dealer have signed and be sure that all blanks are filled in.

Some dealers and lenders may ask you to buy credit insurance to pay off your loan if you should die or become disabled. Before you buy credit insurance, consider the cost, and whether it's worthwhile. Check your existing policies to avoid duplicating benefits. Credit insurance is not required by federal law. If your dealer requires you to buy credit insurance for car financing, it must be included in the cost of credit. That is, it must be reflected in the APR. Your state Attorney General also may have requirements about credit insurance. Check with your state Insurance Commissioner or state consumer protection agency.

Before you negotiate the price of your next new car, use this worksheet to establish the bargaining room. *You can get the invoice price by looking at the dealer's invoice or reviewing car publications.

Trading in Your Old Car

Discuss the possibility of a trade-in only after you've negotiated the best possible price for your new car and after you've researched the value of your old car. Find out what your current vehicle is worth before you negotiate the purchase of a new car. Check the National Automobile Dealers Association's (NADA) Guides, Edmunds, and Kelley Blue Book. This information may help you get a better price from the dealer. Though it may take longer to sell your car yourself, you generally will get more money than if you trade it in.

Considering a Service Contract

Service contracts that you may buy with a new car provide for the repair of certain parts or problems. These contracts are offered by manufacturers, dealers, or independent companies and may or may not provide coverage beyond the manufacturer's warranty. Remember that a warranty is included in the price of the car while a service contract costs extra.

Before deciding to purchase a service contract, read it carefully and consider these questions:

- What's the difference between the coverage under the warranty and the coverage under the service contract?
- What repairs are covered?
- Is routine maintenance covered?
- Who pays for the labor? The parts?
- Who performs the repairs? Can repairs be made elsewhere?
- How long does the service contract last?
- What are the cancellation and refund policies?

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CHAPTER OVERVIEW

10: Personal Risk Management- Insurance

This chapter incorporates risk management into financial planning. An awareness of the need for risk management often comes with age and experience. This chapter focuses on planning for the unexpected. It progresses from the more obvious risks to property to the less obvious risks, such as the possible inability to earn due to temporary ill health, permanent disability, or death.

10.1: Introduction

10.2: Insuring Your Property

10.3: Insuring Your Health

10.4: Insuring Your Income

10.5: Alternate Perspectives

10.5.1: Insurance- What do you need?

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10.1: Introduction

What if the biggest risk is thinking you will not face one?

> *"That sounded expensive," Jordan said, wincing at the crunch.*
>
> *"Parking poles shouldn't hide behind shrubs," Alex muttered, inspecting the back bumper.*

The parking pole was fine, but the bumper needed repair. The driver was not speeding or engaging in risky or reckless behavior. They were just parking. However, the world still has ways of reminding you that not everything goes according to plan.

Some risks you take on purpose because you're chasing something - a return, a thrill, or another possibility. You start a business or buy into a trend. Maybe you take a chance and bet on yourself. These are **speculative risks**, and there's always a chance that they will pay off; however, there's a significant possibility that they may not. The only reliable way to protect yourself from these risks is to avoid engaging in them.

However, other risks emerge without invitation. They don't offer a prize; they exact a price. A lightning strike, a burst pipe, or a cracked sidewalk that leads to a lawsuit are all **pure risks**. They are unwanted, unavoidable, and (here's the good part) often **manageable**.

This chapter is about those.

You can't eliminate risk, but you can **handle it**. Sometimes that means dodging it. Sometimes it means preparing for it. Sometimes it means shifting the cost to someone else, someone whose whole job is being ready.

But first, we need to zoom in. What actually causes a loss?

Peril

A peril is the event itself. The thing that brings the damage. Fire. Flood. Illness.

Hazard

A hazard is what makes that peril more likely to happen. Frayed wires. Slippery steps. A forgotten password.

One is the strike, and the other is the spark. Knowing the difference helps you decide what to protect and how.

So, where do we start?

We begin with tangible items (physical items), such as your home, your car, and other objects that let you live your life.

Then we move closer: to your body, your health, your care.

And finally, to the most fragile asset of all - your ability to earn, to plan, and to build what comes next.

Let's begin with what you own and why it might need a little backup.

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10.2: Insuring Your Property

Learning Objectives

1. Explain how home and auto insurance protect against property loss and liability.
2. Interpret common policy structures, including deductibles, limits, and types of coverage.
3. Identify the factors that influence insurance premiums for homes and vehicles.
4. Understand the function of liability insurance, including the 100/300/50 model.
5. Evaluate how insurance supports financial stability after a property-related loss.

The Things You Own and The Risks You Didn't Expect.

> *"I told you that tree was leaning," Jordan said, staring at the splintered fence.*
>
> *Alex didn't look up from his phone. "So… am I responsible? Or is it just… nature?"*

Turns out, "nature" isn't a great legal defense.

When a tree on your property falls onto a neighbor's fence, car, or roof, it brings more than branches. It brings bills. And the answer to *who pays* depends on more than just bad luck. It depends on whether you're considered **legally responsible**.

That responsibility can take different forms:

Negligence

You didn't remove the obvious hazard, and now someone's paying for it.

Strict liability

You followed all the rules, but the law still says the cost is yours.

Vicarious liability

It wasn't your action, but it was your tree, your property, your problem.

That's where **insurance** steps in, not as a shield against blame, but as a system for **shifting financial risk**.

Here's how it works:

You pay a known amount (your **premium**) to a company (the **insurer**) in exchange for protection against significant, unpredictable losses. That promise is written out in a legal contract called a **policy**. The idea is simple: when something serious happens, you're not facing it alone.

But insurance isn't magic. It won't cover every scenario. And it won't allow you to be careless without consequences. Owning property means managing risk, both your own and that of others. It means preparing for fire, theft, weather, and yes, even falling trees.

Let's begin with one of the most significant financial assets most people ever own: **their home.**

Home Insurance Coverage

Because drywall doesn't heal itself.

> *"It came through the roof?" Jordan asked, blinking.*
>
> *"Not all the way," Alex said. "Just the attic, the ceiling, and then the couch."*
>
> *The tree had been leaning for years half-forgotten, a little too close to the property line, and it only took one windstorm to bring it down. By morning, a jagged trunk was wedged*

> *across the roof, insulation was spilling into the living room, and rainwater was soaking everything from the ceiling fan to the throw pillows.*

That's when the question hit: who pays?

The Benefit

Homeowner's insurance exists to answer exactly that question. It doesn't prevent disaster, but it steps in when disaster strikes. And while most people think of it as protection for the structure (the house, the garage, the shed), it actually does much more.

A typical homeowner's policy provides coverage not only for the building but also for its contents and belongings. That includes furniture, clothing, appliances, electronics - basically, the things you'd take with you if you had to start over. There are limits, of course, and special rules for high-value items, but in many cases, the cost of replacing what's lost would be devastating without insurance.

Beyond your own stuff, a good policy also protects you from the financial consequences of what happens to *other* people because of your home. If someone slips on your icy sidewalk or trips on your broken step and ends up with a medical bill—or even worse, a lawsuit—your policy can provide coverage for legal and medical costs. That kind of personal liability protection is often overlooked until it's needed.

Some events make your home unlivable altogether. If that happens during repairs after a major fire or storm, insurance may also cover the cost of temporary housing and basic living expenses. This part of the policy, often referred to as Additional Living Expenses (ALE), is what makes a total disruption more manageable.

The Cost

How all this plays out depends on the details: the specific language of your policy, your deductible, and whether you're covered for the *actual cash value* of an item or its *replacement cost*. The difference matters. Actual cash value takes depreciation into account. You will not be reimbursed for a new couch, but you will be compensated for the couch you had the day before the tree landed on it. However, replacement cost pays what it would take to buy a new one today. As you might guess, the second option offers better protection, but usually comes with higher premiums.

Premiums that you pay will vary widely. Home insurance cost depends on where you live, how old your home is, what materials it's made of, how far it is from a fire station, and how much coverage you choose. Insurers also consider your claims history and credit score, and many offer discounts if you bundle policies, install security systems, or upgrade your roof or wiring.

To assess the risk to the insured, the insurer requires information about the insured's circumstances and history, the nature of the property, and the desired amount of coverage for protection. This information is summarized in Table 10.2.1 .

Table 10.2.1 : Factors that Determine Insurance Premiums

Insured	Property	Coverage
Employment	Age	Actual cash value
Marital status	Size	Replacement cost
Criminal record	Location	Endorsements for listed property
Credit history	Proximity to fire/police services	Umbrella for personal liability
Insurance claim history	Building materials	
	Number of occupants	
	Heating system	

Home insurance doesn't cover everything. Most policies exclude damage from floods, earthquakes, and certain types of neglect. Coverage for those situations usually requires separate policies or endorsements. But for most homeowners, a well-structured

policy offers essential protection, not just for the bricks and beams, but for the financial stability that comes with knowing you won't have to face a crisis alone.

> *By the time the adjuster left and the cleanup crew arrived, Alex and Jordan had already seen the value. A bad night had turned into a manageable problem. Not cheap, not pleasant—but not ruinous either.*

That's the quiet power of insurance. It doesn't erase risk. It just makes it survivable.

Insuring Your Car

Because metal bends, and people break.

> *"Everyone okay?" the officer asked, jotting notes.*
>
> *Alex nodded. "Yeah. Just shaken. And… the bumper."*
>
> *The light had changed. The cyclist hadn't noticed. The driver braked, but not soon enough. A minor collision, no serious injuries—but a lingering sense of panic.*

This is the kind of moment that makes you grateful you're insured.

The Benefit

Auto insurance, like home insurance, is about risk. But the risks are faster, messier, and often more public. Every time you drive, you're participating in a shared system where one mistake (yours or someone else's) can lead to thousands of dollars in damage, or worse.

A typical auto policy includes **liability coverage**, which pays when *you're* at fault. It's legally required in most states, and it comes in three numbers, such as **100/300/50**.

Those numbers aren't just random—they set the maximum your insurer will pay:

$100,000	$300,000	$50,000
For injuries to **one** person	Total for all injuries in a **single accident**	For damage to **someone else's property**

What trips people up is that *first* number. It's not $300,000 to divide however needed; it's $100,000 **per person**, with a **total cap of $300,000**.

So if one person's medical bills are $175,000 and a passenger's are $5,000, the policy still only pays **$100,000** for the first and **$5,000** for the second. You're responsible for the remaining **$75,000**.

That's when people realize that liability coverage protects *others*, but it's also your **line of defense**. You carry it not just because the law says so, but because lawsuits are expensive and medical bills are worse.

Most drivers also carry **collision** and **comprehensive** coverage. Collision coverage pays if you hit something (even a tree or a light post), and comprehensive coverage covers non-collision risks, such as theft, vandalism, or storm damage.

You can also add **uninsured/underinsured motorist coverage**, in case the person who hits you doesn't have enough insurance, or any at all.

Policies may include **medical payments** to cover injuries to you or your passengers, as well as additional benefits such as **rental car reimbursement** if your car ends up in the shop after a covered event.

The Cost

Auto insurance isn't one-size-fits-all. Your premium is based not just on what you drive or how well, but on **who you are**—or more precisely, what insurers can predict about people *like* you.

Insurance companies look at

- Your **age** and **driving history**
- The **car you drive**
- Your **ZIP code**
- Your **marital status**, **credit score**, and even **commute distance**

Not because they're judging you, but because these factors **correlate** with real-world outcomes. People in certain age groups, neighborhoods, or vehicle types file more claims, or more expensive ones. Insurers use that data to estimate how likely they are to pay out on your behalf.

That's why two drivers with identical cars and clean records might still pay different rates if one lives in a low-traffic suburb and the other parks on a busy street downtown. The risk profile changes.

Higher coverage limits cost more. So do lower deductibles. However, discounts are available. Bundling home insurance with other policies, maintaining good grades (for students), installing safety features, or simply being accident-free for a specified period can help lower premiums.

Driving is freedom, but it comes with high stakes.

Auto insurance doesn't make you invincible, but it can make you whole again when something breaks.

Summary

- Homeowners insurance covers dwellings, possessions, personal liability, and temporary living expenses.
- Auto insurance typically includes liability, collision, comprehensive, and optional add-on coverage.
- Liability insurance protects against legal and financial consequences of causing harm.
- Premiums are based on risk factors like location, structure, driving history, and vehicle type.
- Coverage choices affect both protection and cost.

Exercises

1. Why might someone choose replacement cost over actual cash value in a home insurance policy?
2. What does each number in a 100/300/50 auto policy represent?
3. How does liability coverage protect a policyholder beyond their own property?
4. What role do deductibles play in shaping an insurance policy's cost and coverage?
5. What factors might cause two drivers with the same vehicle to pay very different auto insurance premiums?

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10.3: Insuring Your Health

Learning Objectives

1. Understand how health insurance structures access and affordability.
2. Differentiate between plan types: HMO, PPO, EPO, and POS.
3. Identify the key components of cost, including premiums, deductibles, copays, coinsurance, and out-of-pocket maximum.
4. Recognize the role of government and employer-sponsored accounts (FSA, HSA, HRA).
5. Explore how Medicare, Medicaid, and private options fit into the health insurance landscape.

Because access is not automatic.

> *"Wait, so the doctor's in-network, but the lab isn't?" Jordan asked, holding the envelope like it might bite her.*
>
> *Alex shrugged. "That's what the nice person on the helpline said. On the fourth call."*

The appointment had felt routine; it was an annual physical, covered under the plan. Unfortunately, when the bill arrived, they realized that although the doctor's office was in-network, the lab that processed the blood work was not. The doctor and the lab were located in the same building, but they were not connected to the same insurance network. They now had a lab fee that they didn't expect from an out-of-network lab.

That's when they realized that health insurance doesn't just help pay for care. Health insurance determines the type **of care you can receive**, **where you can access it**, and **what happens afterward.**

Health Insurance Coverage

Health insurance exists to reduce the financial burden of medical care, but it doesn't eliminate confusion or cost. It works more like a complex cost-sharing agreement than a simple payment plan.

At its core, a health insurance policy outlines:

- **What services are covered**
- **How much the insurer will pay**
- **What you're expected to pay**

Most plans include a combination of **premiums**, **deductibles**, **copayments**, and **coinsurance**. Here's how they typically work, though each plan writes its own rules.

You pay a **premium**, usually on a monthly basis, just to keep the coverage active, regardless of whether you actually use it. When you do use it, you often face a **deductible,** an amount you must pay out of pocket before the insurance company begins to contribute. Some services may be covered before you meet that deductible; others aren't.

After the deductible, you may be required to pay a **copay** (a fixed fee for certain visits or prescriptions) or **coinsurance** (a percentage of the total cost). These add up toward your **out-of-pocket maximum**, a cap on how much you'll have to spend in a year before the insurance covers 100%.

Coverage isn't just about numbers. It's also about **networks**. Most plans partner with a defined group of doctors, hospitals, and specialists. Staying in-network usually means lower costs; going out-of-network may result in higher costs or no coverage at all. And that's how two different providers in the same building can fall on opposite sides of your policy.

It's easy to feel like the system was designed for confusion. But at its best, health insurance **protects your access to care,** making it possible to seek treatment when you need it, without fearing financial collapse. You need to conquer that confusion because in health insurance, what you don't know can cost you.

Health Insurance Costs

What you pay. And what you don't see.

For most people, health insurance costs feel like a moving target. You pay a **premium** just to have a plan. Then you pay more when you actually use it. The numbers are scattered across statements, billing portals, and "explanation of benefits" forms that often provide very little explanation. But the core components are consistent, even if they don't always behave in predictable ways.

Premiums are the price of admission. Whether your employer pays part of it or you buy coverage on your own, this is the amount charged just to keep the policy active. It's due whether you visit the doctor or not.

If and when you do need care, **deductibles** come into play. This is the amount you must pay out of pocket before the insurance company begins sharing the cost. A plan with a low premium often comes with a high deductible. It's a trade-off: pay less every month, but more when something happens.

Copays are fixed amounts for specific services, maybe $30 for a primary care visit or $10 for a generic prescription. They don't always count toward your deductible, but they usually count toward your **out-of-pocket maximum,** which is the most you'll ever be required to pay in a given year.

Coinsurance is the percentage you are responsible for after the deductible has been met. For example, your plan might pay 80 percent of a surgery, leaving you responsible for the remaining 20 percent.

All of this culminates in the **out-of-pocket maximum**, your personal financial ceiling for the year. Once you hit it, the insurer pays 100 percent of covered services. But depending on the plan, that ceiling can be thousands or even tens of thousands of dollars high.

Then there's the bigger question: why does it all cost so much?

The answer isn't simple. A unique mix of market pricing, regulation, risk pooling, and provider contracts influences U.S. healthcare costs. But from the insurer's perspective, the math starts with **risk**: the probability and potential cost of claims. That's why some people pay more. Age, health status, location, and tobacco use can all play a role. Insurers don't know exactly what will happen to you, but they've seen the patterns. They price coverage based on the risks you represent, not just the benefits you receive.

It doesn't always feel fair. And sometimes, it isn't. But understanding the structure gives you power: to compare plans, ask better questions, and avoid surprises. Because while you can't control your appendix or your ankle, you can get better at controlling the financial aftermath.

Health Insurance and Health Care

Coverage opens the door. Access walks through it.

Health insurance is intended to make healthcare more affordable, and often it does. However, having insurance doesn't guarantee that you'll receive the care you need, when you need it, or from the provider you prefer.

Sometimes the problem is **network limitations**. Your doctor might not accept your insurance. Or the only approved specialist is hours away. In other cases, the issue is **timing**: long waitlists for appointments, delays in getting referrals, or prior authorizations required before a procedure can be approved.

And then there's the paperwork—forms to complete, claims to submit, appeals to file. For patients undergoing treatment, the administrative layer can feel like a second diagnosis.

Even within the system, there's a wide variation in what is considered *necessary*, *elective*, or *experimental*. A procedure that is approved by one insurer might be denied by another. A brand-name medication may be fully covered under one plan and completely out-of-pocket under another.

The result is that **health insurance doesn't equal health care**. It's a gateway, not a guarantee.

Plan Type Matters

One of the most significant determinants of access is the *type* of insurance plan you have. Most employer and marketplace plans fall into one of four basic models, each with its own rules for how care is delivered, paid for, and approved.

HMO (Health Maintenance Organization)

Usually, the most affordable in terms of premiums and out-of-pocket costs, but also the most restrictive. Care must go through a *primary care physician (PCP)*, who acts as a gatekeeper. Out-of-network care is generally not covered, except in emergency situations.

PPO (Preferred Provider Organization)

Offers greater flexibility—you can usually see specialists without referrals, and you're allowed to go out-of-network (though you'll pay more if you do). You'll pay higher premiums for that freedom.

POS (Point of Service)

A hybrid between HMO and PPO. Like an HMO, you'll need referrals and a PCP—but like a PPO, you may go out-of-network if you're willing to pay extra. Think of it as "structured flexibility."

EPO (Exclusive Provider Organization)

Similar to a PPO, but without out-of-network benefits. You don't need referrals, but you *must* use in-network providers. It's a lower-cost option for people willing to stay within a defined care system.

If this all feels like alphabet soup to you, you're not alone. However, these plan types shape *how care is delivered*. They determine whether you need a referral, whether you can keep your current doctor, and whether you'll be surprised by a bill.

Choosing the right plan isn't just about price; it's about how you like to navigate care. Do you want full control? Low cost? Fewer decisions? More options? The "best" plan is the one that fits your life and your needs.

Health insurance still matters. It significantly reduces the cost of major treatments, emergency care, and the management of chronic conditions. It makes preventive care, like screenings and vaccinations, more accessible. And it's often the only thing standing between a bad diagnosis and financial disaster.

Understanding your plan helps. Knowing what's covered, what's not, and what steps you must take to access services can make the difference between a smooth recovery and a bureaucratic nightmare.

The system isn't always logical. It's not always fair. But it's navigable, especially if you start paying attention before something goes wrong.

Private Health Care Financing

One system, many wallets.

For all its complexity, health insurance typically doesn't cover everything. Most plans come with out-of-pocket costs—such as premiums, deductibles, and copays—and those costs have been rising steadily for years. As a result, people often turn to *additional resources* to help cover expenses and close gaps in their protection.

Employers provide some of those tools. Others come from the government. And nearly all of them are named in three-letter acronyms.

Work-Based Accounts: FSA, HRA, HSA

If you've ever seen a paycheck, you've probably heard of one of these:

FSA (Flexible Spending Account)

Lets you set aside pre-tax dollars for out-of-pocket medical expenses—like copays, prescriptions, or even over-the-counter supplies. But there's a catch: it's "use it or lose it." Funds don't roll over at the end of the year unless your employer allows a small grace period or carryover.

HRA (Health Reimbursement Arrangement)

Employer-funded—only the company contributes. You don't own the account, but you can use the funds for qualified medical expenses. It's like a gift card with rules.

HSA (Health Savings Account)

Available only with high-deductible health plans (HDHPs). Unlike FSAs, HSA funds roll over from year to year and are portable. You can invest them, let them grow, and even use them tax-free in retirement for medical costs. The HSA is often considered the most flexible and long-term friendly of the three.

These accounts help people bridge the growing gap between what insurance covers and the actual costs of healthcare. They don't solve the affordability issue, but they soften it; that is, if you can afford to fund them in the first place.

Public Programs: Medicare and Medicaid

Not everyone gets insurance through work. For millions of Americans, **public insurance** plays a critical role, especially as people age, lose income, or develop serious medical needs.

Medicare is a federal program primarily for people aged **65 and older**, as well as younger individuals with certain disabilities. It's divided into parts:

Part A

Covers hospital stays and inpatient care.

Part B

Covers doctor visits, outpatient services, and some preventive care.

Part C

Also known as **Medicare Advantage**, it is a private plan alternative that combines Parts A and B (and often Part D) into a

Part D

Prescription drug coverage.

single policy with additional benefits.

But Medicare doesn't cover everything. That's where **Medigap** comes in. It is a private insurance policy that fills in the gaps (like coinsurance and deductibles) that Medicare leaves behind. It's optional, but often critical for those on a fixed income.

Medicaid, by contrast, is a **state-managed** program for people with low income. Unlike Medicare, it's needs-based, not age-based. Coverage varies by state, but it often includes hospital services, doctor visits, and long-term care.

Where Medicare is **earned** through work history, Medicaid is **granted** based on need. Together, these programs form a patchwork, not a safety net. Eligibility, cost-sharing, and coverage vary widely, and navigating them requires not just awareness but persistence.

The deeper problem? Many of these systems weren't designed to cover **long-term care**—the kind of care people need when they can no longer live independently but don't require hospital-level care. That's where we turn next.

Long-Term Care Insurance

When care becomes your full-time job.

At some point, roughly half of all Americans will require assistance with basic daily tasks, such as bathing, dressing, eating, and remembering one's daily activities. This isn't traditional medical care. It provides long-term support, often lasting for years. That kind of care doesn't come cheap. And it's not typically covered by health insurance.

Most standard health plans, including Medicare, focus on **acute care, which involves** hospitals, doctors, and treatments aimed at curing or stabilizing a condition. But **long-term care** is about sustained assistance with daily living. And that's where the coverage gap opens wide.

Some people qualify for **Medicaid**, which does cover long-term care, but only after they've spent down most of their assets. Others pay out of pocket until the bills start to eat into retirement savings, home equity, or inheritances.

That's why **long-term care insurance** exists.

These policies help pay for:

- In-home care
- Assisted living
- Nursing homes
- Adult day care
- Specialized dementia care

They don't remove the challenge, but they *do* offer options, such as staying at home longer, choosing the right facility, and avoiding total financial erosion.

Long-term care insurance comes with caveats. It's often best to purchase it **before you need it**, while you're still healthy enough to qualify for it. Premiums can be high, and policies vary in what they cover, the amount they pay, and their duration. Some people hedge with **hybrid policies** that combine life insurance with long-term care benefits, providing flexibility if care isn't needed.

So, who should consider it?

Anyone planning for retirement who:

- Wants to protect their savings
- Has seen a parent or loved one struggle
- Prefers choices over crisis management

Long-term care isn't just a medical issue.

It's a financial decision and a deeply personal one. It's not about how long you live. It's about how much help you need *while* you're living. That's the essence of long-term care planning. And it's where health protection hands off to something even more fundamental: **protecting your income, your independence, and the people who count on you**.

Summary

- Health insurance determines how, when, and where care is accessed.
- Plan types vary in network access, referral requirements, and flexibility.
- Costs are distributed across premiums, deductibles, copays, and coinsurance.
- FSAs, HSAs, and HRAs help manage out-of-pocket expenses using tax-advantaged accounts.
- Medicare and Medicaid provide essential coverage for aging adults and low-income populations.
- Long-term care often requires separate planning and is not covered by standard health insurance.

Exercises

1. What are the key differences between HMO and PPO plans?
2. How does an out-of-pocket maximum provide financial protection to patients?
3. Why might someone choose an HSA-eligible plan, and how does an HSA benefit them long-term?
4. What gaps exist in traditional Medicare coverage, and how can Medigap help address them?
5. In what ways is having health insurance not the same as receiving health care?

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10.4: Insuring Your Income

Learning Objectives

1. Explain the purpose of disability insurance and identify its main types.
2. Understand how life insurance protects dependents from income loss.
3. Compare term and whole life policies in terms of duration, cost, and purpose.
4. Recognize how life insurance can be integrated into broader financial planning.
5. Make informed decisions about selecting the right coverage based on your life stage and needs.

Because the paycheck is the plan.

> *"I mean, the house is insured," Alex said. "The car, too. But what if I can't work?"*
>
> *Jordan raised an eyebrow. "You're insuring the objects, not the engine."*

Most people insure the things they buy with their income. But far fewer think to insure the income itself. And yet for most households, that income is what makes *everything else* possible: the rent or mortgage, the food, the childcare, the utilities, the future plans. When that income disappears, even temporarily, the effects ripple outward fast.

This section is about protecting what fuels it all: Your **ability to earn**, your **financial promises**, and your **loved ones' stability**, with or without you.

We'll begin with **disability insurance**, which covers income loss that is either temporary or long-term. Then we'll explore **life insurance**, where the loss is permanent, but the need persists. And finally, we'll unpack the various types of policies, their actual effects, and how to select among them.

Let's begin with the most overlooked—and statistically most likely—risk of all: **not dying, but being unable to work.**

Disability Insurance

Because bills don't pause for injuries.

> *"It wasn't even a dramatic injury," Jordan said. "He just tripped and tore a ligament. He couldn't drive,so he couldn't work."*
>
> *Alex shook his head. "And no coverage?"*
>
> *"Not the right kind," Jordan replied.*

People imagine disability as something catastrophic, such as a terrible accident or a life-changing illness. And while those things do happen, the truth is far more ordinary and far more common. A bad back, a cancer diagnosis, a lengthy post-injury recovery, or the need for mental health treatment are the kinds of things that don't kill you, but do keep you from working.

According to the Social Security Administration[1], more than one in four current 20-year-olds will experience a disability that keeps them out of work for **at least a year** before they retire. Yet most working adults don't carry any form of **disability insurance**.

So what is it? **Disability insurance replaces part of your income** when a medical condition prevents you from working. It doesn't cover medical bills. That's what health insurance is for. It covers **lost earnings**, helping you pay the rent, the groceries, and other day-to-day expenses. There are two main forms:





Short-term disability

Usually replaces income for **a few weeks to six months**. Often offered through employers. Covers things like childbirth recovery, injuries, or temporary illnesses.

Long-term disability

Covers more extended periods, **years, or even until retirement age**, depending on the policy. It typically kicks in after short-term coverage runs out or after a waiting period.

Policies vary in how they define "disability." Some will pay if you can't perform **your current job**; others only pay if you can't perform **any job** for which you're qualified. That difference matters, and so does the payout structure. Most plans replace **50 to 70 percent** of your income, and benefits may be **taxable or tax-free** depending on how the premiums were paid. Some policies come with cost-of-living adjustments or residual coverage if you return to work part-time.

Many employers offer group disability plans, but not all do. And even if one is available, it may not cover enough. Individual policies exist, especially for self-employed workers or high earners whose lifestyle depends on income continuity. Disability insurance isn't flashy. It doesn't build wealth or leave a legacy. But it keeps your financial life alive when your physical life takes a pause.

Life Insurance

Because some promises shouldn't die with you.

> *"It's not for me," Alex said. "It's for who I'd leave behind."*
>
> *Jordan nodded. "That's the whole point."*

Life insurance is easy to misunderstand. It becomes wrapped in emotions, such as grief, fear, and a sense of legacy. But at its core, it's not about dying. It's about **ensuring that the people who rely on you aren't left vulnerable** if you're no longer there to provide for them. It's income protection in its final form. If you die unexpectedly, your paycheck stops, but the bills don't. Mortgages still come due. Tuition still needs funding. Grocery lists don't shrink. Life insurance helps the people you love **stay afloat**, **stay housed**, and **stay on track** during a time of loss.

Here's how it works:

When you buy a life insurance policy, you agree to pay a **premium**—monthly, quarterly, or annually. In exchange, the insurance company agrees to pay a **death benefit** to your chosen **beneficiary** if you die while the policy is active. That benefit is typically paid as a **tax-free lump sum**, and your beneficiary can use it as they see fit. There are no restrictions. Life insurance doesn't require guessing the future. It requires imagining one without you in it, and then protecting the people who would feel the absence most.

It's not for everyone at every stage of life. But it's essential if

- You have **children**, a **spouse**, or **other dependents** who rely on your income
- You share **financial obligations** (like a mortgage or co-signed loan)
- You want to leave behind a **financial cushion** or **legacy**

Next, we'll walk through the two major categories of life insurance and explore why the choice between them often causes confusion.

Term Insurance

Temporary protection. Lasting purpose.

Term life insurance is exactly what it sounds like: coverage that lasts for a **specific term,** often ten, twenty, or thirty years. If you die during that period, the policy pays your beneficiaries the agreed-upon amount. If you outlive the term, the coverage ends, and no benefit is paid.

That sounds simple, and it is. Term insurance is designed to cover **temporary financial risks**: the years when your family is most vulnerable.

- While your kids are young
- While you're paying down a mortgage
- While your spouse relies on your income

It's **affordable**, especially when you're young and in good health. You can often buy substantial coverage for a relatively low monthly premium. But that affordability comes with tradeoffs: when the term ends, the policy expires. If you still want coverage, you'll need to reapply at an older age, possibly with higher premiums or new health considerations.

Term life is **not an investment**. It's a pure risk management tool. You pay for the protection, and if you don't need it, good. That means you're alive. No payout doesn't mean it was a bad deal. It means life went on as planned. For most people, especially younger families and those on a budget, term life insurance is a clear and practical choice.

But what if you want coverage that doesn't expire?

Whole Life Insurance

Permanent protection. With a price.

Whole life insurance is built to last a lifetime, as long as you keep paying the premiums. It offers the same fundamental promise as term insurance: a payout to your beneficiaries upon your death. But it adds two more features:

1. **It never expires**, no matter how long you live.
2. **It builds cash value** over time—a kind of internal savings account that grows (slowly) on a tax-advantaged basis.

That cash value can be borrowed against, used to pay premiums, or left alone to grow. It's a feature that appeals to individuals who seek **long-term financial solutions** or those with **estate planning needs** later in life. However, a whole life policy comes at a cost, often **10 to 15 times higher** than a term life policy for the same death benefit. And because it mixes insurance with savings, it's more complex to understand and harder to exit. Cancelling a whole life policy too early can trigger fees and tax consequences.

Some people use whole life as a form of **forced savings**, or as a **guaranteed legacy tool** that supports heirs, funds donations, or pays final expenses. Others view it as **overpriced insurance with underwhelming returns**. Which is right? It depends on what you want the policy to do and for how long it will be in effect. Figure 10.4.1 shows the life insurance options.

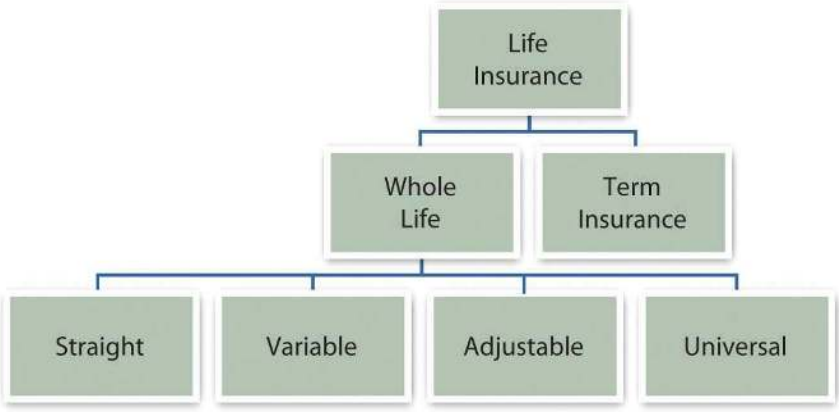


Figure 10.4.1 : Life Insurance Options

Term life answers the question:

"What if I die while people still depend on me?"

Whole life answers a different one:

"What if I want this safety net in place *no matter when I die*?"

There's no single best option. Only the one that fits your goals, your timeline, and your budget.

Choosing a Policy

The best policy is the one that does what you need, when you need it.

Insurance is one of the few financial products you buy, **hoping you will never need to use it**. That's what makes choosing a policy different from choosing a phone plan or a streaming service. There's no daily feedback loop; there is just the quiet knowledge that, if something bad happens, you're not facing it alone.

That's why your first question shouldn't be, *"What's the cheapest policy?"* It should be: **"What risk am I trying to cover?"**

If the answer is: *"If I died tomorrow, my kids couldn't stay in this house,"* you probably need **term insurance** with enough coverage to pay the mortgage. If the answer is, *"My spouse relies on my income, and that won't change,"* you might need a **longer-term** or even a **whole-life** policy. If the answer is: *"I want to leave a guaranteed inheritance,"* a **permanent policy** with cash value could serve that goal. And if the answer is, *"I'm not sure,"* that's okay too. It means you're thinking.

Start by clarifying:

- **Who depends on you** financially
- **What expenses or debts** would remain if you were gone
- **How long would those needs last**
- **What you can realistically afford**

Compare term, whole, and hybrid policies. Look beyond the premium. Be sure to ask these questions:

- How long does the coverage last?
- What happens if you miss a payment?
- Can you convert or cancel the policy?
- What happens to the cash value (if there is one)?

Avoid policies you don't understand. And avoid pressure if the person selling it benefits more than the person living with it; that's a red flag. The good news? Once you choose well, you often don't have to think about it again for years. Life changes, and so can policies. What matters is that you make the choice now, before you find yourself wishing you had chosen a policy sooner.

You can't avoid every risk. But you can choose not to face it alone.

Life Insurance as a Financial Planning Decision

Not just coverage. Coordination.

By now, life insurance may feel more practical, less mysterious, more navigable. But it's more than a product. It's a **planning tool**—one that, when used wisely, becomes part of a bigger picture. Life insurance offers more than just protection; it offers **options**. When integrated with financial planning, a well-chosen policy can

- **Protect dependents** from income loss
- **Create liquidity** to pay estate taxes, settle debts, or buy out a business partner
- **Leave a legacy** for heirs or charitable causes
- **Fund education** or supplement retirement in special policy structures
- **Equalize inheritances** among children when assets aren't easily divisible

Some people use permanent policies (like whole or universal life) as a **stable, tax-advantaged asset**—one that grows predictably and transfers wealth efficiently. Others use the term life as a **temporary shield**, buying time to build assets that make the coverage unnecessary in later years. There is no universal answer, but there is **alignment** between what you value, what you're building, and who you're building it for.

If your financial plan includes people who rely on you, life insurance belongs in the conversation. Life insurance should not be a panic purchase, and it is not a magic solution. However, including life insurance in your financial plan is a strategic act of care, both in theory and in practice.

Summary

- Disability insurance replaces income during periods when an individual is unable to work due to illness or injury.
- Life insurance provides financial support to beneficiaries after a policyholder’s death.
- Term insurance offers temporary, affordable coverage during years of greatest need.

- Whole life insurance offers permanent coverage with a cash value, albeit at a higher cost.
- Choosing a policy involves aligning coverage with financial responsibilities and future goals.

Exercises

1. Why is disability insurance often overlooked, despite its high likelihood of being used?
2. How does term life insurance differ in structure and purpose from whole life insurance?
3. What are some valid financial reasons someone might choose whole life insurance?
4. How can life insurance support broader financial planning goals beyond basic income replacement?
5. What key questions should you ask yourself before selecting a life insurance policy?

[1] Social Security Administration, Disability Planner: The Facts (www.ssa.gov/disabilityfacts/facts.html)

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SECTION OVERVIEW

10.5: Alternate Perspectives

10.5.1: Insurance- What do you need?

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10.5.1: Insurance- What do you need?

Life's Problems Will Happen to You

Sorry to tell you, but life is hard. You will have difficulties, and there will be accidents and events that affect your property or your health. To put it another way, life inherently contains risk. You and your family are at risk that you may be in an automobile accident. You and your family are at risk that one or several of you may become ill and require a hospital stay. You and your family are at risk that a tree may fall on your house. Of course, not all these risks have the same probability of occurring, and not all of these risks will incur the same amount of financial loss.

The Concept of Insuring Against Risk

Insurance companies take on your risk for a fee, known as a premium. By buying insurance, you are protecting your wealth and income against unexpected events that can take away your wealth or income. There are many types of insurance you can buy to protect yourself, your family, and your property:

- Automobile insurance
- Homeowner's insurance
- Health insurance
- Disability insurance
- Life insurance

There are also specialty insurance companies for special risks, such as insuring professional football or basketball players against a career-ending injury. Then there are also a few insurance programs administered by federal and state governments that people often forget:

- Social Security insurance
- Medicare insurance
- Unemployment insurance (federal and state)

Insurance companies have experience with the costs of fire, accidents, and casualties, so they price their premiums on anticipated claims against the insurance policies they sell. As a consumer, you should do a cost/benefit analysis. Always get at least three quotes for your insurance, and if you have been with a company for a few years, you should get quotes to make sure you are being charged a competitive premium.

However, there is one rule that you should always follow. If a potential casualty loss is so large that it will really hurt you financially, you must insure against it. For example, if your house burns down, even though this is an unlikely event, you should insure against the loss because of its financial consequences.

The Business Model of Insurance Companies

Commercial insurance companies are in the business of making a profit. They sell policies to customers and charge an annual premium for the protection. An insurance policy is a legally binding contract, and it obligates the company to pay for any of the claims that are covered in the policy. For example, when you buy automobile insurance, you agree to pay the annual premium, and the insurance company agrees to pay for damages from an accident.

Insurance companies have teams of actuaries who estimate the probable amount of claims in each category of things they insure, based on historical averages. The insurance company charges enough premiums to pay for the claims, while still having a profit left over to pay dividends to their shareholders. In most years, if fate behaves, claims replicate their historical averages. However, when unexpected events happen, such as Hurricane Katrina or the West Coast Wildfires, insurance companies lose money.

Since claims occur over the course of a year, insurance companies invest the premiums they collect in short term investments (e.g., in the case of auto or homeowners' policies) or in long term investments (e.g., in the case of whole life insurance). This gives them another source of profit for their shareholders.

There are insurance companies that are mutual insurance companies. These are analogous to credit unions in the banking sector. In mutual companies, the policyholders are the owners of the company. That means that while a mutual company must cover all their

claims, they do not have to generate a profit for their shareholders. If they have extra cash left over at the end of the year, they can send refund checks to their policyholders or reduce premiums the next year. Mutual insurance companies are very competitive in their rates.

When you are new to the insurance market, it is a good idea to use an insurance broker who can advise you on the ins and outs of the market. The broker is paid a commission by the insurance company (normally in the range of 8% of the premium) to place your insurance with them. Once you become confident, try companies that sell by phone or over the internet. This usually saves money because they do not pay commissions to brokers. Make sure you get at least three quotes. Here are some legitimate companies that sell by phone or internet:

- GEICO
- Liberty Mutual
- Progressive
- USAA (for veterans of families of veterans)

I personally switched a number of years ago from a commercial insurance company to Liberty Mutual for both auto and homeowners' insurance and my premium went down by about 25%.

Health Insurance

Health insurance can be expensive compared to auto or homeowners' insurance. In 2020, the average national cost for health insurance was $5,500 annually for an individual and $13,800 for a family per year. However, costs vary among plans. There is a wide selection of plans and programs for health insurance, such as opting for a Health Maintenance Organization or agreeing to only use the doctors approved by the insurance company. In addition, most companies offer health insurance to their employees, and by joining a group insurance plan of mostly healthy people, premiums are reduced. Further, companies that provide health insurance for their employees usually pay for a good portion of the premium.

As an historical note, the United States is the only developed country (other than China) that does not have a national insurance program. The expansion of private health insurance in the U.S. goes back to World War II. Six million men and women were sent to fight in Europe and the Pacific. Thus, the military-industrial complex on the home front had a shortage of workers just as it was producing war material at full speed. One consequence, of course, was the recruitment of women to staff the manufacturing lines. Another consequence was the competition for employees. Companies were not allowed to give raises during the war in order to avoid inflation; in order to compete for employees, companies started giving benefits, like health insurance. From after the war until today, pharmaceutical companies, hospitals, doctors, and insurance companies have lobbied against the U.S. having a national health insurance plan. They are afraid (and rightly so) that a government insurance program will use its buying power to control their fees.

The most common types of health insurance programs are fee for service and managed care plans. Both cover doctors' visits, hospital outpatient services, medical procedures, and hospitalization. Fee for service (sometimes called Personal Choice) allows you to choose your own doctors and specialists. Your doctor submits a bill to the insurance company and is paid all or part of their fee. If the insurance company thinks the fee from your doctor is higher than the prevailing rate in that area, the insurance company will only pay the prevailing rate, and you must pay the rest, a drawback of the fee for service policy.

Managed care plans require the policyholder to go to a specific group of doctors and hospitals identified by the insurance company. They are called in network doctors and hospitals. The value of this program is that the doctors recommended will not charge you above the fees agreed with your insurer, and you will not be billed for any difference. Health maintenance organizations (HMO) are insurers that usually establish a set annual fee per patient with doctors. You must go first to the primary care doctor, which you choose from their list. Any referral for further treatment by a specialist must first be approved by your primary care physician. The HMO is paying the primary care physician to keep you well and is controlling any unnecessary trips to specialists. The premiums for fee for service are higher than the managed care policies, which are higher than the HMO policies. Your choice of plan affects your premium payment.

Being part of a health insurance group (such as your employer-sponsored health insurance program) significantly reduces the total premiums. Of course, your employer decides how much of the health insurance premiums they are willing to subsidize. If you are

self-employed or between jobs without health insurance, there are often ad hoc groups in your area that sponsor group programs. For example, you can join the local Chamber of Commerce that sponsors a plan that is cheaper than buying as an individual.

Finally, federal law states that an insurance company cannot refuse you coverage due to a pre-existing condition, as part of the Affordable Care Act (ACA) legislation. If you lose your healthcare because you lose your job, you should at least buy a low premium policy in case of an unexpected hospitalization. Hospital stays are expensive, and you should at least protect yourself against those expenses. If you are out of work, you should be able to enroll in a very reasonably priced ACA policy. There are also government subsidies for those with low income. You would likely qualify for this if you are single, and your only source of income is unemployment compensation.

The Main Reason People Go Bankrupt

A 2019 Harvard study found that 66.5% of all bankruptcies were tied to medical issues, due to high costs of care and time out of work. This includes an estimated 530,000 families. This study also shows that 78% of bankruptcy filers had some form of health insurance but not enough to cover their medical costs (CNBC). Even if you are young and healthy, you should at least have health insurance for what are called catastrophic illnesses. This includes things like accidents that put you in the hospital, cancer, and COVID-19. Because you are young and healthy, the probability of these events is low, so the premium is low.

Recent support for Medicare for all stems not just from the plight of uninsured people but also from middle class people who have catastrophic illnesses that are not covered by insurance. With this model, the government can achieve substantial savings by negotiating fees and costs.

Affordable Care Act

The Affordable Care Act (ACA) was passed in 2010, in the second year of President Obama's first term. The Republicans immediately took to calling it Obamacare and have been trying to repeal it as unconstitutional ever since it was passed. A Republican court case even made it to the U.S. Supreme Court, which upheld the constitutionality of the ACA by a five to four vote. Republicans continue to challenge the ACA, so expect it to continue to be in the news. The ACA has three main goals:

1. Reduce the price of health insurance in order to make it available to the millions of people. The government subsidizes the cost of health insurance for households whose incomes are 100% to 400% of the federal poverty level.
2. Expand Medicaid. Medicaid is free health insurance for households whose incomes are substantially below the federal poverty level. States are responsible for administering Medicaid, and many states with Republican governors or legislatures refused to accept this expanded federal aid.
3. Find and support medical care delivery systems that lower the cost of providing healthcare.

The ACA has been successful by any measure. In 2020, 23 million people are covered by the ACA. In addition, 31 states accepted the expanded Medicaid program. In 2020, a total of 73 million people are now insured under Medicaid or under the Children's Health Insurance Program (CHIP). In addition, children are now able to remain on their parents' healthcare policy until they turn 26, and no insurance company can refuse healthcare coverage because of a pre-existing condition.

Another benefit of the ACA is that it modernized the health insurance search, establishing an online marketplace for health insurance. When you access the marketplace, you will be asked some relevant questions and receive an estimate of the subsidy you may qualify for. After this, you will have access to the private insurance companies offered through the marketplace. All participating companies must offer at least these ten essential benefits in their plans:

1. Ambulatory patient services (outpatient care)
2. Emergency services
3. Hospitalization (like surgery and overnight stays)
4. Pregnancy, maternity, and newborn care (both before and after birth)
5. Mental health and substance use disorder services, including behavioral health treatment (this includes counseling and psychotherapy)
6. Prescription drugs
7. Rehabilitative and habilitative services and devices (services and devices to help people with injuries, disabilities, or chronic conditions gain or recover mental and physical skills)

8. Laboratory services
9. Preventive and wellness services and chronic disease management
10. Pediatric services, including oral and vision care (but adult dental and vision coverage are not essential health benefits)

In addition to these, birth control coverage and breastfeeding coverage must also be offered.

Finally, health insurance plans on the marketplace can offer additional coverage for services like dental and vision care, but these plans will cost you more. As I said before, if you lose your healthcare coverage due to any reason, you should at least buy a minimum policy that will cover an unexpected illness. Look at the ACA Marketplace for these options.

Disability Insurance

Disability insurance provides income if you cannot work due to an illness or accident. Short-term disability typically covers you for 13 to 26 weeks and will pay 40% to 70% of your salary during that period. It costs about 1% to 3% of your salary and may be paid for by your employer as a benefit. The premium depends on your age and occupation. Long-term disability insurance also costs about 1% to 3% of your salary, and these policies will begin payment after the period of short-term disability payments. Depending on the policy you select, the long-term disability payments can cover 20 years, 30 years or until retirement.

The Social Security system also pays disability payments under the SSDI program, and, if you qualify, you can collect this in addition to your private insurance. These SSDI payments range from $800 to $1,800 per month, depending on your earnings history, providing only a minimal safety net; it will not replace your income. Buy long-term disability insurance; it is not that expensive if you are part of an employer sponsored plan, and it protects you and your family.

Auto Insurance

All fifty states require auto insurance if you own a car. This is mostly to protect other drivers if you are at fault. However, you should also get a provision against uninsured drivers. This will protect you if someone without insurance hits you, causing damage to your car or injuring you. This is a common provision in auto policies. The national average of car insurance in the U.S. is $1,400. This will vary if you have an expensive car, have just gotten your license, or have a bad driving record. Below are some potential types of coverage you can have.

Coverage A: Liability Coverage

If an accident is your fault, by law you must pay for the damages. This includes both property damage and bodily injury to another. Some states have no-fault property damage laws, eliminating the need for lawyers, thereby reducing costs. In this scenario, your insurance company fixes your car, and my insurance company fixes my car. However, no-fault does not apply to bodily injury.

Coverage B: Medical Payments Coverage

If you are at fault, your insurance company pays any medical bills for the other person. This is the law.

Coverage C: Uninsured or Underinsured Motorist Coverage

If the other driver is at fault and has no insurance, you are covered by your policy. This is a good provision to have.

Coverage D: Collision and Comprehensive Coverage

Collision covers damages to your car if you are at fault in an accident. Comprehensive covers all other damages or loss to your car, such as theft, vandalism, floods, hail damage and other unhappy events.

The deductible is the amount you pay out of the total of each claim. You can choose the deductible, but it normally ranges from $250 to $1,000. The higher the deductible, the lower the premium, because you will not bother your insurance company every time your car gets a dent or scratch. Many insurance companies also offer a discount for safe drivers. Note that each state has a different minimum insurance coverage required.

Renter's Insurance

If you are a renter, almost every lease has a provision that says if an event happens that damages your property, the landlord will not pay for it. If someone breaks into your apartment and steals your laptop, the landlord has nothing to do with that and will not

reimburse you. This is why you should buy renter's insurance. Renter's insurance is inexpensive, with an average price at about $15 per month in 2020. It covers fire, damage and theft.

You should also ask for liability to be included in the policy. This will protect you if a visitor gets injured in your apartment or if your dog bites the neighbor. Also, it is helpful to keep photos of your important property. Take pictures of your new laptop, your television, and expensive jewelry (include receipts if possible). This will help you establish your claim to the insurance company if you have a loss.

Homeowner's Insurance

For many, their most valuable asset is their home, thus it is important to protect it with homeowner's insurance. Homeowner's insurance should protect your home against fire and wind damage, theft, falling trees, and personal liability. Standard forms of homeowners insurance policies are numbered from HO-1 to HO-8. These are structured with different degrees of coverage and the premiums are different for each package.

- HO-1: The most basic and limited type of policy for single-family homes, HO-1s are all but nonexistent nowadays.
- HO-2: A more commonly used policy and a slight upgrade from the HO-1.
- HO-3: The most common type of homeowners insurance policy with broader coverage than the HO-2.
- HO-4: A policy type that is specifically for renters.
- HO-5: The most comprehensive form of homeowners insurance and the second most common policy type for single-family dwellings.
- HO-6: A type of coverage designed for condo owners.
- HO-7: The type of policy you get if you own a mobile or manufactured home.
- HO-8: A special type of homeowners insurance for homes that do not meet insurer standards for other policy forms.

The insurance policy will generally be a cash value policy; if the house is destroyed, you will be paid the current value of the house. Since ground does not burn, what the company is insuring is the structures on the property. You should try to get a replacement value policy which will increase the value of the house according to inflation and pay the cost to replace it. Your policy will also specify the replacement of other structures on the property such as a detached garage or swimming pool. In addition, the policy will cover personal property in the house such as furniture, computers, televisions, jewelry and clothing if there is fire, theft, or vandalism. There is usually a set limit on the cash amount covered under this. If you have especially valuable items in the house, such as jewelry, paintings, or antique rugs, you should catalog them specifically in the policy or buy a separate valuable items policy. The insurance company may ask you to present an appraisal to establish their value.

Liability is also an important part of the homeowners policy. If someone is hurt on your property, you are covered up to a certain amount. However, you are not covered if you are breaking the law. For example, if you allow your teenager to have a party at your house with underage drinking and someone gets hurt, you will be in deep trouble, and your insurance company will not cover your liability.

The national average annual premium for homeowners' insurance is $2,300. However, this is for the average home price of $300,000 and with a $1,000 deductible. Your premium will vary according to several factors, including:

- The value of your house
- The deductible you choose
- Whether your area is subject to earthquakes or wildfires
- Whether there is a fire hydrant nearby

Ask your real estate agent for a recommendation for an insurance broker. After you are comfortable with homeowner's policies, you can get quotes from the direct to customer insurance companies. The Insurance Institute recommends these ways to lower the cost of your insurance premiums:

1. Shop around.
2. Before you buy a car, compare insurance costs.
3. Ask for higher deductibles.
4. Reduce coverage on older cars.
5. Buy your homeowners and auto coverage from the same insurer.

6. Maintain a good credit record.
7. Take advantage of low mileage discounts.
8. Ask about group insurance.
9. Ask about other discounts, such as for safe drivers or if you install smoke alarms in your house.

Flood Insurance

If your home is in a location prone to flooding, you will need to buy flood insurance. Your homeowner's policy does not cover flood damage. The Federal Emergency Management Administration (FEMA) offers flood insurance, with an average annual cost of $700. This is a good investment, since one inch of water in your house can cause about $25,000 in damage. FEMA has detailed maps online of frequent and moderate flood zones to help you determine if your property is at risk. Your mortgage lender may insist you buy flood insurance if you are in a flood zone, but you should whether they insist or not.

Life Insurance

Whole life insurance is like having a savings account that you are forced to put money in each year. Its main function is to protect your family with a lump sum payment if you die prematurely. However, as long as you pay the premiums, the whole life also accumulates savings (building up a cash value) that you can withdraw at the end of the term. If you purchase a 20- or 30-year whole life policy for $400,000 face value, at the end of 30 years, even if you have not died, you can withdraw the $400,000. However, a whole life policy is not a good investment from an economic point of view. The insurance company takes your premiums and invests them, at 7% or 8% annual return. They offer you a guaranteed return on the policy of anywhere between 1.5% to 3% annual return and keep the difference. This is simply not a good deal for you.

Instead, you should purchase a term life policy. This does not build up cash value; rather, it is similar to auto and homeowner's insurance in that you are paying for coverage only against the event of your premature death. Because you are not building up cash value, term life insurance is inexpensive. The premium, of course, depends on your age and health, but the average national cost of a term life policy for a healthy 30-year-old male is $26 per month for a $500,000 policy. The policy premiums will likely increase every year, so be sure to shop around.

A 2020 report by McKinsey and Company showed that life insurance companies have suffered from a decade of declining profitability and growth. One major reason is that customers (and financial advisors) question the value of whole life insurance. McKinsey recommends several changes to revive insurance companies, including a more personal connection to customers and invention of new products, such as whole life policies that can be converted to long term nursing home care policies. We will have to wait and see.

Umbrella Personal Liability Policy

As your wealth increases, you have an economic incentive to protect it. The least expensive way to do this is by purchasing an umbrella personal liability policy. You likely will be carrying personal liability coverage of about $250,000 total on your auto policy and on your homeowner's policy, but it is expensive to increase the limits on these policies. Instead, you can buy a $1,000,000 umbrella policy for about $200 per year. It will pay any excess claims above the limit of $250,000 paid by your auto or homeowner's policy.

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CHAPTER OVERVIEW

11: Personal Risk Management- Retirement and Estate Planning

This chapter focuses on planning for the expected: retirement, loss of income from wages, and the subsequent distribution of assets after death. Retirement planning explores the development of alternative sources of income from capital that can eventually substitute for wages. Estate planning also touches on the considerations and mechanics of distributing accumulated wealth.

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11.1: Introduction

While insurance is about protecting what you have, retirement and estate planning are about protecting what you may have in the future. When you insure what you have, you find the best way to ensure you and your tangible goods are protected. When you plan for retirement, you need to find the best way to protect the life that you'd like to be living after you stop earning income from employment. Estate planning may sound like something only wealthy individuals do; however, it is essential for anyone who owns property or goods. Estate planning can protect your assets, even after your death. If you have assets at the time of your death, what happens to those assets should be documented in a legal estate plan.

Retirement planning and estate planning are strategies designed to create and protect an accumulation of wealth, regardless of the amount of wealth involved. Both types of planning also require you to answer some of the following questions, which can be difficult to answer at the early stages of your life.

- What will my life be like when I retire?
- Will I have a spouse or partner?
- Dependents?
- A home?
- A mortgage?
- Will I be disabled?
- Where will I live?
- What will I do?
- What would I like to do?

Planning, especially for retirement, should begin as early as possible, allowing the most time for savings to accumulate. Ironically, when you are young, you need to imagine answers to these questions. Understanding the practical means of planning and saving for retirement can help you get started. If your plans are flexible, they can adapt to the unexpected as it happens, which it inevitably will.

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11.2: Retirement Planning- Projecting Needs

Learning Objectives

1. Identify the factors necessary to estimate retirement savings.
2. Estimate retirement expenses, length of retirement, and the amount saved at retirement.
3. Calculate relationships between the annual savings required and the time to retirement.

Retirement planning involves the same steps as any other personal planning: determine where you'd like to be, and then figure out how to get there from your current position. More formally, the first step is to define your goals, even if they are no more specific than "I want to be able to afford a nice life after I stop getting a paycheck." But what is a "nice life," and how will you pay for it?

It may seem impossible or futile to project your retirement needs so far in advance, given the numerous uncertainties in life and the distance to retirement. But that shouldn't keep you from saving. You can try to save as much as possible for now, with the idea that your plans will become clearer as you approach retirement, so whatever money you have saved will give you a head start.

Chris and Sam were young urban professionals until they had children. Tired of pushing strollers through the subways, they bought a home in the suburbs. They are happy to provide a more idyllic lifestyle for their kids, but miss the "buzz" and convenience of their urban lifestyle. When their children are on their own and Chris and Sam are ready to retire, they would like to sell their home and move back into the city.

Chris and Sam plan to use the value of their house to finance a condo in the city. Still, they also recognize that real estate prices are often higher in more desirable urban areas and that living expenses may increase in the future. Now in their mid-thirties, Chris and Sam are planning to retire in thirty years.

Chris and Sam need to project how much money they will need to have saved by the time they wish to retire. To do that, they need to project both their future capital needs (to buy the condo) and their future living expenses in retirement. They also need to project how long they may live after retirement, or how many years' worth of living expenses they will need, so that they won't outlive their savings.

They know they have thirty years to save this money. They also know, as explained in Chapter 4, that time affects value. Thus, Chris and Sam need to project the rate of compounding for their savings, or the rate at which time will affect the value of their money.

To estimate required savings, in other words, you need to estimate the following:

- Expenses in retirement
- Duration of retirement
- Return on savings in retirement

If your retirement is years away, a lot can and will happen in the meantime. Estimating future needs may seem complicated, but you can start by using what you know about the present.

Estimating Annual Expenses

One approach is to assume that your current living expenses will remain about the same in the future. Given that over the long run, inflation affects the purchasing power of your income, you should factor in the effect inflation may have so that your purchasing power remains the same.

For example, if your living expenses are around $25,000 per year, you'd like to have that amount of purchasing power in retirement as well. Assuming your cost of living remains constant, if you are thirty years from retirement, how much will you be spending on comparable living expenses when you retire?

The overall average annual inflation rate in the United States is approximately 3.25 percent.[1] If $25,000 is the present value of your expenses, you need to calculate the future value, knowing your expenses will appreciate at a rate of 3.25 percent per year for thirty years. Using any online future value calculator, you can determine that your annual spending needs at retirement would be approximately $65,260.

In thirty years, you will need approximately two and a half times your current annual budget to maintain the lifestyle you currently enjoy. Fortunately, if you have savings, they won't be just "sitting there" during that time. They, too, will be compounding to meet your needs.

You can use your current expenses as a basis to project a lifestyle that is more or less expensive after retirement. You may anticipate expenses dropping with fewer household members and dependents, for example, when your children become independent adults. Alternatively, when you retire, you may wish to increase spending and live a more comfortable life, pursuing the things you've always wanted to do. In any case, your current level of spending can be a starting point for your estimates.

Estimating the Length of Retirement

How much you need to have saved to support your annual living expenses after retirement depends on how long those expenses continue or how long you live. In the United States, life expectancy after the age of 65 has increased significantly over the past century, primarily due to improved access to healthcare, medical advancements, and healthier lifestyles before reaching this milestone.[2] Table 11.2.1 shows the 2021 Period Life Table for Males and Females[3]. As shown below, females generally live longer than males. These additional years must be factored into retirement planning. Table 11.2.2 shows the 2021 Period Life Table for Females[3].

Table 11.2.1 : Actuarial Life Table

Age	Expected Years Remaining
65	16.95
70	13.69
75	10.62
80	7.92
85	5.65
90	3.90
95	2.76
100	2.09
105	1.58
110	1.16

Table 11.2.2 : Actuarial Life Table (Females)

Age	Expected Years Remaining
65	19.75
70	16.00
75	12.49
80	9.38
85	6.72
90	4.65
95	3.22
100	2.35
105	1.71
110	1.20

If life expectancy continues to increase at these rates, in thirty years, your life expectancy at age 65 could be almost another thirty years. In that case, your retirement savings will need to cover your living expenses until you reach age 95. At age 35, you may only have about thirty years to save enough to support yourself (and spouse or dependents) for an additional thirty years.

Estimating the Amount Needed at Retirement

You can use what you know about time and value from Chapter 4 to estimate the amount you would need to have saved up by the time you retire. Your annual expenses in retirement are a series of cash flows that will grow by the rate of inflation. At the same time, your savings will grow by your rate of return, even after you begin making withdrawals to cover your expenses.

Assume that when you retire, your retirement funds are invested to earn a 5 percent annual return. Also, assume the annual inflation rate is 3.25 percent, and your yearly expenses upon retirement are $65,260.

Table 11.2.3 shows what your situation would look like.

Table 11.2.3 : Estimating Annual Expenses and Savings Needed at Retirement

Years after Retirement	Annual Expense (3.25% Inflation Rate)	Return on Savings 5.00%	Return on Savings 2.00%
0	$ 65,260	$ 65,260	$ 65,260
5th Year	$ 76,587	$ 60,008	$ 69,367
10th Year	$ 89,868	$ 55,171	$ 73,723
15th Year	$ 105,453	$ 50,725	$ 78,353
20th Year	$ 123,740	$ 46,636	$ 83,273
25th Year	$ 145,198	$ 42,877	$ 88,503
30th Year	$ 170,377	$ 39,421	$ 94,060
Sum (All Years)		**$ 1,590,290**	**$ 2,443,400**

The amount you need at retirement varies with the expected rate of return on your savings. While you are retired, you will be drawing income from your savings, but your remaining savings will still earn a return. The more return your savings can earn while you are retired, the less you have to save by retirement. The less return your savings can earn in retirement, the more you need to have saved *before* retirement.

In Table 11.2.3 , the total amount needed at retirement is only about $1.5 million if your remaining savings will earn 5 percent while you are retired, but if that rate of return is only 2 percent, you would have to begin retirement with almost $2.5 million.

Let's assume your return on savings is 5 percent. If you want to have $1,590,290 in thirty years when you retire, you could deposit $367,957 today and let it compound for thirty years without making any withdrawals. But if you plan to make an annual investment in your retirement savings, how much would that have to be?

Estimating the Annual Savings for Retirement

In the example above, if you make regular annual deposits into your retirement account for the next thirty years, each deposit would have to be $23,936, assuming that your account will earn 5 percent for thirty years. If the rate of return for your savings is less, you would have to save more to have more at retirement. Your retirement account grows through your contributions and its own earnings. The more your account can earn before you retire, the less you will have to contribute to it. On the other hand, the more you can contribute to it, the less it has to earn.

The amount of time you have to save until retirement can make a significant difference to the amount you must save each year. The longer the time you have to save, the less you have to save each year to reach your goal. Table 11.2.4 shows this idea as applied to the example above, assuming a 5 percent return on savings and a goal of $1,590,290.

Table 11.2.4 : Time to Retirement and Annual Savings Required

Time to Retirement (in years)	Annual Savings Required	Funds at Retirement	Annual Return on Savings
15	$ 153,212	$ 1,590,290	5.00%
30	$ 103,451	$ 1,590,290	5.00%
40	$ 92,679	$ 1,590,290	5.00%

The longer the time you have to save or the sooner you start saving, the less you need to save each year. Chris and Sam are already in their 30's, so they figure they have thirty years to save for retirement. Had they started in their 20's and had forty years until retirement, they would not have to save so much each year. If they wait until they are around age 50, they will need to save significantly more each year to achieve their financial goals. The more you are required to save, the less disposable income you will have to spend on current living expenses, making it harder to save. Saving early and regularly is the superior strategy.

When making these calculations, be aware that you are using estimates to determine the amount of money you'll need at retirement. You use the *expected* inflation rate, based on its historic average, to estimate annual expenses; historical statistics on life expectancy to *estimate* the duration of your retirement; and an *estimate* of future savings returns. Estimates must be adjusted over time because things change. As you progress toward retirement, you'll want to reevaluate these numbers at least annually to be sure you are still saving enough.

Summary

- To estimate the required savings, you need to estimate
  - expenses in retirement, based on lifestyle and adjusted for inflation
  - duration of retirement, based on age at retirement and longevity
  - return on savings in retirement
- You must save more for retirement if
  - expenses are higher
  - duration of retirement is longer
  - return on savings in retirement is less
- Your annual savings for retirement also depend on the time until retirement; the longer you have to save, the less you need to save each year.

Exercises

1. Write in your personal finance journal your ideas and expectations for your retirement. At what age do you want to retire? Will you want to stop working at retirement? Where and how would you like to live? How do you think you would like to spend your time in retirement? How much have you saved toward retirement so far?
2. Experiment with the retirement planning calculator available at Forbes.com (www.forbes.com/advisor/retirement/retirement-calculator/). What will you have saved for retirement by the time you retire? How much will you need to retire without income from employment? How old will you be when your retirement savings run out? Run several combinations of estimates to see how and why you should plan to save for retirement.

[1] McMahon, Tim. "Total U.S. Cumulative Inflation." InflationData.com, August 10, 2022. www.inflationdata.com/articles/2022/08/10/u-s-cumulative-inflation-since-1913/

[2] Basaraba, Sharon. "A Guide to Longevity throughout History, from the Prehistoric Onward." Verywell Health. November 22, 2024. www.verywellhealth.com/longevity-throughout-history-2224054

[3] Social Security Administration, Actuarial Life Table 2021. 2022. www.ssa.gov/oact/STATS/table4c6.html.

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11.3: Retirement Planning- Ways to Save

Learning Objectives

1. Compare and contrast employer, government, and individual retirement plans.
2. Explain the differences between a defined contribution plan and a defined benefit plan.
3. Summarize the structure and purpose of Social Security.
4. State the difference between a Traditional IRA and a Roth IRA.
5. Identify retirement plans for the self-employed.

While knowing the numbers clarifies the picture of your needs, you must reconcile that picture with the realities that you face now. How will you be able to afford to save what you need for retirement?

There are several savings plans structured to help you save. Some offer tax advantages, while others don't. But first, and most importantly, you need to commit to saving.

Saving means not spending a portion of your disposable income. It means delaying gratification or putting off what you could have today until tomorrow. That is often difficult, as you have many demands on your disposable income. You must weigh the benefit of fulfilling those demands with the cost of not saving for retirement, even though the benefit in the present is much easier to credit than the benefit in the future. However, once you resolve to save, employer, government, and individual retirement plans are there to help you.

Employer Retirement Accounts

Employers may sponsor retirement plans for their employees as part of the total employee compensation. There are two kinds of employer-sponsored plans: defined contribution plans and defined benefit plans.

Defined Contribution Plans (e.g. 401(k) plans)

Commonly, larger employers sponsor **defined contribution retirement plans**. Under defined contribution plans, each employee has a retirement account, and both the employee and the employer may contribute to the account. The employer may contribute up to a percentage limit or offer to match the employee's contributions, up to a limit. With a matching contribution, if employees choose not to contribute, they lose the opportunity to have both the employer's contribution and their own. The employee makes untaxed contributions to the account through payroll deduction, up to a maximum limit specified in the current tax code.

Defined contribution plans have become increasingly popular since the introduction of Section 401(k) into the tax code. The **401(k) plans**—or 403(b) plans for employees of nonprofits and 457 plans for employees of government organizations—offer employees a pretax (or tax-deferred) way to save for retirement, to which employers can make a tax-deductible contribution.

The advantages of a 401(k) plan for employees include its flexibility, portability, and tax benefits. A defined contribution account belongs to the employee and can accompany them when they leave an employer. For the employer, there is a lower cost and the opportunity to shift the risk of investing funds onto the employee. There is a ceiling on the employer's costs: either a limited matching contribution or a limit set by the tax code.

The employer offers a selection of investments, but the employee chooses how the funds in their account are diversified and invested. Thus, the employee assumes the responsibility and risk for investment returns. The employer's contributions are a benefit to the employee. Employers can also make a contribution with company stock, which can create an undiversified account. A portfolio consisting only of your company's stock exposes you to market risk should the company not do well, in which case, you may find yourself losing both your job and your retirement account's value.

Defined Benefit Plans (aka Pension plans)

A **defined benefit plan** is a retirement plan, sometimes referred to as a **pension plan**, that is funded by the employer and promises the employee a specific benefit upon retirement. The employer can be a corporation, labor union, government, or other organization that establishes a retirement plan for its employees.

The payout for a defined benefit plan typically consists of an annual or monthly payment for the remainder of the employee's life. In some defined benefit plans, there is also a spousal or survivor's benefit. The amount of the benefit is determined by your wages and length of service with the company.

With a defined benefit plan, your income in retirement is constant or "fixed," and it is the employer's responsibility to fund your retirement. This is both an advantage and a disadvantage for the employee. Having your employer fund the plan is an advantage, but having a fixed income in retirement is a drawback during periods of inflation when the purchasing power of each dollar declines. In some plans, that drawback is offset by automatic cost-of-living increases.

Social Security

The federal government offers a small insurance program for all citizens except federal government employees and railroad workers, known as **Social Security**. Social Security is funded by a mandatory payroll tax shared by employees and employers. That tax, commonly referred to as the Federal Insurance Contributions Act (FICA), also funds Medicare (see Chapter 10). The program is managed by the Social Security Administration (SSA).

Data provided by the SSA as of December 2023 show that almost 67,077,000 beneficiaries receive an average monthly benefit of $1,767.[1] The federal government's total annual payment of benefits in 2023 totaled $1.24 trillion.[2] Most of the beneficiaries are retirees (74.8%) or their spouses and children (3.8%).[3]

Social Security is not an automatic benefit but an entitlement. To qualify for benefits, you must work and contribute FICA taxes for forty quarters (ten years). Retirement benefits may be claimed as early as age 62, but full benefits are not available until age 67 for workers born in 1960 or later.[4] If you continue to earn wage income after you begin collecting Social Security but before you reach full retirement age, your benefit may be reduced. Once you reach full retirement age, your benefit will not be reduced by additional wage income.

The amount of your benefit is calculated based on the amount of FICA tax you paid during your working life and your age when you begin collecting the benefit. Up to 85 percent of individual Social Security benefits may be taxable, depending on the amount of other sources of income. Each year, the SSA provides each potential, qualified beneficiary with a projection of the expected monthly benefit amount (in current dollars) for that individual based on their wage history.

Individual Retirement Accounts

Any individual can save for retirement without a special "account." Still, since the government aims to encourage retirement savings, it has established tax-advantaged accounts to facilitate this goal. Because these accounts provide tax benefits as well as some convenience, it is best to use them first in planning for retirement.

Individual retirement accounts (IRAs) are personal investment accounts that allow individuals to save for retirement. As such, they may be invested in a wide range of financial products, including stocks, bonds, certificates of deposit (CDs), and mutual funds. Types of IRAs differ in terms of the tax treatment of contributions, withdrawals, and contribution limits.

The **Traditional IRA** is an account funded by your tax-deductible and/or nondeductible contributions. The tax-deductible contributions you pay now lower your current tax basis. Deductible contributions are taxed later as funds are withdrawn, but nondeductible contributions are not. In other words, you either pay tax on the money as you put it in, or you pay tax on it as you take it out.

A great advantage of a Traditional IRA is that principal appreciation (interest, dividend income, or capital gain) is not taxed until the funds are withdrawn. As of 2023, withdrawals may be made without penalty after reaching the age of 59.5. Funds may be withdrawn before age 59.5, but penalties and taxes will be applied.[5] Contributions may be made until age 73, at which time required minimum distributions (withdrawals) of funds must begin.[6]

Because they create tax advantages, contributions to a Traditional IRA are limited, currently up to $7,000 (or $8,000 for individuals over 50), effective for tax year 2024.[7] That limit on deductible contributions becomes smaller (the tax benefit is phased out) as income rises. The Internal Revenue Service (IRS) provides a worksheet to calculate how much of your contribution is taxable with your personal income tax return (Form 1040).

For the **Roth IRA**, contributions are not tax-deductible; however, withdrawals are tax-free. You can continue to contribute at any age, and you are not required to take any minimum required distributions. A Roth IRA's most significant advantage is that capital appreciation is not taxed.

As with the Traditional IRA, contributions to a Roth IRA may be limited depending on your income. If you have both a Traditional and a Roth IRA, you may contribute to both, but your combined contribution is limited.

Table 11.3.1 is an adaptation of a guide provided by the IRS to the key differences between a Traditional and a Roth IRA.[8]

Table 11.3.1 : Differences between the Traditional and the Roth IRAs

	Traditional IRA	Roth IRA
Tax-deductible contributions allowed?	Yes	No
Tax-deductible contributions limited?	Yes, by income	N/A
Nondeductible contributions allowed?	Yes	Yes
Nondeductible contributions limited?	Yes	Yes
Withdrawals are taxed?	Yes, of deductible contributions	No
Minimum required distribution?	Yes	No
Age of mandatory distribution?	73[10]	None
Minimum age for distribution?	Yes, 59½	Yes, 59½

A **rollover** is a distribution of cash from one retirement fund to another. Funds may be rolled into a Traditional IRA from an employer-sponsored plan (such as a 401(k), 403(b), or 457 (b)) or another IRA. You may not deduct a rollover contribution (since you have already deducted it when it was contributed initially). Still, you are not taxed on the distribution from one fund that you immediately contribute to another. A **transfer** moves a retirement account, a Traditional IRA, from one trustee or asset manager to another. Rollovers and transfers are not taxed if accomplished within sixty days of distribution.

Self-Employed Individual Plans

People who are self-employed wear many hats: they are both employer and employee, as well as individuals in their own right. To accommodate them, several plans are available that allow for deductible contributions.

A S**implified Employee Pension (SEP)** is a plan that allows an employer with few or no other employees, aside from themselves, to make deductible retirement contributions to an employee's Traditional IRA. Such an account is called a SEP-IRA and is set up for each eligible employee. Contributions are limited: in any given year, they can't exceed 25 percent of salary or $69,000 (in 2024), whichever is less.[9] If you are self-employed and contributing to your own SEP-IRA, the same limits apply, but you must also include any other contributions that you have made to a qualified retirement plan.

A **Savings Incentive Match Plan for Employees (SIMPLE)** is a plan where employees make salary reduction (before-tax) contributions, and the employer matches them. If contributions are made to a Traditional IRA, the plan is referred to as a SIMPLE IRA. Any employer with fewer than one hundred employees who were paid at least $5,000 in the preceding year may use a SIMPLE plan. There are also SIMPLE 401(k) Plans.

A **Keogh Plan** is another retirement vehicle for small or self-employed individuals. It can be a defined benefit or a defined contribution qualified plan with deductible contribution limits.

Summary

- Employers, the government, or individuals may sponsor retirement plans.
- Defined benefit plans differ from defined contribution plans in that the benefit is a specified amount for which the employer is liable. In a defined contribution plan, the benefit is not specified, and the employee is responsible for the accumulation in the plan.

- Social Security is financed by payroll taxes and is designed to supplement employer retirement plans or individual retirement plans.
- Traditional and Roth IRAs differ in their taxable nature, as well as in the age limits for contributions and withdrawals.
- Retirement plans for the self-employed are designed for individuals who are both employees and employers.

Exercises

1. Do you participate in an employer-sponsored retirement savings plan? If so, what kind of plan is it, and what do you see as the benefits and drawbacks of participating? If you contribute to your plan, how did you decide how much to contribute? Could you contribute more?
2. As part of your planning, how can you estimate what you can expect from Social Security as a contribution to your retirement income? Find this answer by visiting the Social Security Administration's Plan for Retirement site (www.ssa.gov/retirement/plan-for-retirement). Using the menus at this site, find out your retirement age. How many credits toward Social Security do you have now? How many do you expect to accumulate over your working life? Use one of the benefit calculators to find your estimated Social Security benefit. How much could you receive monthly? Could you live on your Social Security benefits alone? How much more would you need to save for? What would happen if you continued to work or went back to work after taking your retirement benefit? What would happen if you took your benefit before your full retirement age?
3. Will your career path lead you to employment through government at the local, state, or federal level (for example, in education, law enforcement, or public health)? How are retirement plans for government employees different from the plans described in this section? Find answers to this question by visiting the Office of Personnel Management's Retirement Center (www.opm.gov/retirement-center/).
4. What individual retirement account(s) do you have? Which type of IRA, if any, would be best for you, and why? Why might it be a good idea to have an IRA as a means of funding your retirement, along with other means? According to *Investopedia's* Individual Retirement Account (IRA) article (www.investopedia.com/terms/i/ira.asp), what are the chief advantages of IRAs? How many types of IRAs are there? Can you withdraw money from an IRA account? When must you take a distribution (cash out your IRA)?

[1] Social Security Administration. "Monthly Statistical Snapshot, December 2023", SSA.gov, December 2023. www.ssa.gov/policy/docs/quickfacts/stat_snapshot/2023-12.html.

[2] Social Security Administration, "Fast Facts & Figures about Social Security, 2023", Social Security Administration Research, Statistics, and Policy Analysis, 2023, www.ssa.gov/policy/docs/chartbooks/fast_facts/2023/fast_facts23.html.

[3] Social Security Administration. "Monthly Statistical Snapshot, December 2023", SSA.gov, December 2023. www.ssa.gov/policy/docs/quickfacts/stat_snapshot/2023-12.html.

[4] Social Security Administration, "See Your Full Retirement Age (FRA)", Social Security, August 16, 2023, www.ssa.gov/retirement/full-retirement-age.

[5] Internal Revenue Service, "What If I Withdraw Money from My IRA?", Irs.gov, 2019, www.irs.gov/newsroom/what-if-i-withdraw-money-from-my-ira.

[6] Internal Revenue Service, "Publication 590-A (2024), Contributions to Individual Retirement Arrangements (IRAs)", www.irs.gov, 2023, www.irs.gov/publications/p590a.

[7] ibid.

[8] ibid.

[9] Internal Revenue Service, "Publication 560 (2021), Retirement Plans for Small Business", www.irs.gov, 2023, www.irs.gov/publications/p560.

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11.4: Estate Planning

Learning Objectives

1. Identify the purposes, types, and components of a will.
2. Relate the value of Advance Directive tools.
3. Describe the roles and types of trusts and gifts.

When people hear “estate planning,” they often think of mansions, yachts, or million-dollar assets. But an "**estate**" simply refers to everything you own—your bank accounts, car, home, belongings, and even digital assets. Estate planning is about making sure your wishes are known and your loved ones are supported, no matter your income level. Whether you rent or own, have a little or a lot, planning ahead helps protect what matters most.

Estate planning is a process for managing your assets after your death. Age is not a factor, because death can occur at any time, at any age, by any cause. Arranging for the disposition of your estate is not a morbid concern but a kindness to those you leave behind. Death is a legal and financial event - and in some cases a taxable event - as well as an emotional one. Your loved ones will have to deal with the emotional aftermath of your loss and will appreciate your care in planning for the legal and financial outcomes of your death.

Wills

Since you won't be here, you will need to leave a written document outlining your instructions regarding your estate. That is your **will**, your legal request for the distribution of your estate, that is, assets that remain after your debts have been satisfied. If you die **intestate**, or without a will, the laws of your state of legal residence will dictate the distribution of your estate.

You can write your own will so long as you are a legal adult and mentally competent. The document must be witnessed by two or three people who are not inheriting anything under the terms of the will, and it must be dated, signed, and, in some states, notarized. A **holographic will** is handwritten; it may be more challenging to validate. A **statutory will** is a preprinted will that you can download online. Consider, however, that a will is a legal document. Having yours drawn up by a lawyer may better ensure its completeness and validity in court.

Probate is the legal process of validating a will and then administering the payment of debts and distribution of assets by a court. Probate courts also distribute property in the absence of a will. Probate is not required in every case, however. Probate will not be required if the deceased:

- owned assets of little value, allowing for transfer without court supervision
- owned assets jointly with or "payable on death" to another person
- owned assets that named another person as the beneficiary
- held all assets in a living trust (a legal entity for managing assets on behalf of beneficiaries)

Besides the details of "who gets what," a will should name an **executor**, the person or persons who will administer the payment of your debts and the distribution of your remaining assets, according to your wishes as expressed in your will. If you have legal dependents, your will should name a guardian for them. You may also include a "letter of last instruction" stating the location of important documents, safe deposit keys, and bank accounts. Also, this should specify your funeral arrangements.

There are several types of wills. A **simple will** leaves everything to a spouse. For comparatively small estates, a simple will may be the most appropriate. A **traditional marital share will** leaves one-half of the estate to a spouse and the other half to others, usually children.

A **stated dollar amount will** allows you to leave specific amounts to beneficiaries. A drawback of this type of will is that the stated amounts may be reasonable when your will is drawn up, but may not reflect your intentions at the time of your death, perhaps many years later. For that reason, rather than specifying specific amounts, it may be better to specify percentages of your asset values you would like each beneficiary to have.

You may change or rewrite your will at any time; however, it is essential to update it as your life circumstances change, particularly with significant events such as marriage, divorce, the birth of a child, or the acquisition of substantial assets, like a house. If the

changes in your circumstances are significant, you should create a new will.

Advance Directives

It is possible that you will become mentally or physically disabled before you die and unable to direct the management of your assets. To prepare for this possibility, consider creating a **living will** or advance directive with instructions for your care in the event of an emergency. You may appoint someone - usually a spouse, child, or sibling - who would have **power of attorney**, that is, the right to act on your behalf, especially as regards financial and legal decisions. That power may be limited or unlimited (such as a "durable power of attorney") and is restricted to certain acts or dependent on certain circumstances.

Along with granting power of attorney, your living will may include a health care proxy, requesting that medical personnel follow the instructions of a designated family member who expresses your wishes concerning your end-of-life treatment. For example, many people request that they not be revived or sustained if they cannot experience some quality of life. Be sure to update your advance directive, as your views may change, and medical and technological advances may change our notions of "quality of life."

Trusts and Gifts

A **trust** is a legal entity created by a trustor, also known as a grantor, who owns assets managed by a trustee or trustees on behalf of one or more beneficiaries. A **testamentary trust** may be established in a will, allowing beneficiaries who cannot manage their assets (such as minor children or disabled dependents) to benefit from the assets while having them managed on their behalf. A **living trust** is established while the grantor is alive. Unlike a will, it does not become a matter of public record upon your death. A **revocable living trust** can be revoked by the grantor, who remains the owner of the assets, at any time. Such a trust avoids the probate process but may not shield assets from estate taxes. An **irrevocable living trust** cannot be changed; the grantor relinquishes ownership of their assets, which are transferred to the trust. However, the trust then becomes a separate taxable entity and pays tax on its accumulated income.

Another way to avoid probate and estate taxes is to gift assets to your beneficiaries while you are alive. Ownership of the assets passes to the beneficiaries at the time of the gift, so the assets are no longer included in your estate. The federal government and many state governments levy a gift tax for gifts exceeding certain limits. For tax year 2024, for example, the annual exclusion from federal tax was $18,000 per recipient.[1] Additionally, the federal government does not tax gifts to spouses or payments for another person's medical bills or tuition.

Most trusts, whether testamentary or living, revocable or irrevocable, are created to avoid either the probate process or estate taxes or both. The probate process can be lengthy and costly, and therefore a burden for your executor, your estate, and your beneficiaries (who may have to wait for their distributions).

Estate Taxes

Estate taxes are sometimes called the “death tax,” and the name alone can make them sound scary. However, in reality, estate taxes only apply to very large estates worth millions of dollars. For most of us, this tax isn’t something we’ll ever have to pay.

In planning your estate, your primary objective is that the distribution of your assets provides for your dependents and that your assets are distributed as you would want, were you still there to distribute them yourself.

Summary

- A will describes your wishes for the distribution of your assets (the estate) after your death.
- Probate courts distribute assets in the absence of a will and administer wills in estates with assets valued above a certain (variable) dollar amount.
- There are many kinds of wills, including
  - the simple will
  - the traditional marital share will
  - the stated dollar amount will
- Living wills, with power of attorney and health care proxy, provide medical directives, empower someone to manage your estate while you are still alive, and authorize someone to make decisions about your health and end-of-life care.

- Trusts are used to provide the benefits of assets to beneficiaries without requiring them to assume responsibility for asset management.
- There are testamentary trusts, living trusts, revocable trusts, and irrevocable trusts. Setting up and administering trusts involves some considerable expense.
- Creating trusts and giving gifts are ways to reduce the taxable value of an estate.

? Exercises

1. Draft a will or use a statutory will form recognized in your state. Start by reviewing your balance sheet, showing your assets, liabilities, net worth, and an inventory of personal and household property. Think about how you would want your estate to be distributed upon your death. Identify an executor. Review free advice for writing a will (www.legalzoom.com/articles/how-to-write-a-will) from LegalZoom.com. The same website can help you find out what kind of document your state requires (www.legalzoom.com/articles/state-requirements-for-a-last-will) for a "last will and testament". Finally, investigate if you need to use a lawyer (www.nerdwallet.com/article/investing/estate-planning/do-you-need-lawyer-make-will) to create your will.
2. Review the *Investopedia.com* information about living trusts (also called life estates in some states) (www.investopedia.com/terms/l/living-trust.asp). When and why might you want to create a revocable or irrevocable living trust (www.investopedia.com/articles/pf/06/revocablelivingtrust.asp) in addition to or as an alternative to a will?
3. Investigate the estate tax laws in your state. Does your state tax income from Social Security payments? Does your state tax pensions and other sources of retirement income? How does your state treat inheritance taxes and estate taxes? What tax breaks does your state offer to retirees? Find answers to these questions by visiting Taxes by State (www.retirementliving.com/taxes-by-state).

[1] Internal Revenue Service, “Instructions for Form 709”, www.irs.gov, 2023, www.irs.gov/instructions/i709.

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SECTION OVERVIEW

11.5.1: Insurance

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11.5.1.1: Understanding Your Health Coverage



Health coverage pays for provider services, medications, hospital care, and special equipment when you're sick. It's also important when you're not sick. Marketplace coverage includes preventive health services like immunizations for children and adults, annual doctor visits for women and seniors, screening and counseling for people of all ages, and more. The best news – it's free. Here are 4 things to know about your health coverage:

1. All Marketplace health plans must provide you with a Summary of Benefits and Coverage, which includes coverage examples showing how the plan might help pay for services.
2. The actual costs and care will vary by your health care needs and your coverage.
3. You can use our glossary to understand key terms like copayment, deductible, network, and premium.
4. If you have questions about your coverage, you can contact your health plan, state Medicaid program, or Children's Health Insurance Program (CHIP) to get more information.

See why it's so important to have health coverage and share what you learn with your family and friends.

Watch the video: "Understand the Plan" – from Coverage to Care

Watch the video: "Words to Know" – from Coverage to Care

Print your own booklet: Step 2 – Understand Your Health Coverage

Sample Insurance Card

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11.5.1.2: Buying Insurance

Learn how to find a trustworthy and affordable insurance company.

What's on This Page

- Types of Insurance
- Shop for Insurance

Types of Insurance

Insurance protects you from financial loss in the event of a disaster or other hardship. By purchasing insurance policies, you can receive reimbursement for losses due to car accidents, property theft, natural disasters, medical expenses, disability, or death.

- **Health insurance**—helps pay your doctor's visits and other health care expenses
- **Disability insurance**—replaces some of your income if an injury or illness prevents you from working
- **Life insurance**—helps pay bills and your family's future financial needs after you die
- **Auto insurance**—protects you against financial loss if you have a car accident
- **Homeowner's insurance**—pays you if there is damage to your home, or for loss of personal property due to damage or theft
- **Flood insurance**—protects you against property loss from flooding
- **Renter's insurance**—pays claims for damage or loss of your personal property as a renter
- **Pet insurance**—helps pay veterinary bills for your pet
- **Crop and livestock insurance**—protects your farm from loss due to natural disasters or declining prices
- **Catastrophic health care insurance**—covers certain types of expensive medical care, like hospitalizations
- **College tuition insurance**—refunds college tuition if you must withdraw because of a serious injury or illness
- **Dental and vision insurance**—helps pay your dental or vision care expenses
- **Identity theft insurance**—reimburses you for the cost of restoring your identity and repairing credit reports if you're a victim of identity theft. This insurance may be part of your homeowner's insurance policy or a stand-alone policy.
- **International health care insurance**—provides health coverage no matter where you are in the world. The policy term is flexible, so you can purchase it only for the time you will be out of the country.
- **Liability insurance**—pays if you are sued for negligence or injury to another person
- **Host protection insurance**—protects you if you rent your home out or use your car to drive others for a fee
- **Travel insurance**—protects against losses during travel. There are four kinds of travel insurance: travel cancelation insurance, baggage or personal effects coverage, emergency medical coverage, and accidental death.
- **Umbrella insurance**—supplements the insurance you already have for home, auto, and other personal property. Umbrella insurance can help cover costs that exceed the limits of other policies.

Shop for Insurance

Before you buy insurance, do your homework. Research the insurance company to be sure that the company is financially sound and provides good service. Also find out what factors matter so that you can get the coverage you need at the best price.

Check Out the Insurance Company

- Find out whether your state insurance department offers any information concerning insurance companies and rates.
- Make sure the insurance company is licensed and covered by the state's guaranty fund. The fund pays claims in case the company defaults. Your state insurance department can provide this information.
- Check the financial stability and soundness of the insurance company with credit rating agencies.
- Research the company's complaint record.
- Find out what others think about the company's customer service by reading online reviews from current customers.
- Make sure you receive a written policy. This tells you that the agent forwarded your premium to the insurance company. If you don't receive a policy within 60 days, contact your agent and the insurance company.

Find the Best Rates

- Compare quotes from several companies to get the best better deal.
- Ask your insurance agent about discounts. You may be able to get a lower premium if you have safety features in your home, such as deadbolt locks, smoke detectors, an alarm system, storm shutters, or fire-retardant roofing material. Similarly, you may save on car insurance based on your vehicle's safety features, the number of miles you drive, your age, good grades if you're a student, and your driving record. You might also be able to get discounts if you're a member of civic or alumni associations, or have multiple policies with the same company.
- Consider a higher deductible. Increasing your deductible by just a few hundred dollars can make a big difference in your premiums.

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11.5.1.3: Personal Insurance

Learn about different types of personal insurance.

What's on This Page

- Disability Insurance
- Health Insurance Plans
- Life Insurance
- Life Insurance for Military Personnel and Veterans

Disability Insurance

Disability insurance protects individuals and their families from financial hardship when illness or injury prevents them from earning a living. Many employers offer some form of disability coverage to employees, or you can buy an individual disability insurance policy.

Types of Disability Policies

There are two types of disability policies:

- **Short-term** disability policies have a maximum benefit of two years.
- **Long-term** disability policies have benefits that can last the rest of your life.

Employers may offer short-term disability coverage, long-term disability coverage, or integrate both of these as part of a competitive employee benefits package. When purchasing individual disability insurance coverage, you should ask:

- How is disability defined?
- When do benefits begin?
- How long do benefits last?
- What dollar amount is promised?

Social Security Disability and Supplemental Security Income Programs

Both programs are administered by the Social Security Administration (SSA), and they serve as the largest of several federal programs that offer assistance to people with disabilities.

- The Social Security disability insurance program pays benefits to you and certain members of your family if you are "insured," meaning that you have worked long enough and paid Social Security taxes.
- The Supplemental Security Income (SSI) program pays benefits based on financial need.

Health Insurance Plans

Learn About Health Coverage

Health insurance helps you pay for medical services and sometimes prescription drugs. Once you purchase insurance coverage, you and your health insurer each agree to pay a part of your medical expenses–usually a certain dollar amount or percentage of the expenses.

How to get Health Coverage

You can get health care coverage through:

- A group coverage plan at your job or your spouse or partner's job
- Your parents' insurance plan, if you are under 26 years old
- A plan you purchase on your own directly from a health insurance company or through the Health Insurance Marketplace
- Government programs such as Medicare, Medicaid, or Children's Health Insurance Program (CHIP)
- The Veterans Administration or TRICARE for military personnel
- Your state, if it provides a health insurance plan

- Continuing employer coverage from your former employer, on a temporary basis under the Consolidated Omnibus Budget Reconciliation Act (COBRA)

Types of Health Insurance Plans

When purchasing health insurance, your choices typically fall into one of three categories:

- Traditional fee-for-service health insurance plans are usually the most expensive choice, but they offer you the most flexibility in choosing health care providers.
- Health maintenance organizations (HMOs) offer lower co-payments and cover the costs of more preventive care, but your choice of health care providers is limited to those who are part of the plan.
- Preferred provider organizations (PPOs) offer lower co-payments like HMOs but give you more flexibility in selecting a provider.

Choosing a Health Insurance Plan

Read the fine print when choosing among different health care plans. Also ask a lot of questions, such as:

- Do I have the right to go to any doctor, hospital, clinic, or pharmacy I choose?
- Are specialists, such as eye doctors and dentists, covered?
- Does the plan cover special conditions or treatments such as pregnancy, psychiatric care, and physical therapy?
- Does the plan cover home care or nursing home care?
- Will the plan cover all medications my physician may prescribe?
- What are the deductibles? Are there any co-payments? Deductibles are the amount you must pay before your insurance company will pay a claim. These differ from co-payments, which are the amount of money you pay when you receive medical services or a prescription.
- What is the most I will have to pay out of my own pocket to cover expenses?
- If there is a dispute about a bill or service, how is it handled?

Life Insurance

A life insurance policy states that you will pay premiums to an insurance company over time, and, in exchange, the company will pay a lump sum amount to a designated beneficiary upon your death. The money from your life insurance policy can help pay bills and help support your surviving family members' living expenses. You may need to adjust the amount of your life insurance policy related to major life events, like buying a home, getting married, or having a child.

There is no set amount of life insurance you need. If you have dependents you want to provide for, or leave an inheritance to charities, you may need more life insurance than someone without dependents or charitable causes to support. Consider potential future expenses that your loved ones may need.The life insurance payout could be used to replace the money you would have earned to pay for their college education, moving expenses, or retirement. You can buy an individual life insurance policy from an insurance agent. You may also be part of a group life insurance policy through your employer or civic organization. If you are a veteran, you may be eligible for the VA's life insurance benefits.

Use these tips when you are shopping for insurance.

There are two main types of life insurance policies:

- **Whole (or universal) life insurance policies** are considered permanent. As long as you pay the premium, the policy is in effect. In addition to paying a benefit upon your death, whole life insurance policies also have an investment or savings component. This means that you accumulate cash value over the life of the policy, so you can borrow money from these types of policies if you need to.
- **Term life insurance policies** are in effect for a certain period of time, or term. If you have this type of policy and pass away during the term that the policy is in effect, the insurance company will pay a benefit. If you live past the time that the policy is in effect, the insurance company won't pay a benefit or give you a refund.

Term life insurance policies are usually less expensive than whole life insurance policies. This is because term life insurance policies only cover a set amount of time, while whole life insurance policies are intended to be permanent and because part of the money you pay is put away for savings.

Lost Life Insurance Policies

If you have misplaced a life insurance policy, your state's insurance commission may be able to help you locate a copy of it. A policy locator service can search for it for a fee. If the insurance company knows that an insured person has died but can't locate the beneficiary, the company must turn the benefits over to the state's unclaimed property office.

Life Insurance for Military Personnel and Veterans

The Department of Veterans Affairs (VA) offers life insurance programs for veterans, servicemembers and their families.

There are also voluntary programs that ensure the survivors of retirees (and, in some situations, active duty members) continue to receive income throughout their lives. View more information about military/veteran survivor benefits.

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11.5.1.4: Property Insurance

Learn about the different types of insurance for your property.

What's on This Page

- Auto Insurance
- Homeowners and Renters Insurance
- Flood Insurance
- Pet Insurance

Auto Insurance

Auto insurance protects you from paying the full cost for vehicle repairs and medical expenses due to a collision. A number of things affect the premiums you pay for this protection, including your:

- Gender
- Age
- Marital status
- Credit history
- Car's make and model
- City and neighborhood

Types of Auto Insurance

Every state requires drivers to carry minimum levels of auto insurance coverage, or the equivalent in financial responsibility waivers. These requirements ensure that you can pay for property damages or medical expenses. There are several components that can make up your insurance policy:

- **Liability coverage** protects you if you are at fault for a collision. It pays for medical expenses and vehicle damage for the other driver and passengers.
- **Uninsured motorist coverage** pays for damages to your car and medical expenses if an uninsured driver hits your car.
- **Collision coverage** pays to repair your vehicle, if you were at fault for the collision.
- **Underinsured motorist coverage** pays damages for your car if someone hits it, but doesn't have enough insurance to cover your medical expenses and car damages.
- **Comprehensive coverage** pays for damages to your car due to theft, fire, or falling objects.

Auto insurance requirements vary from state to state, but liability coverage is mandatory in most states. You may choose to opt out of certain types of coverage, depending on your budget and car's age. Check with your state insurance regulator to learn more about its requirements and to research potential insurers.

Be sure to read the declarations page of your auto insurance policy. This summary includes your policy's important details: the duration of coverage, annual premium, the maximum amount your insurance company will pay out for each type of claim, and how your premium payment is split between each part of your coverage.

Homeowners and Renters Insurance

Homeowners and renters insurance protect your home and personal property against damage or loss, and insures you in case someone gets hurt while on your property. You may already have insurance on your home if you have a mortgage on the property, because most lenders make insurance a condition of the loan.

Renters insurance, or tenant insurance, offers renters coverage similar to homeowners insurance. If you are a renter, do not assume your landlord carries insurance on your personal belongings; you may wish to purchase a separate policy.

What Can Homeowners or Renters Insurance Cover?

Homeowners or renters insurance may pay claims for:

- damage to your home, garage, and other outbuildings

- loss of furniture and other personal property due to damage or theft, both at home and away
- additional living expenses if you rent temporary quarters while your house is being repaired

Homeowners or renters insurance may also:

- include liability for bodily injury and property damage that you cause to others through negligence
- include liability for accidents happening in and around your home, as well as away from home, for which you are responsible
- pay for injuries occurring in and around your home to anyone other than you or your family
- provide limited coverage for money, gold, jewelry, and stamp and coin collections
- cover personal property in storage

In addition to general shopping for insurance tips, keep these points in mind when shopping for homeowners insurance:

- Insure your house, not the land under it. If you don't subtract the value of the land when deciding how much homeowner's insurance to buy, you will pay more than you should.
- Purchase enough coverage to replace what is insured. "Replacement Cost Coverage" gives you the money to rebuild your home and replace its contents. An "Actual Cash Value" policy is cheaper but pays the difference between your property's worth at the time of loss minus the depreciation for age and wear.
- Ask about special coverage you might need. You may have to pay extra for computers, cameras, jewelry, art, antiques, musical instruments, stamp collections, etc.
- Flood and earthquake damage are not covered by a standard homeowners policy. The cost of a separate earthquake policy will depend on the likelihood of earthquakes in your area. Homeowners who live in areas prone to flooding should take advantage of the National Flood Insurance Program (NFIP).
- If you are a renter, do not assume your landlord carries insurance on your personal belongings. Purchase a separate policy for renters.

For help in deciding how much insurance coverage to buy, contact your state insurance regulator.

Flood Insurance

Since standard homeowners insurance doesn't cover flooding, it's important to have protection against flood damage. If you live in an area prone to flooding, you should take advantage of the National Flood Insurance Program.

National Flood Insurance Program (NFIP)

Administered by the Federal Emergency Management Agency (FEMA), the NFIP offers flood insurance to homeowners, renters, and business owners if their community participates in the program. The program works closely with more than 80 private insurance companies.

- Homes and businesses with mortgages from federally regulated or insured lenders in high-risk flood areas are required to have flood insurance. While flood insurance is not federally required if you live in a moderate-to-low risk flood area, it is still available and strongly recommended.
  - To find out if your home or business is in a community that participates in the NFIP, refer to the Community Status Book section on FEMA.gov.
- Flood insurance protects two types of insurable property: building and contents. The first covers your building; the latter covers your possessions; and neither covers the land they occupy. Flood insurance only covers damage that is a direct result of flooding.
- Rates are set nationally and do not differ from company to company or agent to agent. These rates depend on many factors, such as the 1) date and 2) type of construction of your home, and 3) your building's level of risk.
- Flood insurance can only be purchased through an insurance agent; you cannot purchase it directly from the federal government. Typically, there's a 30-day waiting period from the date of purchase before your policy goes into effect.
  - If your local insurance agent is unfamiliar with the NFIP, you can find an agent serving your area.

File a Complaint

If you have a problem with an insurance company or agent regarding flood insurance, contact your state insurance regulator.

More Information

Complete the One-Step Flood Risk Profile to rate your risk of flooding, estimate your premiums, and find an agent.

Pet Insurance

Health insurance for pets may help you pay veterinary bills if your pet is injured, gets sick, or needs routine preventive care. Most plans cover dogs and cats, and some plans cover other types of animals.

What to Consider Before Buying Pet Health Insurance

- Shop and compare: Ask your vet to recommend some pet insurers. Be aware that policies and premiums vary widely. Compare monthly or annual costs, and the differences in deductibles, co-pays, and coverage limits. These may limit payouts by incident, annually, or your animal's lifetime.
- Read policies carefully: Read the clauses on deductibles, co-pays, coverage limits, and exclusions before you buy a pet insurance policy. Insurance policies normally exclude pre-existing problems and hereditary conditions.
- Do the math: Add up the total costs of the policy for the anticipated life expectancy of your pet. Be aware that the age of your pet affects the premium. The older your pet is, the higher the premium you'll pay.

Questions to Ask Insurers

As you consider possible insurance providers, it's helpful to have standard questions you ask to each company, that make it easy to compare between policies. Some important questions to ask include:

- Can I choose my vet?
- Is there a waiting period?
- Do you cover routine wellness exams?
- Do you cover neutering or spaying?
- Does the plan include prescription drug coverage?
- Do you cover claims annually or by incident?
- If the coverage is by incident, is there a time limit?
- Is there a dollar limit for vet office fees?
- If my pet has a pre-existing or hereditary condition, will this plan cover it?
- Does this plan cover chronic or recurring conditions?
- How long do you take to pay claims?
- Does the plan cover the costs of vaccinations and required shots?
- Do you give discounts for insuring multiple pets?
- Does this plan cover advertising costs and rewards if my pet is lost or stolen?
- Does this plan make payouts if my pet dies during treatment?

For more information about pet insurance and to research regulations in your state, contact your state insurance regulator.

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SECTION OVERVIEW

11.5.2: Retirement

11.5.2.1: Retirement

11.5.2.2: Types of Retirement Plans

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11.5.2.1: Retirement

Learn some of the basics about retirement and pension benefits.

What's on This Page

- Saving for Retirement
- Determining a Target Retirement Saving Rate
- Social Security Retirement Benefits
- Protecting Your Private Pension Benefits
- Civil Service Retirement
- Public Service and Volunteerism

Saving for Retirement

As you approach retirement, there are many things to think about. Experts advise that you will need about 80 percent of your pre-retirement income to continue your current quality of life. The exact amount depends on your individual needs. Some important factors to consider include:

- At what age do you plan to retire?
- Can you participate in an employer's retirement savings plan, such as a 401(k) plan, or a traditional pension plan?
- Will your spouse or partner retire when you do?
- Where do you plan to live when you retire? Will you downsize, rent, or own your home?
- Do you expect to work part-time?
- Will you have the same medical insurance you had while working? Will your coverage change?
- Do you want to travel or pursue a new hobby that might be costly?

Resources to Help You Prepare for Retirement

To help you plan for retirement:

- Find practical tips for building retirement savings in the Top 10 Ways to Prepare for Retirement(PDF, Download Adobe Reader).
- Use a retirement calculator to find out the best age to claim your Social Security benefits.
- myRA can help you start saving for retirement when you don't have access to an employer-sponsored plan or lack other options to save.
- Find out the trade-offs between taking your pension in a monthly payment or in a lump sum(PDF, Download Adobe Reader).
- Social Security pays benefits that are on average equal to about 40 percent of your pre-retirement earnings. You may be able to estimate your benefits.
- Learn how you can boost your retirement savings at Investor.gov.
- If you have a financial advisor, talk to him or her about your plans.

Back to Top

Determining a Target Retirement Saving Rate

Make a plan with the Retirement Saving worksheet. Learn more at Savings Fitness.

A link to an interactive elements can be found at the bottom of this page.

Social Security Retirement Benefits

Infographic showing the ways people save for retirement in the U.S.If you're like most Americans, Social Security is a key piece of your retirement savings. But how much you will get depends on your earnings over your lifetime, the age at which you'll begin receiving benefits, and whether you'll be eligible to receive a spouse's benefit instead of your own.

You can use Social Security's retirement planning tools to:

- Social Security also administers disability and survivor benefits. Get the answers to many of the top Social Security questions.

Avoiding Errors and Getting Help

If your job is covered by a traditional pension plan, make sure you get the pension amount you're owed.

- Find ways to protect yourself by reading these 10 common causes of errors in pension calculation.
- Get free legal help if you're experiencing a problem with your pension plan.
- Find out whether your pension or annuity income is taxable.
- If you have questions or complaints about your employer-sponsored pension plan, contact your human resources office or locate the Employee Benefits Security Administration (EBSA) regional office near you.

Federal Insurance for Private Pensions

If you've earned a traditional pension, you're likely to receive it even if your company runs into financial problems.

The Pension Benefit Guaranty Corporation (PBGC):

- Insures most private-sector defined-benefit pensions that typically pay a certain amount each month after you retire
- Covers most cash-balance plans, a type of defined-benefit pension that allows you to take a lump-sum distribution
- **Does not** cover government and military pensions, 401k plans, IRAs, and certain other plans.

Is Your Pension Insured?

- To see if your pension is insured, search PBGC's list of single-employer and multi-employer plans.
- If your plan is insured and it ends without enough money to pay all benefits, PBGC will pay you the money you're owed, up to legal limits.
- To learn more about PBGC-insured pensions, view these frequently asked questions.

Find an Unclaimed Pension

More than 38 million people in the U.S. haven't claimed pension benefits they have earned. Find out if you, or someone you know, is owed a pension.

Civil Service Retirement

Federal Employee Retirement Planning and Management

If you are a federal employee planning to retire or a federal retiree looking for information about your benefits, the U.S. Office of Personnel Management (OPM)'s Retirement page can help you:

- Research and learn about retirement options.
- Manage your benefits online.
- Find options for signing up for direct deposit. If you receive paper checks now, you'll soon be required to switch to direct deposit or Direct Express debit card.
- Find answers to frequently asked questions about retirement.

If you are the survivor of a deceased federal employee or federal retiree, you may be eligible for death and survivor benefits. Visit the OPM website to report the death and apply for death benefits.

Thrift Savings Plan

In addition to the defined or basic benefits provided by your CSRS or FERS plan, if you are a current federal employee, you can boost your retirement savings by participating in the Thrift Savings Plan (TSP). The TSP offers the same types of savings and tax benefits as a 401(k) plan.

Credit for Military Service

Military service does not automatically count toward civil service retirement.

- To receive credit for military service performed after 1956, you must pay a deposit.
- If you are a military retiree, you generally cannot receive military service credit towards your civilian retirement unless you waive your military retired pay.

Pension Taxes

The Internal Revenue Service (IRS) offers an online tool and an online publication to help you determine whether or not your pension or annuity payment is taxable.

Contact OPM's Retirement Operations Center

For benefits information or help with a transaction, contact OPM's Retirement Operations Center.

State and Local Government Employees

If you are a state or local government employee and have questions about your pension plan, contact your agency's personnel department. You can also contact the Employee Benefits Security Administration (ESBA) for help.

Public Service and Volunteerism

Many federal organizations offer volunteer opportunities:

- Serve.gov – Sign up for volunteer opportunities and create projects. Tool kits are available to help develop your ideas into projects.
- JoiningForces.gov – Start a volunteer project, send a message of thanks or give service hours to support our service members and their families.
- PeaceCorps.gov – Find volunteer programs where you serve abroad and make a difference by working directly within communities to build capacity in education, health, environment and more.
- CitizenCorps.gov – Get training in first aid and emergency skills. Volunteer to support local emergency responders and disaster relief efforts.
- NationalService.gov – Offers grants for service and volunteering; programs include the AmeriCorps, Senior Corps and Social Innovation Fund.
- Volunteer.gov – Volunteer opportunities in America's natural and cultural resources, including national parks.
- Volunteer.VA.gov – Volunteer at a Veterans Affairs (VA) facility in your area.
- Federal Election Volunteers – Become a Poll Worker – Assist election officials in your state.
- Natural Resources Conservation Earth Team Volunteers – Work with private landowners to improve soil quality, conserve water, improve air quality and enhance wildlife habitat.
- National Oceanic and Atmospheric Administration (NOAA) – Volunteers take part in research, observation and educational roles that benefit science and the planet.

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11.5.2.2: Types of Retirement Plans

Individual Retirement Arrangements (IRAs)
Roth IRAs

401(k) Plans
403(b) Plans

SIMPLE IRA Plans (Savings Incentive Match Plans for Employees)
SEP Plans (Simplified Employee Pension)
SARSEP Plans (Salary Reduction Simplified Employee Pension)
Payroll Deduction IRAs

Profit-Sharing Plans
Defined Benefit Plans
Money Purchase Plans
Employee Stock Ownership Plans (ESOPs)
Government Plans
457 Plans
409A Nonqualified Deferred Compensation Plans

Help with Choosing a Retirement Plan

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SECTION OVERVIEW

11.5.3: Estate Planning

11.5.3.1: Getting Your Affairs in Order

11.5.3.2: Estate and Gift Taxes

11.5.3.3: Planning Your Own Funeral

11.5.3.4: Saving and Investing

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11.5.3.1: Getting Your Affairs in Order

Ben has been married for 47 years. He always managed the family's money. But since his stroke, Ben is not able to walk or talk. His wife, Shirley, feels overwhelmed. Of course, she's worried about Ben's health. But, on top of that, she has no idea what bills should be paid or when they are due.

Across town, 80-year-old Louise lives alone. One night, she fell in the kitchen and broke her hip. She spent a week in the hospital and 2 months in a rehabilitation nursing home. Even though her son lives across the country, he was able to pay her bills and handle her Medicare questions right away. That's because, several years ago, Louise and her son made a plan about what he should do in case Louise had a medical emergency.

Plan for the Future

No one ever plans to be sick or disabled. Yet, it's this kind of planning that can make all the difference in an emergency.

Long before she fell, Louise put all her important papers in one place and told her son where to find them. She gave him the name of her lawyer, as well as a list of people he could contact at her bank, doctor's office, insurance company, and investment firm. She made sure he had copies of her Medicare and other health insurance cards. She added her son's name to her checking account and safe deposit box at the bank. Louise made sure Medicare and her doctor had written permission to talk with her son about her health and insurance claims.

On the other hand, Ben always took care of family money matters, and he never talked about the details with Shirley. No one but Ben knew that his life insurance policy was in a box in the closet or that the car title and deed to the house were filed in his desk drawer. Ben never expected that his wife would have to take over. His lack of planning has made a tough job even tougher for Shirley.

What Exactly Is an "Important Paper"?

The answer to this question may be different for every family. Remember, this is a starting place. You may have other information to add. For example, if you have a pet, you will want to include the name and address of your veterinarian. Include complete information about:

Personal Records

- Full legal name
- Social Security number
- Legal residence
- Date and place of birth
- Names and addresses of spouse and children
- Location of birth and death certificates and certificates of marriage, divorce, citizenship, and adoption
- Employers and dates of employment
- Education and military records
- Names and phone numbers of religious contacts
- Memberships in groups and awards received
- Names and phone numbers of close friends, relatives, doctors, lawyers, and financial advisors
- Medications taken regularly (be sure to update this regularly)
- Location of living will and other legal documents

Financial Records

- Sources of income and assets (pension from your employer, IRAs, 401(k)s, interest, etc.)
- Social Security and Medicare/Medicaid information
- Insurance information (life, health, long-term care, home, car) with policy numbers and agents' names and phone numbers
- Names of your banks and account numbers (checking, savings, credit union)
- Investment income (stocks, bonds, property) and stockbrokers' names and phone numbers
- Copy of most recent income tax return

- Location of most up-to-date will with an original signature
- Liabilities, including property tax— what is owed, to whom, and when payments are due
- Mortgages and debts—how and when they are paid
- Location of original deed of trust for home
- Car title and registration
- Credit and debit card names and numbers
- Location of safe deposit box and key

Steps for Getting Your Affairs in Order

- **Put your important papers and copies of legal documents in one place.** You can set up a file, put everything in a desk or dresser drawer, or list the information and location of papers in a notebook. If your papers are in a bank safe deposit box, keep copies in a file at home. Check each year to see if there's anything new to add.
- **Tell a trusted family member or friend where you put all your important papers.** You don't need to tell this friend or family member about your personal affairs, but someone should know where you keep your papers in case of an emergency. If you don't have a relative or friend you trust, ask a lawyer to help.
- **Give permission in advance for your doctor or lawyer to talk with your caregiver as needed.** There may be questions about your care, a bill, or a health insurance claim. Without your consent, your caregiver may not be able to get needed information. You can give your okay in advance to Medicare, a credit card company, your bank, or your doctor. You may need to sign and return a form.

Legal Documents

There are many different types of legal documents that can help you plan how your affairs will be handled in the future. Many of these documents have names that sound alike, so make sure you are getting the documents you want. Also, State laws vary, so find out about the rules, requirements, and forms used in your State.

Wills and ***trusts*** let you name the person you want your money and property to go to after you die.

Advance directives let you make arrangements for your care if you become sick. There are two ways to do this:

- A ***living will*** gives you a say in your health care if you become too sick to make your wishes known. In a living will, you can state what kind of care you do or don't want. This can make it easier for family members to make tough healthcare decisions for you.
- A ***durable power of attorney for health care*** lets you name the person you want to make medical decisions for you if you can't make them yourself. Make sure the person you name is willing to make those decisions for you.

For legal matters, there are two ways to give someone you trust the power to act in your place:

- A ***general power of attorney*** lets you give someone else the authority to act on your behalf, but this power will end if you are unable to make your own decisions.
- A ***durable power of attorney*** allows you to name someone to act on your behalf for any legal task, but it stays in place if you become unable to make your own decisions.

A link to an interactive elements can be found at the bottom of this page.

Resources

You may want to talk with a lawyer about setting up a general power of attorney, durable power of attorney, joint account, trust, or advance directive. Be sure to ask about the lawyer's fees before you make an appointment.

You should be able to find a directory of local lawyers at your library, or you can contact your local bar association for lawyers in your area. Your local bar association can also help you find what free legal aid options your State has to offer. An informed family member may be able to help you manage some of these issues.

Getting Your Affairs in Order FAQs

Who should you choose to be your health care proxy?

If you decide to choose a proxy, think about people you know who share your views and values about life and medical decisions. Your proxy might be a family member, a friend, your lawyer, or someone with whom you worship.

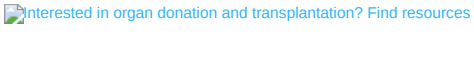
My aging parents can no longer make their own health care decisions. How do I decide what type of care is right for them?

It can be overwhelming to be asked to make health care decisions for someone who is no longer able to make his or her own decisions. Get a better understanding of how to make health care decisions for a loved one, including approaches you can take, issues you might face, and questions you can ask to help you prepare.

How do you help someone with Alzheimer's or dementia get their affairs in order?

A complication of diseases such as Alzheimer's is that the person may lack or gradually lose the ability to think clearly. This change affects his or her ability to participate meaningfully in decision making and makes early planning even more important. Find legal and financial planning tips, including information on advance directives, resources, and additional advance planning advice.

I am considering becoming an organ donor. Is the process different for older adults?



There are many resources for older organ donors and recipients available from the U.S. government. Find information for potential donors and transplant recipientsover age 50, including how to register to be a donor.

I want to make sure my affairs are in order before I die, but I'm not sure where to begin.

The National Institute on Aging has a resource about End of Life: Helping With Comfort and Care. This guide can help you and your loved ones discuss key issues at the end of life, including finding hospice care, what happens at the time of death, managing grief, and preparing advance directives along with resources for more information.

For More Information about Getting Your Affairs in Order

AARP
1-888-687-2277 (toll-free)
1-877-434-7598 (TTY/toll-free)
1-877-342-2277 (español/línea gratis)
member@aarp.org(email)
www.aarp.org

CaringInfo
1-800-658-8898 (toll-free)
caringinfo@nhpco.org (email)
www.caringinfo.org

Centers for Medicare & Medicaid Services
1-800-633-4227 (1-800-MEDICARE/toll-free)
1-877-486-2048 (TTY/toll-free)
www.medicare.gov

Eldercare Locator
1-800-677-1116 (toll-free)
www.eldercare.gov

National Elder Law Foundation
1-520-881-1076
info@nelf.org (email)
www.nelf.org

For more information on health and aging, including the free booklets *Long-Distance Caregiving: Twenty Questions and Answers* and *End of Life: Helping with Comfort and Care*, contact:

National Institute on Aging
Information Center
P.O. Box 8057
Gaithersburg, MD 20898-8057
1-800-222-2225 (toll-free)
1-800-222-4225 (TTY/toll-free)
niaic@nia.nih.gov(email)
www.nia.nih.gov
www.nia.nih.gov/espanol

Sign up for regular email alerts about new publications and other information from the NIA.

Visit www.nihseniorhealth.gov, a senior-friendly website from the National Institute on Aging and the National Library of Medicine. This website has health and wellness information for older adults, including information about planning for end-of-life care. Special features make it simple to use. For example, you can click on a button to make the type larger.

National Institute on Aging
National Institutes of Health
U.S. Department of Health and Human Services

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11.5.3.2: Estate and Gift Taxes

Estate Tax

The estate tax is a tax on your right to transfer property at your death. It consists of an accounting of everything you own or have certain interests in at the date of death.

Frequently Asked Questions on Estate Taxes

Find some of the more common questions dealing with basic estate tax issues.

Gift Tax

If you give someone money or property during your life, you may be subject to federal gift tax.

Frequently Asked Questions on Gift Taxes

Find some of the more common questions dealing with gift tax issues as well as some examples of how different types of gifts are treated.

Filing Estate and Gift Tax Returns

Learn when to file estate and gift taxes, where to send your returns, and get contact information if you need help.

What's New – Estate and Gift Tax

Stay up to date with the tax law changes related to estate and gift taxes.

Deceased Taxpayers – Probate, Filing Estate and Individual Returns, Paying Taxes Due

Information to help you resolve the final tax issues of a deceased taxpayer and their estate.

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11.5.3.3: Planning Your Own Funeral

To help relieve their families, an increasing number of people are planning their own funerals, designating their funeral preferences, and sometimes paying for them in advance. They see funeral planning as an extension of will and estate planning.

- Funeral Planning Tips
- Prepaying

Funeral Planning Tips

Thinking ahead can help you make informed and thoughtful decisions about funeral arrangements. It allows you to choose the specific items you want and need, and compare the prices offered by several funeral providers. It also spares your survivors the stress of making these decisions under the pressure of time and strong emotions. You can make arrangements directly with a funeral establishment.

An important consideration when planning a funeral pre-need is where the remains will be buried, entombed, or scattered. In the short time between the death and burial of a loved one, many family members find themselves rushing to buy a cemetery plot or grave — often without careful thought or a personal visit to the site. That's why it's in the family's best interest to buy cemetery plots before you need them.

You may wish to make decisions about your arrangements in advance, but not pay for them in advance. Keep in mind that over time, prices may go up and businesses may close or change ownership. However, in some areas with increased competition, prices may go down over time. It's a good idea to review and revise your decisions every few years, and to make sure your family is aware of your wishes.

Put your preferences in writing, give copies to family members and your attorney, and keep a copy in a handy place. Don't designate your preferences in your will, because a will often is not found or read until after the funeral. And avoid putting the only copy of your preferences in a safe deposit box. That's because your family may have to make arrangements on a weekend or holiday, before the box can be opened.

Prepaying

Millions of Americans have entered into contracts to arrange their funerals and prepay some or all of the expenses involved. Laws of individual states govern the prepayment of funeral goods and services; various states have laws to help ensure that these advance payments are available to pay for the funeral products and services when they're needed. But protections vary widely from state to state, and some state laws offer little or no effective protection. Some state laws require the funeral home or cemetery to place a percentage of the prepayment in a state-regulated trust or to purchase a life insurance policy with the death benefits assigned to the funeral home or cemetery.

If you're thinking about prepaying for funeral goods and services, it's important to consider these issues before putting down any money:

- What are you are paying for? Are you buying only merchandise, like a casket and vault, or are you purchasing funeral services as well?
- What happens to the money you've prepaid? States have different requirements for handling funds paid for prearranged funeral services.
- What happens to the interest income on money that is prepaid and put into a trust account?
- Are you protected if the firm you dealt with goes out of business?
- Can you cancel the contract and get a full refund if you change your mind?
- What happens if you move to a different area or die while away from home? Some prepaid funeral plans can be transferred, but often at an added cost.

Be sure to tell your family about the plans you've made; let them know where the documents are filed. If your family isn't aware that you've made plans, your wishes may not be carried out. And if family members don't know that you've prepaid the funeral costs, they could end up paying for the same arrangements. You may wish to consult an attorney on the best way to ensure that your wishes are followed.

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11.5.3.4: Saving and Investing

Find popular topics about saving and investing.

What's on This Page

- Manage Finances and Save Money
- Steps to Make a Budget
- Saving for Retirement
- Savings Bonds
- Treasury Securities
- Trusts
- Things to Consider Before You Invest
- Tools to Research Investments
- Choose a Financial Professional
- Pyramid Schemes

Manage Finances and Save Money

To help you manage your money and reach your saving goals:

Create a Budget

A budget is your plan for how you will spend money over a set period of time. It shows how much money you make and how you spend your money. Creating a budget can help you:

- Pay your bills on time.
- Save for unplanned expenses in the future.
- Prepare for retirement.

Download a budget spreadsheet that you can use to create your own to manage your monthly income and expenses.

Consider Ways to Save

Saving money involves looking for deals and buying the quality items you need at the best price. You can save money by comparison shopping, comparing the prices and quality of products you plan to buy. MyMoney.gov offers ways to manage your spending and build your savings accounts to achieve your saving goals.

Invest in Long Term Goals

Investing is a way to make money grow, by buying shares of stocks, mutual funds, bonds, or real estate. When you invest, there is risk that you could lose the money you invest; in general the greater the earnings you can make, the greater the risk. You can save for long term goals, such as retirement (PDF, Download Adobe Reader) and college education, by investing. Learn how to savefor emergencies, short term and long term goals, and become an informed investor.

Steps to Make a Budget

See this video to learn how to make a budget and plan your finances.

A link to an interactive elements can be found at the bottom of this page.

Saving for Retirement

As you approach retirement, there are many things to think about. Experts advise that you will need about 80 percent of your pre-retirement income to continue your current quality of life. The exact amount depends on your individual needs. Some important factors to consider include:

- At what age do you plan to retire?
- Can you participate in an employer's retirement savings plan, such as a 401(k) plan, or a traditional pension plan?
- Will your spouse or partner retire when you do?

- Where do you plan to live when you retire? Will you downsize, rent, or own your home?
- Do you expect to work part-time?
- Will you have the same medical insurance you had while working? Will your coverage change?
- Do you want to travel or pursue a new hobby that might be costly?

Resources to Help You Prepare for Retirement

To help you plan for retirement:

- Find practical tips for building retirement savings in the Top 10 Ways to Prepare for Retirement(PDF, Download Adobe Reader).
- Use a retirement calculator to find out the best age to claim your Social Security benefits.
- myRA can help you start saving for retirement when you don't have access to an employer-sponsored plan or lack other options to save.
- Find out the trade-offs between taking your pension in a monthly payment or in a lump sum(PDF, Download Adobe Reader).
- Social Security pays benefits that are on average equal to about 40 percent of your pre-retirement earnings. You may be able to estimate your benefits.
- Learn how you can boost your retirement savings at Investor.gov.
- If you have a financial advisor, talk to him or her about your plans.

Savings Bonds

U.S. savings bonds are one of the safest types of investments because they are endorsed by the federal government and, therefore, are virtually risk free.

Visit TreasuryDirect, a website from the U.S. Department of the Treasury, to learn about savings bonds, treasury bonds, and securities: how to buy and redeem your investments, what to do in the event of the death of an owner, and much more. TreasuryDirect is your one-stop shopping site for government securities where you can find information about the wide range of savings options, including EE/E, HH/H, and I savings bonds.

Manage and determine the value of savings bonds using these tools:

- Savings Bond Calculator
- Savings Bond Wizard
- Redemption Tables

You can give savings bonds for many occasions, such as birthdays, weddings, and graduations. Learn how to give savings bonds as gifts.

Treasury Securities

Treasury securities are debts issued by the federal government's Bureau of Fiscal Service. When you buy a treasury security, you are lending money to the federal government for a set amount of time. In return the government promises to pay you back the entire amount, also known as the face value, when the security matures.

There are several types of treasury securities:

- Treasury Bills—Short term securities that mature between a few days and 52 weeks.
- Treasury Notes—Medium term securities that mature between one and 10 years.
- Treasury Bonds—Long term securities, with a 30 year term that pays interest every six months, until the bond matures.
- Treasury Inflation-Protected Securities (TIPS)—Securities with principle values that adjust based on inflation, but with fixed interest rates for five, 10, or 30 year maturities.
- Savings Bonds—Securities that offer a fixed interest rate over a fixed period of time.
- Floating Rate Notes (FRNs)—Securities with variable interest rates, so that as bank interest rates increase or decrease, the interest rates on the FRNs change in the same direction.

You can purchase treasury securities for yourself or as gifts. You can purchase them in several ways:

- Banks, brokers, and other financial institutions through the Commercial Book-Entry System.

- Online through Treasury Direct
- Payroll savings plans
- Public auctions

Trusts

A trust (or trust fund) is a legal entity that allows a person (the grantor, donor, or settlor) to transfer assets to another person or organization (the trustee). Once the grantor establishes the trust, the trustee controls and manages the assets for the grantor or for another beneficiary—someone who will ultimately benefit from the trust. To help you decide if a trust is right for you, first consult a licensed attorney experienced with estate planning and trust matters.

Reasons to Set Up a Trust

Some common reasons for setting up a trust include:

- Providing for minor children or family members who are inexperienced or unable to handle financial matters
- Arranging for management of personal assets, if you become unable to handle them yourself
- Avoiding probate and immediately transferring assets to beneficiaries upon death
- Reducing estate taxes and providing liquid assets to help pay for them
- The terms of a will are public while the terms of a trust are not, so privacy makes a trust an appealing option.

Types of Trusts

Trusts can be living (inter vivos) or after-death (testamentary). A living trust is one that a grantor sets up while still alive and an after-death trust is usually established by a will after one's death. Living trusts can be irrevocable (can't be changed) or revocable (can be changed), although revocable trusts don't get the same tax shelter benefits as irrevocable ones do.

The most common type of trust is the revocable living trust. If there's a specific purpose in mind for the trust, dozens of different options exist (charitable trusts, bypass trusts, spendthrift trusts, and life insurance trusts). Two types of trusts can help pay for long-term care services:

- **Charitable Remainder Trusts** – This trust allows you to use your own assets to pay for long-term care services while contributing to a charity of your choice and reducing your tax burden at the same time. You can set up the trust so that you receive payments from the trust to pay for long-term care services while you are alive.
- **Medicaid Disability Trusts** – These trusts are limited to persons with disabilities who are under age 65 and qualify for public benefits. Parents, grandparents, and legal guardians often set up these trusts to benefit people with disabilities and a non-profit organization manages the assets. This is the only kind of trust that is exempt from rules regarding trusts and Medicaid eligibility.

Trust Scams and Fraud

If someone approaches you to set up a trust, be careful. Before signing any papers to create a living trust, will, or other kind of trust, make sure to explore all options and shop around to compare services. Some other tips to avoid trust scams and fraud include:

- Avoid high-pressure sales tactics and high-speed sales pitches.
- Stay away from salespeople who give the impression that specific organizations and recognized brands back or sell the trust.
- Research and get information about local probate laws from the Clerk or Register of Wills.
- If someone tries to sell a living trust to you, ask if they are an attorney. Some states restrict the sale of living trusts to licensed attorneys.
- If you buy a trust in your home or in another location that is not the seller's permanent place of business, remember you have the right to take advantage of the Cooling Off Rule and cancel the transaction within three business days.

Things to Consider Before You Invest

Do you have a financial goal in mind, such as saving for retirement, paying for college, or buying a new house? If so, then you may decide to invest your money to earn enough to fund your goals. Before you invest, make sure you have answers to all of these questions:

- **How quickly can you get your money back?** Stocks, bonds, and shares in mutual funds usually can be sold at any time, but there is no guarantee that you will get back all the money you invested. Other investments, such as limited partnerships, certificates of deposit (CDs), or IRAs, often restrict your ability to cash out your holdings.
- **What can you expect to earn on your money?** While bonds generally promise a fixed return, earnings on most other securities go up and down with market changes. Keep in mind, just because an investment has done well in the past, there is no guarantee it will do well in the future.
- **What type of earnings can you expect?** Will you get income in the form of interest, dividends, or rent? Some investments, such as stocks and real estate, have the potential for earnings and growth in value. What is the potential for earnings over time?
- **How much risk is involved?** With any investment, there is always the risk that you will not get your money back or the earnings promised. There is usually a trade-off between risk and reward–the higher the potential return, the greater the risk. While the U.S. government backs U.S. Treasury securities, it does not protect against loss on any other investments.
- **Are your investments diversified?** Some investments perform better than others in certain situations. For example, when interest rates go up, bond prices tend to go down. One industry may struggle while another prospers. Putting your money in a variety of investment options can reduce your risk.
- **Are there any tax advantages to a particular investment?** U.S. savings bonds are exempt from state and local taxes. Municipal bonds are exempt from federal income tax and, sometimes, state income tax as well. Tax-deferred investments for special goals, such as paying for college and retirement, are available that let you postpone or even avoid paying income taxes.

More Information on Investing

To learn more about investing, refer to these resources:

- You can find useful tips on investing at Investor.gov, a website from the Securities and Exchange Commission (SEC).
- For all of your investment-related questions, contact the SEC's Office of Investor Education and Advocacy.
- To get help preparing to invest, consult the Financial Industry Regulatory Authority (FINRA).

Tools to Research Investments

To help you make informed decisions when investing and avoid investment fraud, there are a variety of research tools available:

- Find investor news and alerts and a guide to investment products at Investor.gov, a website from the Securities and Exchange Commission (SEC).
- The SEC requires public companies to disclose financial and other information to help you make sound decisions. You can view the text of these files on EDGAR.
- The Financial Industry Regulatory Authority (FINRA) has up-to-date market data and information for a wide range of stocks, bonds, mutual funds, and other securities.
- If you are considering investing in collectible coins, refer to the U.S. Mint. Before you purchase coins or coin-related products, research the seller with a government agency, such as your state consumer protection office or the Federal Trade Commission (FTC).

Choose a Financial Professional

A financial professional can have multiple titles and be authorized to provide various services, including investment, financial planning, and insurance products. When researching a financial professional, find out what the titles and licenses mean, as well as the educational, work experience, and ethical requirements. Keep in mind that a professional title is not the same as a license. The Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and state regulators do not grant or endorse any professional titles.

When choosing a broker or investment adviser, research the person's education and professional history as well as the firm the person works for. Make sure you have answers to all of these questions:

- **Has the person worked with others who have circumstances similar to yours?**
- **Is the person licensed in your state?** Your state securities regulator lists individuals and firms that are registered in your state. Ask whether the regulatory office has any other background information. To find out how to contact your state securities regulator, consult the North American Securities Administrators Association (NASAA).

- **Has the person had any run-ins with regulators or received serious complaints from investors?** Contact your state securities regulator or the SEC. To review licensing, employment, and disciplinary information, use FINRA's BrokerCheck tool.
- **How is the person paid?** Is it an hourly rate, a flat fee, or a commission that depends on the investments you make? Does the person get a bonus from their firm for selling you a particular product?
- **What are the fees for setting up and servicing your account?**

Resources to Help You Choose a Financial Professional

For more information on choosing a financial professional, refer to these resources:

- The Commodity Futures Trading Commission's (CFTC's) SmartCheck allows you to check the background of financial professionals and stay informed on the latest fraud schemes.
  - To ask a question, report information, or file a complaint, contact the CFTC.
- The Financial Industry Regulatory Authority (FINRA) has information on the professional designations of financial professionals and the organizations that offer them.
- Both the North American Securities Administrators Association (NASAA) and the National Futures Association can offer helpful information on saving and investing.

Pyramid Schemes

A pyramid scheme, also known as Ponzi scheme, is an illegal form of multilevel marketing. In these scams, your ability to earn profits is based on the number of new participants you recruit, instead of the amount of products or services you sell. Sometimes there actually aren't any real products that are being sold. These types of schemes are common with investment and independent direct selling opportunities.

These schemes rely on the income from new participants in order to pay fake "profits" to people that have been part of the scheme for longer amounts of time. However, the scheme falls apart when there aren't enough new recruits to pay into the system, so the earlier participants no longer receive earnings.

Tips to Avoid Being a Victim

Take steps to protect yourself from being a victim of a pyramid scheme:

- Be wary of "opportunities" to invest your money in franchises or investments that require you to bring in more investors to increase your profit, or recoup your initial investment.
- Be wary if the company sells non-tangible products or technical services, rather than physical items.
- Independently verify the legitimacy of any franchise or investment with the Better Business Bureau, your state Attorney General, or any licensing agencies.
- Be skeptical of success stories and testimonials of fantastic earnings.

File a Complaint

If you are aware of a pyramid scheme or have been the victim of one, file a complaint with your state consumer protection office, state Attorney General, or the Better Business Bureau (BBB). If the pyramid scheme involved securities, you should also file a complaint with your state's securities administrator, or the Securities and Exchange Commission.

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CHAPTER OVERVIEW

12: Behavioral Finance and Market Behavior

This chapter looks at how both personal and market behavior can deviate from the classic risk-return relationships and the consequences for personal financial planning and thinking.

12.1: Introduction

12.2: Investor Behavior

12.3: Market Behavior

12.4: Extreme Market Behavior

12.5: Behavioral Finance and Investment Strategies

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12.1: Introduction

Learning Objectives

- Explain how *framing* alters financial decision-making despite identical outcomes.
- Identify key cognitive biases that affect individual financial behavior (e.g., loss aversion, anchoring).
- Recognize the central premise of behavioral finance: Psychological tendencies influence financial choices.

The Illusion of Rationality

> *"Of course I make good financial decisions. I think about them."*

We begin with a lie. It is a well-intentioned, self-affirming lie that most of us tell without knowing. We imagine ourselves as thoughtful, calculating, maybe even clever investors. We might not think we're Warren Buffett, but we're not out of control. We believe in the power of logic. We trust our reasoning.

But then, we're offered a choice.

The Two Gamble Problem

Imagine this:

Option A	Option B
A sure **gain** of $500	A 50 percent chance of gaining $1,000, and a 50 percent chance of gaining nothing

Most people choose Option A. Risk feels... risky. Now imagine a second version:

Option A	Option B
A sure **loss** of $500	A 50 percent chance of losing $1,000, and a 50 percent chance of losing nothing

Most people flip and choose Option B. The risk feels like a rescue. Same numbers. Same math. Different choices. What changed? Only the frame. This isn't just a trick. It's one of the most important realizations in behavioral finance: We don't choose based solely on outcomes; we choose based on how outcomes are presented. And once you see it, you can't unsee it.

The Bias Beneath the Frame

The example above is often used to introduce *loss aversion*, a cognitive bias that causes people to fear losses more than they value equivalent gains. Losing $500 feels worse than gaining $500 feels good. But it doesn't stop there. The moment you start looking at your financial choices through this lens, a whole internal architecture emerges that was invisible before, but is obvious now.

- You **overestimate the importance of vivid information** (*availability bias*).
- You **judge by similarity to known stories**, even when irrelevant (*representativeness bias*).
- You **cling to numbers you've already seen**, even if they're arbitrary (*anchoring bias*).
- You **avoid decisions with uncertain outcomes**, even if the odds favor you (*ambiguity aversion*).
- You **prefer choices that isolate wins from losses**, even when aggregation would serve you better (*choice segregation*).

These aren't personality flaws. They're universal and wired into our DNA. They're evolutionary holdovers from a world where reacting fast was more important than calculating well.

What You Think Shapes What You Choose

Most financial education starts with facts, formulas, or tips. But beneath those strategies are assumptions about what people *will* do or *should* do. The problem is this: Those assumptions are often based on the idea that people behave rationally. And that's where the illusion begins to crack.

If we were purely rational:

- We'd invest based on probabilities, not feelings.
- We'd never overpay for trends or panic during downturns.
- We'd view $1 earned and $1 saved as equally valuable.
- We'd make decisions today that serve our future selves tomorrow.

But we don't. Not consistently. Not even close. And here's the real kicker: We're usually not aware when we're being irrational. The result? Our decisions feel right, even when they are economically wrong. We *feel smart* while we're doing something dumb.

> "I knew this stock was going to bounce back."
>
> "I felt like this one was a winner."
>
> "Everyone else was getting in, and I didn't want to miss out."

These are perfectly human statements. And they are not rational investment strategies.

Welcome to Behavioral Finance

This is where behavioral finance begins. Behavioral finance is not a rejection of financial logic, but a revision of its assumptions. It says: What if the problem isn't the formula….but the person using the formula?

Behavioral finance doesn't discard traditional financial theory; behavioral finance re-frames financial theory to include psychology, emotion, and context. It brings the messy, unpredictable, fascinating reality of human behavior into the clean world of numbers and models.

It asks:

- Why do people chase losses?
- Why do bubbles inflate and burst?
- Why do people keep buying high and selling low?

And it starts with a single premise: We are not perfectly rational agents.

So What Now?

Maybe that's unsettling. Maybe it's a relief. Because if you're not purely rational, and no one else is either, then investing isn't just about finding the right numbers; investing is about understanding the people behind those numbers. This includes you.

In the next section, we'll go deeper into this behavioral architecture. You'll meet your biases not as abstract flaws, but as recognizable habits of mind. And just like that, the myth of the rational investor begins to unravel. The market isn't moved by

numbers alone. It’s moved by minds like yours.

Summary

We open the door to behavioral finance by confronting a comfortable lie - that we are rational decision-makers. The Two Gamble Problem introduces framing, revealing how presentation, not content, shapes choice. This section outlines a constellation of biases, including loss aversion, anchoring, and availability bias, showing how they emerge naturally from our evolutionary wiring.

- People often favor certainty in gains and risk in losses, even when outcomes are equivalent.
- Biases aren’t personal failings; biases are universal features of human cognition.
- Behavioral finance begins by re-centering the discussion from “perfect logic” to “predictable imperfection.”

Exercises

1. Can you recall a time when the way something was phrased influenced your decision more than what was being said?
2. Why might framing have evolved as a useful shortcut in our psychology?
3. Which bias listed (e.g., anchoring, availability, loss aversion) feels most familiar or personally recognizable to you?

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12.2: Investor Behavior

Learning Objectives

- Identify and define common cognitive biases (e.g., availability, anchoring, representativeness) and explain how they influence financial decisions.
- Interpret how these biases can distort the perception of risk, opportunity, and value in investing contexts.
- Recognize how multiple biases may interact to influence behavior in complex or uncertain financial situations.

Cognitive Bias

In theory, investors weigh risk and reward, sort through available data, and make rational decisions based on expected outcomes.

In practice, investors buy high because their cousin did, hold losing assets because selling feels like admitting defeat, and spend hours comparing five nearly identical options because they "want to be sure."

The mind wasn't built to optimize; it was built to survive. This means that even the best intentions are filtered through a series of mental shortcuts. These shortcuts, known as **cognitive biases**, are useful in a world of uncertainty. They help people make decisions quickly when there's no time to gather every data point. But in the world of investing, those same shortcuts can become costly detours.

Availability: What's Easy to Recall Feels Real

When a certain idea or memory comes to mind quickly, the brain treats it as more significant. If a news story about a market crash is fresh, risk feels imminent even if the probability hasn't changed. If someone just watched a viral clip of a "crypto millionaire," the odds of success seem higher than they are.

This is known as the **availability heuristic**. What's vivid becomes persuasive. What's recent becomes relevant.

It's not a flaw. It's a feature, but one that doesn't always serve financial reasoning.

A dramatic example sticks longer than a thousand insignificant ones.

Representativeness: The Pattern That Isn't There

Suppose a small tech firm launches with a charismatic founder and sleek product design. It feels like Apple in the early days. So investors treat it that way, even if the fundamentals are shaky.

This is **representativeness bias**: judging a situation by its similarity to a known category, rather than by analyzing its actual data. It's the mind mistaking a pattern for proof.

The market is full of echoes. Some are meaningful, and some are misleading. Just because something *looks* like a winner doesn't mean it *is* one.

Anchoring: The First Number Sticks

In the early days of the iPhone, Steve Jobs announced a $599 price tag. Then, almost as an afterthought, he said it would cost just $499. The crowd cheered. The first price, though never real, **anchored** expectations.

Anchoring is the tendency to rely too heavily on the first piece of information encountered, even when it's irrelevant. For investors, this can mean clinging to a previous stock price, treating it as the "true value," and resisting decisions that contradict it.

A stock that fell from $100 to $70 doesn't automatically become a good deal. But anchoring makes $100 hard to forget.

Overconfidence: Trusting the Gut Too Much

Overconfidence is among the most persistent of all cognitive biases. It's the belief - sometimes quiet, sometimes loud - that one's insight or intuition is above average.

It shows up in predictions that turn into convictions, trades made on hunches, and the belief that one's personal research can outperform the market.

It’s not about arrogance. It’s about trust misplaced in instinct.

Ambiguity Aversion: The Fear of the Unknown

Given a choice between a known risk and an unknown one, most people prefer the known, even when the unknown has better odds.

This is **ambiguity aversion**, and it can lead to missed opportunities. Investors might avoid newer asset classes or unfamiliar sectors, not because they’ve evaluated the risk, but because the uncertainty feels uncomfortable.

In markets, where the future is never certain, this discomfort can lead to avoidance when exploration might serve better.

Choice Segregation: Decisions in Isolation

A person may invest in five funds, each chosen independently for different reasons. But together, they might be heavily overlapping, redundant, or misaligned. **Choice segregation** is the habit of treating each decision on its own, without considering how it fits into the whole.

Investing isn't just about individual choices; it's about how they work together.

Framing: The Power of Presentation

Return to the scenario from the last section. Gains and losses are presented differently and, therefore, produce different decisions. That’s **framing** in action.

The brain doesn't evaluate outcomes in a vacuum; it evaluates them relative to how they are posed. A “90 percent survival rate” feels different from a “10 percent mortality rate,” even though they're identical.

In financial contexts, framing influences everything from portfolio descriptions to market headlines. The same investment can sound conservative or aggressive, depending on the language used.

Biases Don’t Happen in Isolation

Each of these tendencies can shape a decision, but they rarely appear alone. Instead, they weave together. Availability influences representativeness; anchoring reinforces overconfidence. Together, they form a network of intuitive reasoning that feels right but isn't always reliable.

These patterns don’t just distort perception. Over time, they shape behavior, and that behavior scales into the markets themselves.

As investors act on these patterns, they create trends, spikes, sell-offs, and bubbles. The result isn’t a market that moves purely on logic. It pulses with psychological rhythm.

Recognition Before Reaction

The goal isn’t to eliminate bias because that’s not possible. The goal is **recognition**. Once a bias is visible, it loses some of its grip. A pattern named is a pattern weakened. So when a familiar headline feels urgent, or when a stock price “feels right,” it's time to pause. That pause is where intuition meets inquiry. And inquiry is where better decisions begin.

In the next section, we’ll zoom out. Bias doesn’t live in a vacuum - it scales. The same cognitive patterns that influence individual decisions ripple across groups, firms, and entire economies. And when enough people follow a flawed instinct together? That’s not investor behavior anymore. That’s **market behavior**.

Summary

This section explores heuristics, the psychological shortcuts that guide financial behavior for better or worse. Our brains aren’t calculators; they’re survival machines that are trained to make fast judgments in uncertain conditions. That speed comes at a cost: We over-rely on vivid examples (availability), mistake resemblance for truth (representativeness), cling to first impressions (anchoring), and avoid what we don’t fully understand (ambiguity aversion). These aren’t isolated bugs. They’re systemic features of the mind.

- **Availability** bias makes recent or vivid information feel more important than it is.
- **Representativeness** causes us to see patterns where none exist.
- **Anchoring** locks us to initial values, even when irrelevant.

- **Overconfidence** inflates our trust in our own judgment.
- **Ambiguity aversion** makes us reject options we don't fully understand.
- **Choice segregation** leads us to consider financial decisions in isolation, undermining overall strategy.
- **Framing** distorts interpretation based on wording and context. The kicker? These biases often operate together, forming an invisible architecture of behavior that feels right, even when it's wrong.

? Exercises

1. Pick a recent financial or purchasing decision you made. Which bias or heuristic might have influenced it - availability, anchoring, or something else?
2. Thought Prompt: Why might ambiguity aversion cause investors to miss out on new opportunities, even when the math is in their favor?
3. You're reading a glowing news article about a startup described as "the next Tesla." What bias is being activated? How would you step back and assess the situation more critically?

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12.3: Market Behavior

Learning Objectives

- Explain how individual investor behaviors scale into collective market trends and distortions.
- Identify the behavioral finance mechanisms behind common market patterns, such as herding, momentum, and narrative-driven pricing.
- Evaluate the influence of cognitive biases and emotional factors on large-scale market movements.

The Investor *Is* the Market

Markets are often described in clinical terms: efficient, rational, self-correcting. They're portrayed as machines - cold and calculating, absorbing information and pricing it perfectly. But look closer, and the gears are not made of steel. They're made of **beliefs**, **decisions**, and **people**. The market doesn't exist apart from us. The market is us - scaled, networked, and amplified. The same biases that shape individual investors begin to echo, repeat, and cascade. Personal behavior becomes collective behavior. Investor psychology becomes **market behavior**.

A Crowd With a Spreadsheet

At any given moment, the market reflects the aggregated choices of millions - retail investors, institutional firms, analysts, bots, and algorithms - all responding to data, rumors, charts, gut feelings, and social cues. It would be neat to imagine the rational actors canceling out the irrational ones. But it rarely works that way. Biases aren't outliers. They're embedded.

Availability bias

Availability bias doesn't just affect one investor; it defines what gets reported and what gets ignored.

Anchoring

Anchoring shapes not just personal decisions, but entire pricing expectations.

Framing effects

Framing effects dictate how earnings reports are written and how headlines move markets.

When enough people follow the same mental shortcut, it stops looking like bias and starts looking like a **trend**.

Herding and Momentum

Investors often look to others for cues, especially in uncertain situations. If a stock is rising fast, the instinct is to assume that someone knows something. And no one wants to miss out. This is the root of **herding behavior**, where people follow the majority, not out of logic, but out of fear of being left behind.

In the early stages, herding can look like rational consensus. But as it builds, it generates **momentum** that is not grounded in fundamentals, but in psychology. Rising prices attract more buyers, which fuels more rises, which, in turn, attract even more buyers.

Until the story breaks.

The Role of Narrative

Markets don't just run on data. They run on stories.

- A new technology is "the next big thing."
- A company is "too big to fail."
- A coin is "going to the moon."

Narratives reduce complexity. They create a structure where data feels messy. They give investors a reason to believe, to buy, to hold, or to run. But stories also compress nuance. They blur the line between facts and assumptions. They're sticky - and sometimes, they're wrong.

Mispricing and the Myth of the Perfect Market

In theory, if a stock is under-priced, savvy investors will buy until its price reflects its true value. This is **arbitrage**, and it's one of the core self-correction mechanisms of the **Efficient Market Hypothesis**.

But arbitrage assumes that prices are only distorted by temporary informational gaps. Behavioral finance suggests something deeper: That prices can remain misaligned not just because of a lack of information, but because of **collective error**.

If everyone is anchoring on past performance, telling themselves the same story, and resisting the urge to be the first to exit the herd, then bad things may ensue. The correction may come, but not before a bubble forms, the narrative breaks, and a crash overwhelms the market.

Enter the Machines

Now add speed.

In today's markets, algorithms and bots handle vast volumes of trades in milliseconds. These systems don't feel fear or euphoria, but they are still shaped by human assumptions - coded by people, trained on historical patterns, and tuned to respond to other traders' behavior.

In other words:

> *Quants and bots don't eliminate human bias - they just automate it.*

Behavioral patterns baked into code can create feedback loops, flash crashes, and self-reinforcing volatility. And while a human trader might pause, a machine never blinks.

From Quirks to Currents

The biases explored earlier weren't just academic terms. They were clues, hints about how markets move, not because they must, but because we make them.

The upward surge of a hyped stock? This momentum is fueled by **availability**, **herding**, and **representativeness**. The slow decline of a once-loved company? This is likely the result of anchoring, overconfidence, and narrative inertia. The panic of a sudden sell-off? This happens when loss aversion is amplified by ambiguity aversion and spread through a hundred screens at once.

These aren't exceptions. They're patterns. The market doesn't ignore human behavior. Instead, it reflects it.

The Crowd Is Not Always Wrong - But It Is Always Human

To say the market is behavioral is not to say it is irrational at every moment. It's to say that rationality is **bounded** - shaped by fear, hope, stories, timing, and the structure of decision-making itself.

Some investors beat the crowd. Some predict crashes. But most are shaped by it. They surf waves they didn't create, chase signals they half-understand, and react to a crowd they both follow and help form.

Understanding markets, then, isn't just about reading graphs. It's about recognizing the **psychology beneath the price**.

In the next section, we'll introduce the model that once promised to explain it all. This is a theory of elegant simplicity, where markets *price in* all information and mispricing vanishes in a blink.

It's called the **Efficient Market Hypothesis**. And it's about to meet its behavioral counterpart.

Summary

What begins in the mind of a single investor doesn't stay there. This section zooms out, revealing how personal bias becomes market behavior. From the aggregation of individual decisions comes something much larger: pricing momentum, bubbles, and even systemic risk.

Key dynamics include:

- **Herding:** Following the crowd not for insight, but to avoid isolation or fear of missing out (FOMO).
- **Momentum:** Rising prices attract more buyers, creating a self-reinforcing cycle.
- **Narratives:** Investors lean on stories, not just spreadsheets, to explain value.
- **Mispricing:** Collective bias can keep prices out of sync with fundamentals far longer than expected.
- **Automation:** Algorithms don't erase human flaws; they repeat them at scale and speed.

The market, in this view, is not an objective judge but a mirror that reflects millions of minds, with all their brilliance and blind spots.

Exercises

1. Think of a recent market trend or viral stock surge. What human behaviors (e.g., herding, narrative, overconfidence) do you think contributed to it?
2. "The market is made of beliefs." What does this statement suggest about the limits of data in predicting market behavior?
3. A sudden sell-off hits a sector despite no major news. Headlines point to investor anxiety. What behavioral explanations could you propose for this market movement?

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12.5: Behavioral Finance and Investment Strategies

Learning Objectives

- Recognize how awareness of bias can inform practical investment strategy.
- Describe behavioral techniques (e.g., automation, diversification, reflective risk assessment) that help manage common cognitive pitfalls.
- Reflect on their own financial behavior, risk preferences, and decision-making patterns.

So What Do You Do?

By now, the idea of a perfectly rational investor or a perfectly rational market feels more like a myth than a model. We've walked through the architecture of behavior. We've seen how stories move prices. Algorithms don't escape emotion, but they do automate its patterns. Confidence becomes momentum, and unchecked bias can echo through an entire economy.

But this isn't a cause for despair. It is quite the opposite. It's clarity. Once you understand what shapes decisions - yours and everyone else's - the market starts to look different. It looks less like a game of genius and more like a system of habits, stories, feedback loops, and time. And that brings us to the real question:

> *How do people invest with that awareness in mind?*

A New Lens, Not a New Rulebook

Understanding behavioral finance isn't about becoming hyper-vigilant. It's not about second-guessing every instinct or chasing some impossible objectivity. It's about learning to recognize the **pattern behind the price** and the tendency behind your decision-making. This recognition doesn't mean you'll avoid every mistake. It means you'll **understand what the mistake is** when it happens. And that can change everything.

From Bias to Strategy

Investing, after all, isn't just numbers on a screen. It's behavior over time. When people structure their portfolios, they often find themselves building around truths that once seemed theoretical, but now feel deeply personal:

- That **diversification** isn't a trick, but a hedge against our uncertainty
- That trying to **time the market** usually reflects confidence we haven't earned
- That **automating contributions** can help bypass the impulse to buy high and sell low
- That **risk** is not a single number, but a shape that changes with life stage, income, experience, and mindset

These aren't rigid rules. They're adaptive tools built not in defiance of human behavior, but in cooperation with it.

A Quiet Kind of Discipline

In the beginning, many investors think of success in terms of cleverness. They want to find the edge, spot the trend, and beat the system. But the longer people stay in the market, the more they tend to shift their focus from performance to process. Instead of prediction, they rely on preparation. People learn to be resilient instead of just trying to be right. The market doesn't reward fearlessness. It rewards **clarity**, **patience**, and the ability to stay grounded when others drift.

Investing as Self-Knowledge

There is no single right portfolio, perfect allocation, or universally optimal strategy. However, there is a set of decisions made over time and shaped by circumstance and belief. Understanding investing is not just about understanding assets - it's about understanding **yourself**:

- What are you afraid of losing?
- What stories do you believe about risk?
- What patterns pull you in - and which ones push you away?
- How does your confidence shift when the market moves?

Behavioral finance doesn't answer these questions. But it helps you ask them more clearly.

The Market as Mirror

In the end, the market reflects all of us: our logic and our fear, our research and our rumor, our vision and our blind spots. To participate in it is not just to make financial decisions; it is to engage in a conversation with millions of others, all trying to do the same thing. And in that complexity, something remarkable emerges:

Not a perfect system or a predictable outcome, but a pattern of behavior that, once seen, can't be unseen.

If you understand that (even in fragments), then you're already ahead of where most investors start. You're not just watching prices. You're watching the patterns that shape them. And that's where the study of investment options begins. Studying options does not begin with a stock pick or product comparison, but with a clearer sense of the terrain, and a growing awareness of how people - including you - move through it.

Summary

Behavioral finance isn't just a diagnosis; behavioral finance is a starting point for strategy. This final section reframes investing not as a test of brilliance but as a practice in discipline and self-awareness.

- **Bias is inevitable**, but naming it gives it less power.
- Investors can build **process-oriented strategies** - diversify, automate, avoid timing games, and focus on resilience.
- Success shifts from cleverness to **clarity** - knowing your tendencies, not beating the market.
- The market reflects human psychology. The better you know yourself, the better your financial decisions.

Investing, at its core, is an exercise in self-knowledge. The goal isn't perfect rationality; the goal is resilient behavior.

Exercises

1. Which idea from behavioral finance has changed how you think about your own financial behavior? How might you adapt your strategy as a result?
2. If investing is more about managing behavior than predicting outcomes, what kind of "tools" does that require? What would a behavioral toolkit include?
3. You tend to panic and sell when the market dips, then hesitate to buy when it rebounds. What behavioral pattern is this? What strategy could help you break the cycle?

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CHAPTER OVERVIEW

13: Introduction to Investing

This chapter presents basic information about investment instruments and markets and introduces modern portfolio theory, explaining the classic relationship between risk and return.

13.1: Why Invest At All?
13.2: Investing vs. Saving
13.3: Risk and Return
13.4: Goals to Strategy
13.5: Instruments as Tools
13.6: Getting Help

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13.1: Why Invest At All?

Learning Objectives

- Describe how investing relates to future goals and financial surplus.
- Recognize the role of time in building wealth through investment.
- Reflect on personal readiness to begin investing and identify motivating factors.

1. Why Invest at All?

Most people don't start their investing journey with a spreadsheet. They start with a question:

> *What should I do with my money?*

Maybe you've saved a little more than expected. Maybe a side hustle is starting to pay off. Or maybe a raise, a refund, or a gift landed in your account and now you're wondering whether to spend it, save it, or invest it.

That question is more powerful than it seems. It means you're starting to think not just about *money*, but about *time*. Specifically: How can the money you have today help you build the life you want tomorrow?

That's what investing is really about. It's not about guessing the stock market or chasing headlines. It's about **putting today's surplus to work for future goals.**

From Surplus to Strategy

If you've read *Market Behavior*, you already know that financial decisions don't always come down to logic. We're human. We're biased. We overestimate our control, underestimate risk, and react emotionally to markets. But now, we shift perspective. Instead of thinking about how *markets* behave, we turn inward:

> *How do **I** behave when I have more money than I need today?*

This moment, when your income exceeds your immediate spending, is when investing becomes possible. It is not required or automatic, but it is *possible*. What you do with that possibility is where the journey begins.

A Familiar Face

Let's check in with Alex and Jordan.

Alex just got his first salaried job and is surprised by how much is left at the end of each month.

Jordan, a little further along in her career, has been setting aside money in a savings account, but inflation has been eroding its value.

Both are asking: *What next?*

- For Alex, it's about learning the landscape.
- For Jordan, it's about doing more with what's already been saved.

They're in different places, but they're both standing at the entrance to the same road.

Investing Is Not One Decision - It's a Series

Some people consider investing a *leap of faith*. In reality, it's more like climbing a ladder step by step. The first step might be learning how a retirement account works. The second might be choosing between a savings account and a brokerage account. The third might be comparing different investment options and deciding how much risk you're comfortable with.

You don't have to start with stocks. You don't even have to start big.

You just have to start with a question:

> *What's something I want for my future that I can start working toward now?*

Where We're Headed

In this section, we'll walk through the foundational ideas behind investing, not just the "how," but the "why." We'll explore:

- How investing differs from saving
- Why risk and return are always connected
- How to set goals and plan around them
- And how to evaluate investment tools and the people who offer them

But before we go there, pause for a moment and consider:

- Do you see yourself as an investor?
- What future are you building toward?

Don't worry if the answers feel vague right now. That's what the next few sections are here to explore.

Summary

Investing doesn't begin with products or platforms. It begins the moment when you realize that today's surplus can serve tomorrow's goals. This section introduces the fundamental why behind investing.

- Investing occurs when income exceeds immediate spending and a person begins to plan for the future.
- It's not just about money. It's about shaping a future life using financial decisions made today.
- Alex and Jordan, two recurring characters, highlight different paths into investing: curiosity and re-evaluation.
- Investing is a process of gradual, intentional steps, not a one-time leap.

Before diving into mechanics, this section invites students to connect investment decisions to purpose, timing, and self-perception.

Exercises

1. Have you ever experienced a financial surplus? What did you do with it? How did you decide?
2. Why do you think investing often begins with a question rather than a plan? What does that suggest about how people learn?
3. Imagine you just received a bonus or an unexpected gift. List three future-oriented goals you might use that money to pursue. How would investing support those goals?

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13.2: Investing vs. Saving

Learning Objectives

- Differentiate between saving and investing based on access, risk, and timeline.
- Identify the role of time in compounding investment returns versus savings stability.
- Evaluate how to balance saving and investing based on personal financial goals.

What's the Difference?

Alex's bank app lights up when his direct deposit lands. Rent is covered, bills are paid, and there's still a little left over. Jordan's account balance has been slowly growing, but lately she feels like she is *just* keeping up with expenses.

Both wonder the same thing:

> *Should I just keep this in savings, or is it time to invest?*

It's a simple question, but beneath it lies a powerful distinction that shapes everything that follows.

What Savings *Does*

Saving is about **safety**. It's keeping your money close, within reach, ready to respond to life's unpredictability. An emergency fund is for saving and planning for a new laptop next year is also for saving.

You use savings when you want:

- **Access** without delay (liquidity)
- **Stability** without fluctuation (minimal risk)
- And **certainty** about short-term goals (clarity of timeline)

In savings accounts or money market funds, your money doesn't do much, but it also doesn't wander far. That's the point. You're paying for peace of mind by sacrificing potential growth.

What Investing *Asks*

Investing is different. It asks you to **delay access**, **tolerate uncertainty**, and **accept fluctuation** in exchange for the possibility of greater growth over time.

You invest when your timeline stretches beyond the horizon of next month or next year. It might be five years away, or ten. It might not even be a specific date, just a vision - financial independence, a future home, a secure retirement. In these cases, holding cash becomes a risk in its own right. Inflation quietly erodes purchasing power. Growth opportunities go untapped.

Investing doesn't promise more; it just makes *more* possible.

Time: The Quiet Multiplier

Here's where the real magic happens.

The **longer** your money stays invested, the more time it has to benefit from **compounding**, growth on top of growth. Even modest returns, given time, can become meaningful.

- When you're just starting out, you may not have much to invest, but you do have **time** on your side.
- If you are starting a bit later in your career, you may have **more to invest**, but you must think carefully about how much time each goal truly requires.

Time isn't just a number. It's part of your strategy. Saving might preserve what you have, but investing, over time, can **amplify** it.

Tension, Not a Tug-of-War

One of the biggest misunderstandings is the notion that saving and investing are opposites. They aren't. They're partners in a well-balanced financial plan.

- **Saving** prepares you for the near future.
- **Investing** prepares you for the future.

The real question isn't "which one?" It's **how much of each**, and **when**.

A Personal Check-In

Ask yourself:

- Do you have enough saved to weather an unexpected expense?
- Do your savings fully cover your short-term goals?
- Is there money that could work harder if only you gave it a longer leash?

Building an emergency fund is the first step. But once that fund was in place, the leftover money could begin to serve future goals. You may split future deposits - some into savings, some into investments - each with its own job to do. You don't have to decide everything right now. Recognizing the difference between saving and investing is what turns good intentions into smart action.

Summary

This section contrasts the core purposes of saving and investing. While saving provides liquidity and security for short-term needs, investing is about long-term growth at the cost of short-term certainty.

- **Saving** favors stability, liquidity, and near-term certainty.
- **Investing** involves delay, volatility, and potential for growth.
- **Time** is not just a feature; it's the foundation of investing's value.

It is essential to explore both saving and investing, as well as how to blend the two. Move beyond binary thinking and consider how both strategies serve different roles within a financial plan.

Exercises

1. Think of a recent financial decision. Did you treat it as saving or investing? What factors guided your choice?
2. Why might someone view holding cash as safe, even when inflation reduces its value? What psychological factors reinforce that belief?
3. Create a sample allocation: 70 percent to savings and 30 percent to investing. What kind of goals might match each category? How would those ratios shift over time?

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13.3: Risk and Return

Learning Objectives

- Explain the concept of investment risk and how it relates to return.
- Evaluate personal risk tolerance using emotional and time-based factors.
- Distinguish between different types of risk and their impact on investment choices.

The Trade You Can't Avoid

Alex is excited. He just read that a certain mutual fund returned over 15 percent last year. That's way more than his savings account. "Why wouldn't I just put all my money there?" he wonders. Jordan hears the same stat, and she winces. "Fifteen percent? That probably means it could *drop* just as fast."

Two people hear the same fact, but experience two completely different reactions. Neither is wrong, but both are staring down the same question:

> *How much am I willing to risk to get a better return?*

Which Would You Choose?

Try this:

- **Option A:** You earn exactly 2 percent every year. No surprises. No losses.
- **Option B:** Some years, you earn 12 percent. Other years, you lose 5 percent. Over time, you might average around 6 percent, but it's never guaranteed.

Now ask yourself:

- Which option feels safer?
- Which one sounds smarter?
- Which one are you more *comfortable* with?

That's not a quiz. It's the tension at the heart of every investment decision. And it doesn't go away, because **there's no return without risk.**

So What *Is* Risk?

Most people think of risk as "losing money." But in investing, it's more than that. Risk is the **range of possible outcomes** that exists in the space between what you expect and what actually happens. Sometimes that means losing. Sometimes it just means *not gaining as much as you hoped*. Here's the paradox:

The **bigger the possible upside**, the **wider the range of outcomes**. That's why savings accounts don't swing wildly. But they also don't grow much. That's why stocks can build wealth or leave you wondering what just happened.

The Unexpected Always Arrives

Maybe you expect a 7 percent return this year. Great. But the market doesn't read your plan. A headline, a war, a company's misstep, or a surge in demand - any of these can jolt prices up or down. Your return is real only when time passes and the dust settles.

Alex thought that a high-return fund sounded like a sure thing until he saw it lose 3 percent the following month. Jordan remembered losing money in the 2008 crash, and she felt that echo every time the market dipped.

Risk doesn't just exist on paper. It's emotional and it's lived.

What Shapes *Your* Risk Tolerance?

There's no universal answer. But you can explore it by asking these questions:

- How long can I go without this money?

- How would I feel if my investment were to drop 10 percent this year?
- Would I sell out of fear or stay in for the long run?

That tension between your ability to take risks and your willingness to stomach them is what defines **risk tolerance**.

Some investors want calm waters. Others are okay with storms, knowing what might be waiting beyond the horizon. Even a small loss can make an investor anxious. One may decide to keep some money in safer options. Others realize they may be overestimating their tolerance and dial back some of their riskier bets. It isn't because of fear. It was a decision aligned with personal risk tolerance.

The Trade You Can't Avoid, But *Can* Navigate

You'll never fully escape the risk-return tradeoff. But you can approach it on your terms.

- Think in timelines. What money do you need soon? What money can grow over the years?
- Think in roles. Which dollars protect your present? Which will build your future?
- Think in comfort. Not every opportunity is for you, and that's okay.

You don't have to chase the highest return. You just have to **understand the price you pay to pursue it**.

Summary

Risk is unavoidable, but it's also manageable. This section examines the tension between risk and return and how this tradeoff influences every investment decision. It introduces risk not just as a mathematical concept, but as a lived experience.

- Greater returns require greater tolerance for fluctuation and uncertainty.
- Risk is shaped by time horizon, emotional resilience, and financial flexibility.
- The difference between expected outcomes and actual experiences can trigger emotional responses, such as fear or overconfidence.

Reflect on your own risk profile - what you can afford to lose, what you can emotionally handle, and how long you can stay invested.

Exercises

1. Recall a time you took a financial risk. What was the outcome, and how did it feel? Would you take that same risk again?
2. Why might two people react differently to the same investment? What internal and external factors shape those responses?
3. You're offered two investments: One guarantees a 2 percent annual return, the other averages 6 percent but can lose value in bad years. Which would you choose and why?

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13.4: Goals to Strategy

Learning Objectives

- Describe the components of an Investment Policy Statement (IPS) and their purpose.
- Construct a basic personal investment plan aligned with specific financial goals, risk tolerance, and constraints.
- Evaluate the tradeoffs between return objectives, risk personality, and life circumstances.

From Goals to Strategy

By now, Alex and Jordan both feel more confident about *why* investing matters and how it differs from saving. They understand that risk is a part of the deal, not a glitch in the system.

But there's still a big question hanging in the air:

> *How do I actually decide what to invest in?*

That's where planning comes in. And not the vague, "I should really do this someday" kind. We're talking about turning goals into strategies and strategies into action.

The Investment Policy Statement (IPS): Your Personalized Blueprint

You don't need a finance degree to build a smart investing plan. What you *do* need is a framework to clarify your thinking and maintain consistent decisions over time.

Enter the **Investment Policy Statement**, or IPS. It may sound technical, but it's really just a written summary of four things:

1. What you're trying to **achieve**
2. What kind of **risk** you're willing to take
3. What **constraints** or **needs** you have to plan around
4. How you'll **measure** whether you're on track

It's a living document, your compass. And it evolves as your life does.

Step One: Set the Goalposts

Imagine Alex wants to buy a home in seven years. Jordan is thinking about retiring in fifteen years. Each has a different **return objective—**the amount of growth their money needs to achieve in a given time. The clearer the goal, the easier it is to plan for it.

If you say, "I want to grow my wealth," that's a start. But "I want $30,000 in seven years for a down payment on a home" is a goal you can calculate backward from.

This part of the IPS keeps you grounded. It forces you to be honest about *how much*, *by when*, and *why*.

Step Two: Know Your Risk Personality

Some people love roller coasters, while others prefer to keep their feet on the ground. The same goes for investing.

Your **risk tolerance** isn't just about math; it's about mindset. It includes

- Your **ability** to take risks (based on your time horizon, current savings, and income)
- Your **willingness** to take risks (based on your comfort with uncertainty, past experiences, and temperament)

Alex knows he won't need this money for a decade, and that gives him more flexibility. Jordan remembers panicking during the last market drop and selling early. That shaped her willingness.

When you know your limits, you build a plan that respects them. That's how you stay invested when things get rough.

Step Three: Map Your Constraints

Investing doesn't happen in a vacuum. You have real-world boundaries to consider:

- **Liquidity needs** – Will you need to withdraw this money soon?

- **Time horizon** – How long can you let it grow?
- **Taxes** – Are there better or worse places to hold these investments?
- **Legal or structural limits** – Are you investing through a trust or foundation?
- **Personal values** – Do you want to avoid certain industries or support others?

Alex, for example, might decide to exclude fossil fuel companies from his portfolio. Jordan may want to invest only in assets that she can access without penalty in case of job loss.

These constraints don't block your plan; they shape it. And the better you define them, the fewer surprises you'll face down the road.

Putting It All Together

Here's the magic of the IPS: It connects your goals, your mindset, and your life realities into a single strategy.

- If your goals require high returns but you're not comfortable with high risk, you'll need to adjust something.
- If you want to invest aggressively but may need the money in two years, that's a red flag.

The IPS forces you to reconcile hope with habit, and dreams with data. It doesn't guarantee success, but it dramatically increases your odds of making choices you can live with, even when markets get turbulent.

Ready to meet the tools that can help make your IPS a reality? Next up: **The Instruments Are Just Tools,** and we'll help you choose the right ones for the job.

Summary

This section introduces students to the concept of strategic planning for investing. Rather than treating decisions as ad hoc, it encourages the use of a personalized framework, the Investment Policy Statement (IPS).

Core structure

1. Set clear and measurable goals (e.g., timeline, dollar amount, purpose)
2. Understand your ability and willingness to take risks
3. Map out personal constraints - liquidity needs, legal limits, values

An IPS draft reflects where you are and where you want to go. The section shows how a written plan provides both structure and clarity in the face of market uncertainty.

Exercises

1. Think of a future financial goal you have. What is your timeline, risk comfort, and one constraint that might affect how you pursue it?
2. Why is it valuable to write down your investment goals and boundaries, even if you're the only one who sees them?
3. Draft a simple IPS: define one goal, your risk level, and a constraint. What type of investments would or wouldn't fit that strategy?

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13.5: Instruments as Tools

Learning Objectives

- Differentiate between common investment instruments based on purpose, risk, and time horizon.
- Select appropriate financial tools to match specific goals and strategies.
- Analyze how mismatches between tools and goals can impact investment success.

An Investing Toolkit

Alex is ready to start investing. Jordan is revisiting old choices with fresh eyes. Both sit down to make decisions, and both immediately hit the same wall:

> *Should I buy stocks? Bonds? What about a fund? Or real estate? Am I supposed to know all of this already?*

It's easy to feel like investing is about picking the right product. But here's the truth most people miss:

Investing is not about finding the "best" tool. It's about choosing the *right* tool for *your* job.

Tools Don't Make the Plan. They *Serve* It

You wouldn't use a hammer to fix a leaky faucet or a screwdriver to paint a wall. Financial instruments are the same way. They don't define your strategy, they **express** it.

- Stocks may be right when growth is your priority and time is on your side.
- Bonds may be suitable when you need income or stability.
- Funds offer built-in diversity.
- Real estate can build equity, but with different risks and time horizons.
- Cash equivalents protect liquidity but don't generate significant growth.

The point isn't which is better. It's about choosing the financial instrument that best **matches your investment** strategy, goals, risk profile, constraints, and timeline.

It's Not Just About "Where" You Put Your Money

Let's flip the question investors often ask:

Instead of *"What should I invest in?"* ask *"What am I trying to accomplish with this money?"*

Financial planning serves many different goals: a short-term emergency fund, a long-term plan for a future business, retirement, or your child's education. Each of those goals could lead to a different set of investment choices, even if they both use the same underlying tools.

One Size Never Fits All

This is where many new investors go wrong: They hear a friend say, "Buy this stock," or read a headline about "The Next Big Thing," and they jump in without checking if it aligns with *their* investment plan. An excellent investment for someone else might be a terrible choice for you.

Why? Because **risk tolerance, timelines, and goals vary**, so should strategies.

That's why tools aren't inherently good or bad. They're contextual. They need to be matched to the *job they're hired to do*.

Preview, Not Deep Dive

In the next section, we'll walk through the most common investment instruments one by one: what they are, how they work, and when they might make sense.

You'll learn

- How stocks, bonds, and funds differ
- Why diversification matters
- And how real people mix these tools to fit their lives

But for now, take this with you:

Choosing an investment instrument **before** you know your goals is like packing for a trip without knowing the destination.

Your first investment doesn't need to be flashy - it just needs to match your five-year plan. Examine your portfolio with a fresh perspective. Realize that some of the tools may serve your current purpose, but others may not. That evaluation is a decisive moment of realignment. Tools can empower, but only if you know what you're building.

Let's wrap this journey with one final insight: how to evaluate help, avoid traps, and stay in charge of your financial future.

Summary

This section reframes investment instruments not as magic bullets, but as tools to be matched to specific jobs. Stocks, bonds, mutual funds, real estate, and cash equivalents each serve a role, but their usefulness depends on the clarity of purpose.

- Tools express strategy; they don't define it.
- The right tool depends on timeline, risk tolerance, and liquidity needs.
- No tool is inherently good or bad; it is only more or less appropriate for a given context.

The section cautions against trend-chasing and emphasizes intentional alignment between instruments and goals. Strategic investing begins with purpose, not products.

Exercises

Explain your choices.

1. Think of a financial tool you've heard about (e.g., stocks, bonds, mutual funds, real estate). What kind of goal would it best serve? What might make it a poor fit?
2. Why do people often treat investment tools like trends or shortcuts? What might help them think more like planners and less like gamblers?
3. Match each of the following tools to the appropriate use/scenario:

A. stock
B. bond
C. fund
D. real estate

1. building long-term wealth
2. preserving capital
3. earning income
4. maintaining liquidity

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13.6: Getting Help

Learning Objectives

- Identify different forms of financial guidance and evaluate their alignment with investor goals.
- Distinguish between helpful and potentially harmful sources of financial advice.
- Reflect on the role of personal responsibility when seeking professional or automated.

Knowing Who to Trust

By now, Alex and Jordan both have a clearer picture of where they want to go, what kind of risks they're comfortable with, and how their investments might support that journey. But a final, familiar question remains:

> *"Do I need someone to help me with this?"*

The answer is classic personal finance: *It depends*. But let's reframe the question. Instead of asking *whether* to get help, ask:

"What kind of help will keep me in control of my financial future?"

The Responsibility Always Stays With You

Even if you hire an advisor, use an app, or let someone else manage the portfolio, the responsibility always stays with you.

You are still the decision-maker.

And that's a good thing. It means your goals, values, and constraints—not someone else's incentives or assumptions—stay at the center of the strategy. Hiring a financial advisor does not mean handing off responsibility. Guidance is helpful, but **delegating isn't the same as disengaging**.

What "Help" Looks Like

Help can take many forms:

- A **human advisor**, who listens, asks questions, and tailors a plan
- A **robo-advisor**, which uses algorithms to invest your money based on your profile
- A **platform with tools and education**, letting you learn and invest at your own pace
- **Mentors, community, and resources** that help you interpret what you're seeing

There's no one right choice. The right kind of help is the one that **fits your needs without blinding you to the process**.

A Quick Test: Who's Really Working for You?

Here are a few questions worth asking anytime you consider professional guidance:

- Are they required to act in your best interest (*fiduciary standard*)?
- How are they compensated - by a flat fee, commission, or a percentage of assets?
- Do they explain things clearly, or try to make it sound too complex to question?
- Do they adjust their approach based on your IPS, or push you toward what *they* like?

If the answers don't build trust, it might be time to look elsewhere.

Your Tools Are Only as Smart as Your Decisions

The financial world can sound intimidating on purpose. However, the truth is that the core ideas of investing are learnable. The best decisions are yours to make. The right kind of help is the kind that makes you *more* confident, not more confused. You don't have to become an expert overnight. But you should always be an *informed participant* in your financial life.

Final Thought: From Idea to Action

Investing isn't just about money; it's about shaping your future. You don't need to be wealthy to get started. You don't need to time the market perfectly. You just need clarity, a plan, and the courage to begin.

Start where you are. Invest what you can. Learn as you go. And always remember: *You're not alone, but you are in charge.*

Summary

The final section shifts from strategy to support, helping students evaluate what kind of guidance, if any, might serve their investing journey. Whether it's a human advisor, robo-advisor, app, or mentor, the core message remains the same: Responsibility can be shared, but never outsourced.

- Even with professional help, you remain the ultimate decision-maker.
- Advisors should be evaluated based on transparency, alignment, and clarity, not complexity or charm.
- The right kind of help empowers you; the wrong kind of help confuses or controls.

A fiduciary mindset and a strong personal strategy (like an IPS) make it easier to seek help without surrendering control.

Exercises

1. Have you ever followed advice (financial or otherwise) that didn't align with your goals or values? What did you learn from the experience?
2. Why is it important to ask how an advisor is paid or whether they are required to act in your best interest? What could happen if you don't?
3. Make a short checklist for evaluating financial guidance. What questions would you ask a potential advisor, platform, or service?

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CHAPTER OVERVIEW

14: Investment Options and Opportunities

This chapter investigates investments commonly made by individual investors and their use in and risks for building wealth as part of a diverse investment strategy.

14.1: Investing Fundamentals
14.2: Instruments
14.3: Markets
14.4: Strategies
14.5: Research
14.6: Formulas and Metrics

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14.1: Investing Fundamentals

Learning Objectives

- Identify the motivation behind expanding one's understanding of investment tools and options.
- Recognize how different investment choices support different personal goals.
- Reflect on your current confidence in choosing between investment vehicles.

Introduction: Real Investing

Most people don't start their investing journey with a financial degree or a five-year plan. They start with a question:

> *What should I do with my money?*

Maybe you've heard about stocks from a friend who made a lucky trade. Maybe someone told you to "diversify" or warned you about market crashes. Or maybe you just want to stop feeling behind when people talk about 401(k)s, Roth IRAs, or interest rates.

This introduction to investment options and opportunities is designed to help you place investing into the context of personal risk preference and life stage priorities. We'll explore the landscape of investing through five structured parts:

Instruments	Markets	Strategies	Research	Math & Metrics
The core investment tools (like stocks, bonds, funds, and real estate), how they work, and how they differ.	Where those investments are bought, sold, and priced. We'll look at the systems and players that keep it all moving.	How people use these tools thoughtfully to pursue their goals - balancing growth, income, and risk.	How to ask the right questions, understand key metrics, and make informed choices.	A guided tour of the numbers behind investing, presented with clarity and confidence.

This chapter explores real-world scenarios using Alex and Jordan, two ordinary people just starting out and learning to make financial decisions with more curiosity and confidence. Their decisions and actions will reveal many of the terms and equations that define investing.

Summary

You've already begun investing, and now it's time to deepen your knowledge. This module prepares students to explore a more detailed landscape of investments, moving from general strategy to hands-on understanding. From stock shares to real estate, every financial instrument carries a purpose. But no tool is helpful without context. The work ahead is to gain fluency, not just in terms and tickers, but in how different options serve different lives.

Exercises

1. What's one investment tool you've heard about but never really understood? What has kept you from exploring it?
2. Why do people often confuse complexity with quality when choosing investments?
3. List two investments you've seen mentioned in the news or ads. Classify what kind of goals they might serve.

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14.2: Instruments

Learning Objectives

- Classify investment instruments based on their underlying characteristics (e.g., equity, debt, ownership).
- Compare how different instruments are structured to create value or income.
- Identify the role that instrument type plays in an investment portfolio.

What You're Really Buying

> Alex once thought buying a stock was like placing a bet. Jordan thought it was just a fancy way to save. At first, neither Alex nor Jordan realized that investing isn't about gambling or guessing. It is about choosing the correct tools. And like any set of tools, each one has its purpose, its strength, and its trade-offs.

This section introduces the core investment instruments, financial vehicles that carry your money into the future. Some are built for growth. Some are designed for income. Some bundle the best of both. And all of them work differently than they might seem to at first glance.

Stocks - Buying a Piece of the Future

When you buy a stock, you become a **partial owner** of a business. That's more than just a technical detail - it's a fundamental shift in perspective. You're not lending money to a company. You're buying into its future.

Stocks represent ownership. As the company grows, innovates, and earns profits, your share of ownership can become more valuable. Some companies even return a portion of those profits through **dividends** - regular cash payments made to shareholders. You can take this money as cash, or you can reinvest it automatically, buying more shares each time a dividend is issued. This is known as a Dividend Reinvestment Plan, or DRIP. It's a way to let your investment grow quietly, behind the scenes, without needing to manually make a new purchase. Think of it like round-up investing: Instead of collecting spare change, each dividend gets automatically rolled into more shares with no action needed - just quiet, steady growth.

You make money with stocks in two main ways: By selling them for more than you paid (**appreciation**) or by collecting dividends. And if you reinvest those dividends, your investment can grow even faster through **compounding** - a concept first covered in our chapter on the Time Value of Money.

Stocks tend to be more volatile than other investments. Their prices move quickly. Sometimes prices fluctuate because of company performance, and sometimes due to news, trends, or even global events. But over long periods, stocks have historically delivered strong returns, especially for those who stay invested through the ups and downs.

Most people think stocks only make money when they go up. But many of the world's most successful investors have built wealth by holding quality stocks *through* ups and downs, and letting time do the heavy lifting.

Bonds - Lending with Interest

If stocks are about ownership, bonds are about lending. When you buy a bond, you're giving your money to a government, a company, or a municipality. In return, they promise to pay you interest over a set period and then return your original investment, or **principal**, when the bond reaches **maturity**.

This makes bonds fundamentally different from stocks. You're not sharing in the company's profits. You're charging them rent on your money.

That rent comes in the form of **interest payments**, often made semiannually. These payments are typically fixed, which makes bonds a reliable source of income for many investors. If you sell a bond before it matures, its price will depend on current interest rates and how attractive your bond's rate looks by comparison.

The safest bonds (like those issued by the U.S. government) pay relatively low interest. Riskier issuers have to offer higher returns to attract investors. That's why bond yields can serve as a signal of risk.

Picture two companies, one strong and stable, and the other struggling. If both offer the same bond rate, would you pick the riskier one? Most investors wouldn't, unless the second company paid more. That's how bonds signal risk. They offer higher returns to compensate for uncertainty.

Mutual Funds and ETFs - Portfolios in a Package

Buying individual stocks or bonds is like picking your own ingredients for a meal. But what if you'd rather let a professional chef cook for you? That's where **mutual funds** and **ETFs (exchange-traded funds)** come in.

Mutual funds pool money from many investors to create a portfolio that may include dozens or even hundreds of securities. Some funds are actively managed by professionals who try to outperform the market. Others simply track a broad market index like the S&P 500.

The benefits? **Diversification** and **professional management**. Instead of putting all your money in one company or bond, you're spreading it across many, thereby reducing the impact of any single investment's performance.

Funds make money in the same ways stocks and bonds do - through capital gains, dividends, and interest. The fund collects earnings from its holdings and passes them along to investors. And because of the diversity that is baked in, funds tend to offer a smoother ride than individual stocks.

Mutual funds are typically bought directly from the provider and priced once per day. **ETFs** trade on exchanges throughout the day, like stocks. Many investors use **index funds** (a type of mutual fund or ETF) to gain broad market exposure at a low cost.

Real Estate and Alternatives - Physical and Unique Assets

Not all investments come in digital form. Some are as physical as the ground beneath your feet.

Real estate is one of the most time-tested ways to build wealth. The real estate market is typically categorized by type: Residential, Commercial, Agricultural, Industrial, and Mixed-Use. Whether it's a rental property, a vacation home, or land purchased for development, real estate offers the potential for two kinds of return: **income** and **appreciation**. For a property owner, rent payments provide steady cash flow, and properties generally rise in value over time.

Alternative investments include collectibles, precious metals, cryptocurrencies, and fine art. These assets don't always follow traditional market patterns, which can make them attractive but also harder to analyze. Their value often depends on scarcity, timing, and sentiment.

These assets have distinct traits:

- They're often **less liquid** - harder to buy or sell quickly
- They may require more specialized knowledge or higher initial capital
- They offer exposure to markets that don't move in lockstep with stocks and bonds

Real estate has a reputation for being "grown-up investing," but that's often a matter of scale. Whether it's a rental home or a piece of farmland, the real magic of real estate is how time can turn slow growth into significant wealth.

Wrapping Up: Instruments Are Building Blocks

Investing isn't about finding the one perfect vehicle. It's about understanding how each instrument works - and when to use it.

- Stocks offer ownership and the potential for high growth.
- Bonds provide steady income with relatively lower risk.
- Funds bring diversification and ease through professional management.
- Real estate and alternatives offer tangible, time-driven returns with unique trade-offs.

Most investors use a combination of these instruments to balance risk and reward. Over time, the blend may shift based on goals, life stage, and market outlook. What matters most is understanding what you're buying - and why.

In the next section, we'll explore the **markets** where these instruments trade and how the structure of those markets shapes opportunity and access.

Summary

This section demystifies financial instruments by returning to fundamentals: What exactly are you buying when you invest? A stock represents ownership. A bond is a loan. A mutual fund is a basket. A REIT is a share in property. These tools differ in structure, return profile, risk exposure, and investor expectations, but they all channel capital into a productive outlet.

- Instruments are defined by what they *give* the investor: ownership, repayment, income, and exposure.
- Structure shapes expectation: risk, liquidity, return potential, and time horizon.
- No one instrument does everything. Investors select instruments to match strategy and constraints.

This section focuses less on technical detail and more on conceptual clarity; that is, building a framework for thinking about what you are really buying.

Exercises

1. Choose one instrument - stock, bond, fund, or REIT - and describe what it represents from the investor's perspective.
2. Why might someone treat a mutual fund or ETF as less "real" than a share of stock, even though both are investments?
3. Match each of the following goals to the most appropriate instrument: steady income, long-term growth, diversification, and real estate exposure.

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14.3: Markets

Learning Objectives

- Describe the purpose of financial markets and how they facilitate investment activity.
- Differentiate between primary and secondary markets.
- Evaluate how market behavior and access shape investor decision-making.

Markets - Where Investments Change Hands

> Alex thought buying a stock meant owning a piece of a company. Jordan thought it meant betting on a rising price. In a way, they were both right, but they hadn't yet discovered the deeper truth: Every investment you make moves through a marketplace. And every market has rules, players, risks, and opportunities.

This section pulls back the curtain on how markets in fact work.

Primary vs. Secondary Markets - The First Stop and the Open Road

When a company or government issues a security for the first time, it enters the **primary market**. This is where stocks are born via Initial Public Offerings (IPOs) and bonds are first sold to investors. The issuer receives the money directly, and you become the first owner.

But most investing happens in the **secondary market** - where existing securities are bought and sold among investors. This is where prices change every day, sometimes every second. When you buy a share of Ford on the stock exchange, you don't send money to Ford. You're buying it from another investor who already owns the share. Ford doesn't benefit directly, but your decision reflects market belief in its future.

This distinction matters. The primary market is about **creation**. The secondary market is about **valuation**, where thousands of individual decisions shape the price of everything. Valuation in the secondary market isn't set by a committee; it's constantly negotiated. Every time someone buys or sells, they're making a judgment about what an asset is worth. Over time, those judgments, all those little yes's and no's, become the price the next investor sees.

Exchanges, Brokers, and Market Mechanics

Markets aren't physical places anymore (at least, not usually). They're systems - networks of buyers, sellers, brokers, and electronic exchanges.

Exchanges like the NYSE or NASDAQ act like digital arenas. They match buyers and sellers and display current prices in real time. Their role is to provide structure, transparency, and liquidity.

Brokers operate a little differently. Some brokers simply connect you to the exchange. Others buy and hold securities themselves, taking temporary ownership and hoping to profit on the spread between buy and sell prices. This is called **arbitrage**, and while it can be profitable, it involves risk. Brokers, unlike exchanges, may hold inventory and face exposure.

Historically, trades were placed over the phone or in shouting pits on trading floors. Today, much of that action has moved online. When you place an order through an investing app or online broker, you're tapping into this system. Behind every click, algorithms and institutions are working to fill your order efficiently. Technology hasn't changed the fundamentals; it's just changed the speed and scale.

What Moves Prices - Supply, Demand, and Sentiment

Prices in secondary markets fluctuate constantly. But why?

At the most basic level, it's the same principle that moves prices in a farmers market: **supply and demand**. When more people want to buy than sell, prices rise. When more people want to sell than buy, prices fall.

But in investing, price movement often reflects more than just supply. It reflects beliefs, fears, headlines, and expectations. That's called **market sentiment** - the collective psychology of thousands of participants. Sometimes, it aligns with the fundamentals. Sometimes, it doesn't.

This is why a company's stock can drop even after strong earnings. It is also why a rumor can cause a sudden spike. The market is part calculator, part weather vane. It measures not just data, but the shifting winds of public opinion.

How Different Instruments Travel Through Markets

Each instrument we've introduced finds its way into the market differently. Each journey affects not only how it's traded, but also how it's priced, accessed, and experienced by the investor.

- **Stocks** usually trade on public exchanges like the NYSE, accessible to individual investors through brokers or trading apps. Pricing is transparent, transactions are near-instant, and the cost to trade is typically low.
- **Bonds** may be sold initially through investment banks and later resold over-the-counter (OTC), an industry term for a decentralized market with less price transparency and higher barriers to entry. Corporate bonds, especially, may require more research and carry different transaction fees.
- **Mutual funds** are typically purchased directly from the fund company at the end-of-day price, which limits trading flexibility but provides predictable valuation. **ETFs**, by contrast, trade like stocks throughout the day and offer real-time pricing, though their liquidity depends on trading volume.
- **Real estate and collectibles** operate in slower, less transparent markets. A home may sit on the market for months. A rare comic book might require a specialized auction or appraisal. These transactions come with negotiation, due diligence, and often substantial closing costs.

When investors understand not just *what they're investing in*, but *how that asset travels*, they're more prepared for the rhythm and risk of the journey.

Market Depth and Liquidity - Can You Get In and Out?

One final concept worth noting is **liquidity** - how easily you can buy or sell an asset without significantly affecting its price.

Highly liquid markets, like those for large company stocks, let you move in and out quickly. Less liquid markets, like those for niche collectibles or rural real estate, can leave you waiting for a buyer or settling for less.

Liquidity isn't just about convenience. It's about confidence. If you need your money back, can you get it?

Wrapping Up: Markets as Mirrors

Markets don't just move money. They reflect priorities, fears, goals, and beliefs. The more you understand how markets function, the better equipped you are to use them thoughtfully.

Summary

Investments don't sit in isolation; they move. This section introduces the markets where buying and selling happen. These are not just physical exchanges, but systems that price assets, set expectations, and influence behavior. From IPOs to ETFs, and from stock tickers to cryptocurrency exchanges, the market is where theory meets liquidity.

- The primary market is where investments are created (e.g., IPOs).
- The secondary market is where they are traded (e.g., NYSE, NASDAQ).
- Markets offer liquidity, but also volatility, reaction, and noise.

Markets are not perfectly rational; they are ecosystems of belief and expectation. This section lays the groundwork for understanding what drives market movements - and why investor psychology matters.

Exercises

1. Have you ever followed a financial trend or market movement in real time? What did you learn from the experience?
2. Why do people often treat price as value when they are not the same thing?
3. Give an example of a primary market transaction and a secondary market transaction. What makes them different?

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14.4: Strategies

Learning Objectives

- Identify core principles of portfolio strategy, including diversification and asset allocation.
- Analyze how time horizon, risk tolerance, and personal goals shape strategic decisions.
- Apply strategic frameworks to evaluate sample investor profiles.

Strategies - Navigating Risk, Return, and the Investor Mindset

Alex and Jordan need to consider the question that every investor eventually faces:

> *"How do I know what kind of investment is right for me?"*

It's a deceptively simple question, because behind it lie all the complexities of personal goals, emotional responses to risk, and the reality of time.

This section explores what it means to invest *intentionally*. We'll walk through the core components of investment strategy - risk, return, time horizon, and diversification - and emphasize discovery and application. The goal isn't to give you a script. It's to help you develop a playbook.

Risk and Return - Two Sides of the Same Coin

Imagine two companies, A and B. Both want to borrow your money by selling bonds. Both offer a 5 percent coupon rate. But Company A is a highly rated, blue-chip corporation with a long history of profitability. Company B is a newer firm, with inconsistent earnings and a few rough years behind it.

Which would you choose?

If the return is the same, almost everyone would pick Company A. But here's the rub: Investors won't buy Company B's bond *unless* they're compensated for the extra risk. So Company B increases its coupon rate to 7 percent. Now it has your attention.

This is the risk-return tradeoff. Riskier investments must offer the *potential* for higher returns. The opposite is also true: The safer an investment is, the more modest the return you should expect. These forces play out across every instrument you'll encounter.

Understanding this principle helps explain why some investors embrace volatility, while others seek stability. Neither choice is inherently wrong, but your comfort with risk will help shape the mix of assets in your portfolio.

Gauging Risk Tolerance

Your risk tolerance isn't just about emotion. It is about facts and the situation. Consider these reflective questions:

- How would you feel if your portfolio dropped 20 percent in a month?
- Do you need access to your money in the next year or in 20 years?
- Would a guaranteed but low return feel better than a chance at something higher?

Your answers will shape your approach. If volatility makes you anxious, you may prefer conservative, income-oriented investments. If you're still in the early stages of your career and willing to ride the ups and downs, you might be drawn to growth-oriented stocks or equity-heavy funds.

This leads us to another essential piece of strategy: Time.

Life Stage and Diversification - Matching the Strategy to the Season

Time isn't just a number; it's an asset. The earlier you start investing, the more flexibility and recovery room you have. That's why younger investors often lean toward aggressive growth. If a risky investment underperforms, younger investors have time to rebound.

Later in life, the calculus changes. Imagine approaching retirement and experiencing a market downturn. There's less time to recover, and less margin for error. That's why many investors shift to more conservative portfolios over time, favoring bonds, dividend stocks, or balanced funds.

Early Career (20s-30s)	Mid Career (40s-50s)	Pre-Retirement (60s)	Post-Retirement
Heavy equity allocation, high growth focus	Blend of growth and income; introduction of bonds	Increased emphasis on income and capital preservation	Conservative mix; goal = reliable income + low volatility

This evolution isn't rigid, but it is rooted in risk tolerance and needs. Life doesn't move in perfect decades, and neither will your portfolio. However, understanding these shifts can help you respond with confidence instead of confusion.

Diversification: Spreading Risk

Diversification isn't just a *cliché*. It's a tool to manage risk and smooth returns. Think of it this way:

- If you only own one stock, and that company falters, your portfolio takes a direct hit.
- If you hold ten companies across different industries, one dip won't derail your progress.

But not all diversification is equal. Holding both Coca-Cola® and Pepsi® stock isn't diversification. It is redundancy. Both companies belong to the same industry and may respond similarly to market trends.

True diversification goes deeper. It includes an understanding of **correlation** - how different assets move relative to each other:

- If two investments are **positively correlated**, they tend to rise and fall together.
- If they are **negatively correlated**, one may rise when the other falls.
- If they are **uncorrelated**, they behave independently.

The goal isn't to bet against your own holdings; the goal is to build a portfolio where different elements react differently to market conditions. Like a building supported by multiple pillars, your foundation is stronger when those supports don't all shift in the same direction at once.

Diversification is the intentional spreading of risk. Relying on a single asset, investment, or strategy makes outcomes more fragile. A resilient plan anticipates volatility. Smart diversification also reflects your research and expectations. If you anticipate rising interest rates, you might reduce bond exposure and increase sectors that tend to benefit. You're not trying to outguess every move; you're constructing a portfolio that stays upright no matter which way the wind blows.

True diversification spreads across multiple spaces:

Asset classes	Sectors	Geography
Stocks, bonds, real estate, alternatives	Healthcare, tech, consumer goods, energy	Domestic and international markets

Diversification doesn't guarantee profits, but it does help protect you from the unexpected. It's a strategy that aligns with any life stage and can become even more powerful when paired with consistent, intentional investing.

Strategy in Practice - Building Habits That Work Over Time

If risk and time shape your approach, habits carry it forward. Strategy is as much about behavior as it is about selection. This section introduces practical tools and patterns that make investing more predictable, less emotional, and more aligned with your goals.

Dollar-Cost Averaging (DCA)

Imagine you want to invest $1,200 in a fund. You can invest the total amount all at once, or you could invest $100 every month for a year. With DCA, you're making regular purchases, regardless of whether prices are up or down.

This strategy has two big advantages:

1. It removes timing pressure, so you're not trying to guess when prices will hit bottom.
2. It averages out your cost over time, so sometimes you buy high, sometimes low, but you are consistently building.

DCA works especially well for long-term goals like retirement, where steady investing yields better results than trying to time the market. The phrase "time the market" is shorthand for a difficult and often unproductive goal (trying to predict short-term movements in prices).

Trying to outguess the market direction can feel empowering, but history shows it's incredibly hard to do. DCA provides a calmer alternative: You focus on *when you invest*, not *where the market is heading*.

Buy and Hold

A buy-and-hold strategy is a simple idea with powerful results: Buy quality investments and hang onto them.

Imagine investing in a company you believe in. Instead of obsessively tracking daily prices, you let time and compounding do their work. This strategy avoids emotional trading. You can avoid the pitfalls of panic-selling in a downturn or jumping into a hot trend by relying on research instead.

Of course, this approach doesn't mean you should ever ignore your portfolio. Choose well, rebalance occasionally, and let the market's long-term upward trend work in your favor.

Growth vs. Value

These two labels are often misunderstood.

Growth stocks

Companies are expected to expand quickly. They may not pay dividends because profits are reinvested.

Value stocks

Companies that look under-priced based on fundamentals. They may offer dividends and tend to have lower volatility.

These aren't mutually exclusive. Some companies grow and offer value. However, your portfolio may tilt toward one or another based on your risk profile, time horizon, or market outlook.

Understanding these distinctions helps you interpret *what* you're investing *in*, not just *how much* you're investing.

Strategy is a collection of aligned choices: It is your tolerance for risk and your time horizon, combined with the consistency and discipline of your investing habits.

Summary

Strategy connects tools to outcomes. This section introduces how to build portfolios, balance competing priorities, and plan for uncertainty. It doesn't teach what to invest in; it teaches how to think about investing systematically.

- Diversification: spreading risk across assets
- Asset allocation: aligning tools with goals and timeframes
- Risk personality: how comfort with volatility affects design

A well-designed portfolio isn't about predicting the future - it's about preparing for it. This section helps students develop frameworks for building investment habits that are resilient, intentional, and aligned with their identity.

Exercises

1. What kinds of risk feel most uncomfortable to you - loss, uncertainty, missing out? How would that shape your strategy?
2. Why do investors often chase performance instead of trusting their strategy?
3. Given an investor with a 30-year horizon and moderate risk tolerance, propose an allocation strategy and justify it.

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14.5: Research

Learning Objectives

- Distinguish between qualitative and quantitative investment research.
- Evaluate common sources of financial information and potential biases.
- Recognize how research supports strategic clarity and confidence.

Research - From Guesswork to Groundwork

Alex once admitted he had spent more time researching where to get the best burrito in town than he did choosing his first investment. Jordan laughed at first, until she realized she'd done about the same. That moment led to a question every intentional investor eventually asks:

> *How much research is enough to make a smart financial decision?"*

You don't start as a market expert; you can start by being curious and protecting your future self. This section is about building a foundation, not for Wall Street but for your street. Research is not an intimidating wall of numbers. It's a habit of asking good questions and interpreting useful signals.

What Research Really Means

You've met the instruments. Now it's time to learn how to look inside them.

Research means getting to know what you're buying and why. It's about going beyond the ticker symbol to understand the engine behind the investment. A few good questions can tell you a lot:

- What does this company, bond issuer, or fund do?
- How does it make (and keep) money?
- Who's managing it, and can you trust their track record?
- What happens if things go wrong?

Think of browsing stocks like window shopping. If you only give two minutes of attention before investing, and your time is worth $30/hour, then you've spent about one dollar of mental energy. Would you expect that level of research to deliver above-average results?

Research begins with curiosity, not expertise. It's about slowing down and asking: *What am I getting into?* You will be able to answer that question with confidence once you understand these tools and calculations.

Researching Stocks - Peeking Behind the Ticker

Stock research starts with the story. What business is this company in? How does it make revenue? Who are its competitors? Then come the numbers:

Earnings

Is the company profitable?

Price-to-Earnings (P/E) Ratio

How expensive is the stock compared to its earnings? A very high ratio may suggest overvaluation or optimism. A very low one

Dividend History

Does the company share profits with investors? Has it been consistent or erratic?

could mean undervaluation or a problem.

Reports like the SEC 10-K or annual summary help, but so do **earnings call transcripts** and **analyst summaries**. Even reading one thoughtful article can add layers of insight. In the next section, we will look more closely at these numbers. You will find they are good indicators of a company's financial health.

Researching Bonds - Assessing the Borrower

When you buy a bond, you're lending money. The research question becomes this: *How likely is it that I'll get paid back - and on time?* Check all the key signals:

Credit Ratings

Moody's or S&P 500: These help assess default risk. AAA is the safest; anything below BBB is considered junk or speculative.

Issuer Type

Government bonds are often safer, while corporate bonds carry more variation in risk.

Yield vs. Risk

A higher yield might seem tempting, but it often reflects greater risk. Ask: What's the catch?

You don't need to run a full credit analysis, but knowing the basics can help avoid reaching for yield without recognizing the risk. In the next section, we'll demonstrate how to calculate yield and compare bond types.

Researching Funds - Reading the Recipe

Mutual funds and ETFs bundle multiple investments. But who chooses what goes into the basket, and why? Good research focuses on these questions:

Fund Strategy

What's the fund's objective? Is it focused on growth, value, income, or a specific sector?

Holdings

What companies or assets are inside? Do they duplicate other investments you already own?

Turnover Rate

How high is the turnover? Is high turnover leading to higher transaction costs and tax consequences?

Expense Ratio

What are you paying for this fund to be managed?

Some investors choose a fund based solely on its name or past performance. Additional research can reveal whether the fund adds diversity to your portfolio or adds clutter. Later in this section, we'll explore how these factors affect overall cost and return.

Researching Alternatives - Appraisals, Comps, and Context

Real estate, collectibles, and other alternatives require their own lens. With real estate, it's all about **comps** (comparable properties) and trends in local demand. You need to ask these questions:

- What are similar properties worth?
- How is the market moving in this area?
- Who's managing the asset, and what's their history?

For real estate investors, appraisals provide an objective valuation, but those numbers often rely on local trends. Market momentum, vacancy rates, and zoning changes can all influence future value.

With collectibles or non-traditional assets, research means vetting authenticity, assessing rarity, and understanding buyer sentiment. This research is less about balance sheets and more about trust, verification, and contextual signals.

Behavior and Bias - The Hidden Research Hurdles

The biggest threat to research isn't ignorance - it's *narrative bias*. We're emotional creatures trying to survive in a numbers-driven world. Our brains crave clarity, stories, and shortcuts. We are vulnerable to behavioral traps that can shape our decisions before we even know it. Some common traps were covered in the Market Behavior chapter:

Recency Bias

Giving too much weight to the latest headlines. A dramatic event from last week might feel urgent, but investing requires a longer lens.

Herd Mentality

When everyone's buying, it's tempting to jump in. But the crowd doesn't always know where it's going or why.

Confirmation Bias

We naturally search for information that supports our existing opinions and ignore what doesn't. That's not research; it is reinforcement.

Overconfidence

Doing your homework is important, but it doesn't guarantee success. Even the best research must live alongside humility.

Analysis Paralysis

Waiting for the perfect set of data can become its own form of procrastination. Sometimes, progress comes from making the best decision you can with the information you have.

Market behavior is driven by these patterns more than we often realize. The prices we see reflect not just company performance but the collective emotions of fear, greed, optimism, and doubt of thousands. Awareness of bias is itself a form of protection.

The next time you make a quick decision that feels automatic or emotional, pause. Ask: *Am I reacting, or am I reasoning?* Pausing to reflect or reconsider can put you ahead of many investors.

Building a Repeatable Research Habit

Research doesn't have to be an all-or-nothing sprint. You can build a rhythm:

- Scan company or fund news once a month
- Revisit your portfolio quarterly
- Set alerts for major news or price swings
- Keep a personal "why I bought this" note for every investment

Over time, your instincts will improve. It's not because you got lucky, but because you got intentional.

Research is how you go from reacting to planning. It's how you shift from investing based on noise to investing based on knowledge.

And it all starts with curiosity and the knowledge to protect your future self. The next section will demystify the key math and metrics that make all this research even more actionable.

Summary

Good decisions rely on good information. This section helps students move beyond hype and guesswork by emphasizing the value of thoughtful research. It introduces tools and mindsets for asking better questions and interpreting the answers.

- Reading company reports, analyst opinions, and performance metrics
- Understanding qualitative context - news, leadership, industry trends
- Questioning bias and narrative in media and social platforms

Research is not about perfect prediction; it's about consistent preparation and becoming a critical thinker, not an information hoarder.

Exercises

1. Think of a time you acted on limited or one-sided information. How might better research have changed your outcome?
2. What makes certain sources feel more trustworthy, even if they're less reliable?
3. Choose a stock or fund and describe one qualitative and one quantitative insight you would look for before investing.

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14.6: Formulas and Metrics

Learning Objectives

- Describe how taxes, fees, and account types influence investment outcomes.
- Recognize the value of automation and structure in reducing behavioral errors.
- Evaluate the tradeoffs of different investing platforms and custodial options.

Technical Aspects of Investing

Jordan had always trusted her instincts when buying stocks. If a company name sounded sharp or a product felt cool, she figured it had to be a good investment. One afternoon, she proudly showed off her latest pick, a company with flashy ads and a brand-new app. Alex asked a simple question: "What's the stock's P/E ratio?"

Jordan paused. "What's that?"

That moment launched a conversation, and for Jordan, a quiet realization. Behind every stock ticker is a story written in numbers. The story is not just about prices, but performance, value, and potential. In this section, we'll unpack those numbers and explore the technical tools investors use to make decisions grounded in more than just gut feeling.

This isn't about turning you into a Wall Street analyst. It's about giving you the confidence to read financial signals with clarity instead of confusion. And like any good story, we'll explore each investment instrument through its own lens of valuation metrics. These tools help you understand what you're buying, why it matters, and how your money might grow.

Let's begin our walk through the investment neighborhood with a walk down the stock market block.

Stock Metrics: Understanding Ownership Performance

When you buy stock, you're buying a slice of ownership in a company. You're not just betting on its future; you're sharing in it. Many investors come into the market thinking the goal is simple: buy low, sell high. In other words, they hope their stock appreciates.

But price appreciation is only part of the story. Stocks can also pay dividends, signal value through earnings, and reflect investor sentiment through various ratios. Let's look at some of the most important ways investors measure stock performance and potential.

A. Market Capitalization

$$\text{Market Capitalization} = \text{Share Price} \times \text{Total Shares Outstanding}$$

Example: A company with one million shares trading at $50 per share has a market cap of $50 million.

This gives you a quick sense of the company's scale. Investors often use terms like "small-cap," "mid-cap," or "large-cap" based on market capitalization, which can influence risk and growth potential. Smaller companies may offer more growth, but also more volatility.

B. Earnings Per Share (EPS)

$$\text{EPS} = \frac{\text{Net Income}}{\text{Total Shares Outstanding}}$$

Example: A company with a net income of $1,000,000 and 500,000 shares has an EPS of $2.00.

Think of EPS as a measure of how productive your share is and how much of the company's profit is attached to your investment. When EPS grows steadily, it's often a signal that the business is thriving.

C. Price-to-Earnings (P/E) Ratio

$$\text{P/E Ratio} = \frac{\text{Stock Price}}{\text{EPS}}$$

Example: If a stock trades at $50 and has an EPS of $2, the P/E ratio is 25.

That number tells you what investors are willing to pay for each dollar of earnings. A high P/E might signal optimism about future growth, or it could mean the stock is over-hyped. A low P/E could mean a bargain or could signal a red flag. Context is key.

D. Dividend Yield

$$\text{Dividend Yield} = \frac{\text{Annual Dividend}}{\text{Price per Share}} \times 100$$

Example: A $50 stock paying a $2 annual dividend yields 4 percent.

For income-focused investors, dividends can be a steady reward. Even when the stock doesn't climb in value, dividends can provide real returns. Reinvesting dividends can accelerate portfolio growth.

E. Price-to-Book (P/B) Ratio

$$\text{P/B Ratio} = \frac{\text{Stock Price}}{\text{Book Value per Share}}$$

Example: If a stock is trading at $40 and the book value per share is $20, the P/B ratio is 2.

This tells you how much you're paying compared to what the company owns outright. If the ratio is low and the company is healthy, it could mean you're buying in at a discount.

F. Total Return

$$\text{Total Return} = \frac{\text{Ending Value - Beginning Value} + \text{Dividends}}{\text{Beginning Value}} \times 100$$

Example: You buy a stock at $50, it rises to $60, and pays a $2 dividend. Your total return is

$$\frac{60 - 50 + 2}{50} = 24\%$$

This is the number that matters most. It combines income and appreciation. It is the full reward for your patience and planning.

Bond Metrics: Measuring Borrowing and Return

Bonds work differently from stocks. Instead of owning part of a company, you're lending money to a company (or government). In return, they promise to pay you interest and eventually return your original investment.

Let's take a look at how investors evaluate bonds.

A. Coupon Rate

$$\text{Coupon Rate} = \frac{\text{Annual Interest Payment}}{\text{Face Value}} \times 100$$

Example: A $1,000 bond paying $40 annually has a 4 percent coupon rate.

This is what the bond offered when it was first issued. This is a useful starting point, but not the full picture of today's return.

B. Current Yield

$$\text{Current Yield} = \frac{\text{Annual Interest Payment}}{\text{Current Bond Price}}$$

Example: If the bond is selling for $950, the current yield is about 4.21 percent.

That small price discount increases your return slightly. Current yield helps investors decide whether a bond is currently offering competitive income.

C. Yield to Maturity (YTM)

$$\text{YTM} \approx \frac{\text{Interest} + \frac{\text{Face Value - Price}}{\text{Years}}}{\frac{\text{Face Value} + \text{Price}}{2}} \times 100$$

Example: A bond priced at $950 with five years to maturity and a $40 coupon will yield approximately 5.13 percent.

YTM paints a fuller picture. It includes everything you'll earn from the bond if you hold it to the end, and whether you bought it at a discount or a premium.

D. Bond Rating

Instead of a formula, this metric is based on evaluations by credit rating agencies like Moody's and Standard & Poor's (S&P). Ratings such as AAA, BBB, or junk-grade indicate the bond issuer's likelihood of paying you back.

Think of bond ratings as a report card for reliability. Safer bonds tend to offer lower returns, while riskier bonds might tempt investors with higher yields.

E. Duration

Duration is a measure of how sensitive the bond's price is to changes in interest rates. Bonds with longer durations fluctuate more when rates move.

This becomes more important in rising or falling interest rate environments. Longer bonds may drop more in value if rates rise, making this an essential concept for long-term bond investors.

Fund Metrics: Evaluating Pooled Investments

Not everyone wants to pick and manage individual stocks and bonds, and that's where mutual funds and ETFs come in. They let you invest in a broad collection of securities with a single purchase, often managed by professionals. But how do you evaluate a basket instead of a single apple?

Let's look at the key numbers that help investors assess fund performance and structure.

A. Expense Ratio

$$\text{Expense Ratio} = \frac{\text{Annual Operating Expenses}}{\text{Average Assets Under Management}} \times 100$$

Example: A fund with $10 million in assets and $50,000 in annual expenses has an expense ratio of 0.5 percent.

Even a small difference in expense ratios can add up over time. A fund charging 1.5 percent consumes more of your returns than one charging 0.3 percent, especially in long-term accounts like retirement funds.

B. Net Asset Value (NAV)

$$\text{NAV} = \frac{\text{Total Assets - Liabilities}}{\text{Outstanding Shares}}$$

NAV updates daily for mutual funds. For ETFs, market price and NAV often stay close, but intraday trading allows slight fluctuations.

It's like asking, "What is my slice of the pie worth right now?" NAV helps you track that value, especially when comparing performance over time.

C. Turnover Ratio

The turnover ratio shows how often the fund's holdings are bought and sold. Some managers trade frequently to chase opportunities. Others stick with a long-term plan.

Example: A turnover ratio of 100 percent means the fund changed out all its holdings during the year.

High turnover can lead to higher costs and potentially higher taxes. Realized gains may be passed on to investors. Some investors prefer "low-turnover" funds for cost and tax efficiency.

D. Benchmark Comparison

Most funds are measured against a benchmark index, like the S&P 500 or the Russell 2000. These comparisons help you evaluate how well the fund performs relative to its peers or intended goal.

If a large-cap U.S. stock fund consistently underperforms the S&P 500, that's a signal worth watching. Likewise, if a fund beats its benchmark but charges high fees, you'll need to decide whether the outperformance justifies the cost.

Alternative Investments: Real-World Valuation Without Formulas

Alternative investments like real estate, collectibles, and commodities don't always come with clean math. But that doesn't mean they're guesswork. Investors use other tools like comparables, professional opinions, and income models to estimate value.

A. Comps (Comparables)

"Comps" are similar assets recently sold in the same market. Real estate investors use comps to estimate property worth based on nearby sales.

Think of it as pricing your home by looking at similar homes on your street. Comps also help mortgage lenders decide how much they're willing to finance.

B. Appraisals

Appraisals are professional evaluations of an asset's worth. In real estate, certified appraisers look at location, condition, market trends, and comps. In art and collectibles, appraisers assess authenticity, provenance, and demand.

These estimates may not be precise, but they're grounded in professional expertise and real data.

C. Capitalization Rate (Cap Rate)

$$\text{Cap Rate} = \frac{\text{Net Operating Income}}{\text{Property Value}} \times 100$$

Example: A property earning $12,000/year in net income and worth $200,000 has a cap rate of 6 percent.

Cap rate helps compare properties and decide whether the income justifies the investment. But it doesn't account for debt, taxes, or property appreciation. It is simply one tool among many.

Pulling It All Together

Stocks, bonds, funds, and other alternatives all have their own language of metrics. Some are as simple as a ratio. Others require judgment, experience, or professional advice. Once you know what to look for, these tools help transform investing from a guessing game into a thoughtful, informed process. The numbers won't decide for you, but they'll help you ask better questions and see clearer choices.

You don't have to love math. You just have to make friends with it.

Summary

Even the best investment strategy can be undone by neglecting the technical details. This final section introduces the infrastructure that supports successful investing: the accounts, platforms, tax implications, and automation options that shape results behind the scenes.

- Account types: taxable, tax-deferred, tax-free (e.g., brokerage, IRA, Roth)
- Fees: hidden and visible costs of platforms, advisors, and products
- Automation: recurring contributions and rebalancing to reduce emotional errors

Technical literacy doesn't mean becoming a tax expert; technical literacy means knowing what to ask and what to watch. This section ties the series together by showing how logistics serve strategy.

Exercises

1. Have you ever been surprised by a fee or tax outcome? What would you do differently next time?
2. Why is it so tempting to delay technical setup even when it directly affects outcomes?
3. List three questions you would ask when choosing a platform or account for long-term investing.

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CHAPTER OVERVIEW

15: Other Investment Options

15.1: Mutual Funds
15.2: Real Estate Investments
15.3: Commodities and Collectibles

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15.1: Mutual Funds

Learning Objectives

1. Identify the general purposes of using mutual funds in individual investment portfolios.
2. Analyze the advantages of an index fund or a fund of funds.
3. List and define the structures of mutual funds.
4. Describe the strategic goals of lifestyle funds, leveraged funds, and inverse funds.
5. Identify the costs and differences in costs of mutual fund investing.
6. Calculate returns from mutual fund investing.
7. Summarize the information found in a mutual fund prospectus.

As defined in the Chapter 12, a mutual fund is a portfolio of securities, consisting of one type of security or a combination of several different types. A fund serves as a convenient way for an investor to have a diversified portfolio of investments in just about any investable asset. The oldest mutual fund is believed to have been founded by Adriaan van Ketwich in 1774. Ketwich invited investors to contribute to a trust fund to spread the risk of investing in foreign bonds. The idea moved from the Netherlands to Scotland to the United States, where the Boston Personal Property Trust established the first mutual fund in 1893.FinanceScholar.com, http://www.financescholar.com/history-mutual-funds.html (accessed June 15, 2009).



Figure 17.1.1 . © 2010 Jupiterimages Corporation

The mutual fund's popularity has grown in periods of economic expansion. At the height of the stock market boom in 1929, there were over seven hundred mutual funds in the United States. After 1934, mutual funds fell under the regulatory eye of the Securities and Exchange Commission (SEC), and it wasn't until the 1950s that there were once again over one hundred mutual funds in the United States.

Mutual funds multiplied in the 1970s, spurred on by the creation of IRAs and 401(k) retirement plans, and again in the 1980s and 1990s, inspired by economic growth and the tech stock boom. By the end of 2008, U.S. mutual funds—which account for just over half of the global market—had $9.6 trillion in assets under management. Forty-five percent of all U.S. households owned mutual funds, compared to 6 percent in 1980. For 69 percent of those households, mutual funds were more than half of their financial assets.The Investment Company Institute, *2009 Investment Company Fact Book*, 49th ed., 2009, http://www.ici.org/pdf/2009_factbook.pdf (accessed June 15, 2009). Mutual funds play a significant role in individual investment decisions.

A mutual fund provides an investor with cheaper and simpler diversification and security selection, requiring only one transaction to own a diversified portfolio (the mutual fund). By buying shares in the fund rather than individual securities, you achieve

extensive diversification for a much lower transaction cost than by investing in individual securities and making individual transactions. You also receive the benefit of professional security selection, which theoretically minimizes the opportunity costs of lesser choices. So by using a mutual fund, you get more and better security selection and diversification.

A mutual fund also provides stock and bond issuers with a mass market. Rather than selling shares to investors individually (and incurring the costs of doing so), issuers can more easily find a market for their shares in mutual funds.

Structures and Types of Mutual Funds

Like stocks and bonds, mutual funds may be actively or passively managed. As you read previously, actively managed funds provide investors with professional management and the expected research, analysis, and watchfulness that goes with it. Passively managed **index funds**, on the other hand, are designed to mirror the performance of a specific index constructed to be representative of an asset class. Recall, for example, that the Standard & Poor's (S&P) 500 Index is designed to mirror the performance of the five hundred largest large cap stocks in the United States.

Mutual funds are structured in three ways:

1. Closed-end funds
2. Open-end funds
3. Exchange-traded funds

Closed-end funds are funds for which a limited number of shares are issued. Once all shares have been issued, the fund is "closed" so a new investor can only buy shares from an existing investor. Since the shares are traded on an exchange, the limited supply of shares and the demand for them in that market directly determines the value of the shares for a closed-end fund.

Most mutual funds are **open-end funds** in which investors buy shares directly from the fund and redeem or sell shares back to the fund. The price of a share is its **net asset value (NAV)**, or the market value of each share as determined by the fund's assets and liabilities and the number of shares that exist. Here is the basic formula for calculating NAV:

$$\text{NAV} = \frac{\text{market value of fund securities} - \text{fund liabilities}}{\text{number of shares outstanding}}.$$

Demand for shares is reflected in the number of shares outstanding, because the fund can create new shares for new investors. NAV calculations are usually done once per day at the close of trading, when mutual fund transactions are recorded.

The NAV is the price that the fund will pay you when you redeem your shares, so it is a gauge of the shares' value. It will increase if the market value of the securities in the fund increases faster than the number of new shares.

Exchange-traded funds (ETFs) are structured like closed-end funds but are traded like stocks. Shares are traded and priced continuously throughout the day's trading session, rather than once per day at the end of trading. ETFs trade more like individual securities; that is, if you are trying to time a market, they are a more nimble asset to trade than open-end or closed-end funds.

Originally designed as index funds, exchange-traded funds now target just about every asset, sector, and economic region imaginable. Because of this, ETFs have become quite popular, with over $529 billion invested in over seven hundred funds (as of April 2009).The Investment Company Institute, *2009 Investment Company Fact Book*, 49th ed., 2009, Figure 17.2 compares the features of closed-end funds, open-end funds, and ETFs.

	Closed-End	Open-End	ETF
Number of Shares	Limited	Unlimited	Limited
Trades	End of the trading day	Fund sponsor	Continuously
Traded with	Other shareholders (after the fund closes)	End of the trading day	Other shareholders

Figure 17.1.2 : Fund Features

Shares of closed-end funds and exchange-traded funds are bought and sold on exchanges, much like shares of stock. You would go through a broker to make those transactions. Shares of open-end funds may be bought and sold directly from the fund sponsor, a mutual fund company or investment manager such as Fidelity, Vanguard, Janus, T. Rowe Price, or Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF). You can make those transactions at any of the company's offices, by telephone, or online. About 40 percent of all mutual fund transactions are done directly (without a broker) through a retirement plan contribution or a mutual fund company.The Investment Company Institute, *2009 Investment Company Fact Book*, 49th ed., 2009, http://www.ici.org/pdf/2009_factbook.pdf (accessed June 15, 2009).

Some other types of mutual funds are shown in Table 17.1. Some research companies, such as Morningstar, track as many as forty-eight different categories of mutual funds.

Table 17.1.1 Other Types of Mutual Funds

Funds of funds	Mutual funds that own shares in other mutual funds rather than in specific securities. If you decide to use mutual funds rather than select securities, a fund of funds will provide expertise in choosing funds.
Lifestyle funds	Funds of stocks and bonds that manage portfolio risk based on age or the time horizon for liquidity needs. Lifestyle funds perform both security selection and asset allocation for investors, determined by the target date. For example, if you were now thirty years old, you might choose a lifestyle fund with a target date of thirty-five years from now for your retirement savings. As the fund approaches its target date, its allocation of investments in stocks and bonds will shift to carry less risk as the target nears. Lifestyle funds are used primarily in saving for retirement; many are created as funds of funds.
Leveraged funds	Funds that invest both investors' money and money that the fund borrows to augment the investable assets and thus potential returns. Because they use borrowing, leveraged funds are riskier than funds that do not use leverage.
Inverse funds	Funds that aim to increase in value when the market declines, to be countercyclical to index funds, which aim to increase in value when the market rises. Inverse funds, also called bear funds, are set up to perform contrary to the index. Since most economies become more productive over time, however, you can expect indexes to rise over time, so an inverse fund would make sense only as a very short-term investment.

Mutual Fund Fees and Returns

All funds must disclose their fees to potential investors: sales fees, management fees, and expenses. A **load fund** charges a sales commission on each share purchase. That sales charge (also called a **front-end load**) is a percentage of the purchase price. A **no-load fund**, in contrast, does not charge a sales commission, because shares may be purchased directly from the fund or through a discount broker. The front-end load can be as much as 8.5 percent, so if you plan to invest often or in large amounts, that can be a substantial charge. For example, a $5,000 investment may cost you $425, reducing the amount you have to invest and earn a return.

A fund may charge a **back-end load**, actually a deferred sales charge, paid when you sell your shares instead of when you buy them. The charge may be phased out if you own the shares for a specified length of time, however, usually five to seven years.

A fund may charge a management fee on an annual basis. The management fee is stated as a fixed percentage of the fund's asset value per share. Management fees can range from 0.1 percent to 2.0 percent annually. Typically, a more actively managed fund can be expected to charge a higher management fee, while a passively managed fund such as an index fund should charge a minimal management fee.

A fund may charge an annual **12b-1 fee** or distribution fee, also calculated as not more than 1.0 percent per year of the fund's asset value. Some mutual funds charge other extra fees as well, passing on fund expenses to shareholders. You should consider fee structure and rate when choosing mutual funds, and this can be done through calculations of the expense ratio.

Taken together, the annual management, distribution, and expense fees are measured by the **expense ratio**—the total annual fees expressed as a percentage of your total investment. The expense ratio averages around 0.99 percent for all mutual funds, but it may be more than 2 percent of your investment's value.The Investment Company Institute, *2009 Investment Company Fact Book*, 49th ed., 2009, http://www.ici.org/pdf/2009_factbook.pdf (accessed June 15, 2009). That may not sound like much, but it means that if the fund earns a 5 percent return, your net return may be less than 3 percent (and after taxes, it's even less). When choosing a fund, you should be aware of all charges—especially annual or ongoing charges—that can affect your investment return.

Say you invest in a load fund with a 5 percent front-end load and an expense ratio of 2.25 percent and suppose the fund earns a 5 percent return. Figure 17.3 shows how your $5,000 investment would look after one year.

Original investment	5,000.00
Load (5%)	– 250.00
Net investment	4,750.00
Return (5%)	+ 237.50
End-of-year assets	4,987.50
Less expenses (2.25%)	– 112.22
Ending investment	4,875.28
Net return (ending investment value – net investment)	125.28
Net percentage return	2.64%

Figure 17.1.3 : Mutual Fund Example

Expenses can be a significant determinant of your net return, and since expenses vary by fund, fund strategy (active or passive), and fund sponsor, you should shop around and understand what your costs of investing will be.

Owning shares of a mutual fund means owning shares in a pool of assets. The returns of the fund are the returns of those assets: interest, dividends, or gains (losses). Income may come from **interest distributions** if the fund invests in bonds or interest-producing assets or as **dividend distributions** if the fund invests in stocks.

Mutual funds buy and sell or "turn over" the fund assets. Even passively managed funds need to rebalance to keep pace with their benchmarks as market values change. The **turnover ratio** is the percentage of fund assets that have been turned over or replaced in the past year, a measure of the fund's trading activity.

Turnover can create capital gains or losses. Periodically, usually once per year, the fund's net capital gains (or losses) are distributed on a per share basis as a **capital gains distribution**. You would expect turnover to produce more gains than losses. The more turnover, or the higher the turnover ratio, the greater the capital gains distributions you may expect.

Unless you have invested in a tax-exempt savings plan such as an Individual Retirement Account (IRA) or a 401(k), interest and dividend distributions are taxable as personal income, as are capital gains, including capital gains distributions. A higher turnover ratio may mean a higher tax expense for capital gains distributions. Most open-end mutual funds allow you the option of having your income and gains distributions automatically reinvested rather than paid out, which means that you may be paying taxes on earnings without ever "seeing" the money.

Mutual Fund Information and Strategies

All mutual fund companies must offer a **prospectus**, a published statement detailing the fund's assets, liabilities, management personnel, and performance record. You should always take the time to read it and to take a closer look at the fund's investments to make sure that the fund will be compatible and appropriate to your investment goals.



Figure 17.1.4 . © 2010 Jupiterimages Corporation

For example, suppose you have an investment in an S&P 500 Index fund and now are looking for a global stock fund to complement and diversify your holdings in domestic (U.S.) equities. You go to the Web site of a large mutual fund company offering hundreds of funds. You find a stock fund called "Global Stock Fund"—sounds like it's just what you are looking for. Looking closer, however, you can see that this fund is invested in the stocks of companies in Germany, Japan, and the United Kingdom. While they are not U.S. stocks, those economies are similar to the U.S. economy, perhaps too similar to provide the diversity you are looking for.

Or suppose you are looking for a bond fund to create income and security. You find a fund called the "Investment Grade Fixed Income Fund." On closer inspection, however, you find that the fund does not invest only in investment grade bonds but that the *average* rating of its bonds is investment grade. This means that the fund invests in many investment grade bonds but also in some speculative grade bonds to achieve higher income. While this fund may suit your need for income, it may not be appropriate for your risk tolerance.

Mutual fund companies make this information readily available on Web sites and in prospectuses. You should always make the extra effort to be sure you know what's in your fund. In addition, mutual funds are widely followed by many performance analysts. Ratings agencies such as Morningstar and investment publications such as *Barron's* and *Forbes* track, analyze, and report the performance of mutual funds. That information is available online or in print and provides comparisons of mutual funds that you may find helpful in choosing your fund.

In print and online newspapers, mutual fund performance is reported daily in the form of tables that compare the average returns of funds from week to week. Reported average returns are based on the net asset value per share (NAVPS). Investors can use this information to choose or compare funds and track the performance of funds they own.

In conclusion, since a mutual fund may be made up of any kind or many kinds of securities (e.g., stocks, bonds, real estate, and commodities), it is not really another kind of investment. Rather, it is a way to invest without specifically selecting securities, a way of achieving a desired asset allocation without choosing individual assets.

The advantages of investing in a mutual fund are the diversification available with minimal transaction costs and the professional management or security selection that you buy when you buy into the fund.

Compared to actively managed funds, passively managed or index funds offer similar diversification but with lower management fees and expense ratios because you aren't paying for market timing or security selection skills. The turnover ratio shows how passive or active the fund management is. About half of all equity mutual funds have a turnover ratio of less than 50 percent.The Investment Company Institute, *2009 Investment Company Fact Book*, 49th ed., 2009, http://www.ici.org/pdf/2009_factbook.pdf (accessed June 15, 2009).

Performance history has shown that actively managed funds, on average, do not necessarily outperform passively managed funds.Burton G. Malkiel, *A Random Walk Down Wall Street* (New York: W. W. Norton & Company, Inc., 2007), 360. Since they usually have higher fees, any advantage created by active management is usually canceled out by their higher costs. Still, there are investors who believe that some mutual funds and mutual fund managers can, on average, outperform the markets or the indexes that provide the benchmarks for passively managed funds.

Summary

- Mutual funds provide investors with
  - diversification,
  - security selection,
  - asset allocation.
- Funds may be actively or passively managed.
- Index funds mirror an index of securities, providing diversification without security selection.
- Funds of funds provide the investor with preselected funds.
- Mutual funds may be structured as
  - closed-end funds,
  - open-end funds,
  - exchange-traded funds.
- Some funds are structured to achieve specific investment goals:
  - Lifestyle funds with target dates to minimize liquidity risk through asset allocation
  - Leveraged funds to increase return through using debt
  - Inverse funds to increase return through active management with the expectation of a down market
- Mutual fund costs may include
  - a sales charge when shares are purchased, or front-end load,
  - a sales charge when shares are sold, or back-end load,
  - a management fee while shares are owned, or
  - a 12b-1 (distribution) fee while shares are owned.
- The management expense ratio is the total mutual fund cost expressed as a percentage of the funds invested.
- Fees vary by
  - fund sponsor,
  - fund strategy (active or passive),
  - fund sales (direct or through a broker).
- Returns from a mutual fund include returns on the securities it owns, including
  - interest distributions,
  - dividend distributions,
  - capital gains distributions.
- A fund prospectus details the fund's investment holdings, historic returns, and costs. Mutual fund ratings in the financial media are another source of information.

Exercises

1. View the video "Investing in Mutual Funds" at efinancedirectory.com/multime...nds_Video.html. According to the speaker, are no-load funds free? Should you buy mutual funds near the end of a year? Survey the articles and tools at "Mutual Funds 101" on Yahoo! Finance at finance.yahoo.com/funds/mutual_funds_101. According to both this source and the video, what are the two key benefits of mutual funds? How are mutual funds classified? How can you gauge the performance of a mutual fund? What are the costs of owning mutual funds? Where can you get information about a mutual fund?
2. Securities regulations require complete and continuous disclosure, also referred to as transparency, so that investors will know what they are getting into when they invest. This requirement is partly satisfied through a fund prospectus. Read the SEC's advice on how to read a prospectus and what to look for at http://www.sec.gov/answers/mfprospectustips.htm. Then compare

that information with the advice offered at http://www.getrichslowly.org/blog/2009/04/23/how-to-read-a-mutual-fund-prospectus/. On the same page, browse the “Best of Get Rich Slowly” links, too. How does this information reinforce the idea that you should thoroughly read and understand a prospectus before investing in a fund?

3. View Morningstar’s performance data chart for various categories of mutual funds at http://news.morningstar.com/fundReturns/CategoryReturns.html. What general categories of funds are included in the chart? Over what time periods are average returns compared? On July 15, 2009, the chart identified the following funds as having average returns of more than 5 percent after five years: natural resources stock, utilities stock, Latin America stock, Pacific/Asia stock, diversified emerging markets stock, emerging markets bonds, long-term government bonds, and equity precious metals. What is the performance of those funds today?
4. Read Investopedia’s article on the costs of investing in mutual funds at http://www.investopedia.com/university/mutualfunds/mutualfunds2.asp. What is your management expense ratio (MER)? Do mutual funds with higher expenses generally earn higher returns?
5. Take Investopedia’s tutorial on how to read a mutual fund table in the financial news at http://www.investopedia.com/university/mutualfunds/mutualfunds4.asp. What do the columns mean? What is being compared? What can you learn from mutual fund tables that may help you choose funds or track the performance of funds you own? Share your ideas with classmates.
6. In My Notes or your personal finance journal, record your study of a fund you choose to track. Read the prospectus, check its ratings, and compare its week-to-week performance with that of similar funds in the mutual funds table in the financial section of a newspaper. Record your observations, questions, and commentary as you go about deciding hypothetically whether or not to invest in that fund.

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15.2: Real Estate Investments

Learning Objectives

1. Distinguish between direct and indirect investments in real estate.
2. Identify the four main ways to invest in real estate indirectly.
3. Explain the role and the different kinds of REITs.
4. Discuss the role and uses of mortgage-backed securities.

When you buy a home, even with a mortgage, you are making a **direct investment**, because you are both the investor and the owner who holds legal title to the property. For most people, a home is the single largest investment they ever make.

As an investor, you may want to include other real estate holdings in your portfolio, most likely as an **indirect investment** in which you invest in an entity that owns and manages real estate. Studies have shown that real estate is a good diversifier for financial investments such as stocks and bonds.Jack Clark Francis and Roger G. Ibbotson, *Contrasting Real Estate with Comparable Investments, 1978–2004* (Ibbotson Associates, 2007), http://corporate.morningstar.com/ib/asp/detail.aspx?xmlfile=1409.xml (accessed June 24, 2009).

Direct Investments

Sonia is looking to buy her first home. After graduating from college, she decided to stay on because she liked the town and found a job as an elementary school teacher. She loves her job, but her income is limited. She finds a nice, two-family house in a neighborhood close to the college. It needs some work, but she figures she can use the summer months to fix it up—she's pretty handy—and renting to students won't be a problem. The tenants will pay their own utilities. Sonia figures that the rental income will help pay her mortgage, insurance, and taxes, and that after the mortgage is paid off, it will provide a nice extra income.



Figure 17.2.1 . © 2010 Jupiterimages Corporation

Many real estate investors begin like Sonia, buying a rental property that helps them to afford their own home. If you actively manage the rental property, there are tax benefits as well. Of course, you have to provide maintenance services and arrange for

repairs, and, in Sonia's case, perhaps give up a bit of privacy. A second or vacation home can be used as a rental property as well, although the tax benefits are less assured. In both cases, the investor is making a direct investment in the property.

The advantages to a direct investment are the additional rental income and tax benefits. The disadvantages are that real estate is relatively illiquid, and the investment concentrates your portfolio in one asset class—residential real estate. Conventional wisdom was that real estate was a good hedge against inflation, but the recent burst of the housing bubble—not only in the United States but also worldwide—has cast a shadow on that thinking. Also, to realize the tax benefits, you must actively manage the rental property, and being a landlord is not for everyone.



Figure 17.2.2 : © *2010 Jupiterimages Corporation*

Other direct real estate investments include **commercial property**, or property exclusively for rent, and undeveloped land. Developers buy property or land and seek to profit from quickly improving and reselling it. Both are more speculative investments, especially if purchased with debt financing. They may also prove to be illiquid and to concentrate assets, making them inappropriate investments for investors without a large and diversified portfolio.

Indirect Investments

Investors who want to add a real estate investment to their portfolio more often make an indirect investment. That is, they buy shares in an entity or group that owns and manages property. For example, they may become limited partners in a real estate syndicate.

A **syndicate** is a group created to buy and manage commercial property such as an apartment, office building, or shopping mall. The syndicate may be structured as a corporation or, more commonly, as a limited partnership.

In a **limited partnership**, there is a general partner and limited partners. The general partner manages the entity, while the limited partners invest in partnership shares. The limited partners are only liable for the amount of their investment; that is, they can lose only as much as they have put in. Limiting liability is particularly important in real estate, which relies on leverage or debt financing. Investors find syndicates valuable in limiting liability and in providing management for the property.

Another form of indirect investing is a **real estate investment trust (REIT)**—a mutual fund of real estate holdings. You buy shares in the REIT, which may be privately held or publicly traded on an exchange. The REIT is a fund invested in various commercial properties. Some REITs specialize, concentrating investments in specific kinds of property, such as shopping malls, apartments, or vacation properties.

To qualify as a REIT in the United States (for the allowable tax benefits), a fund must

- be managed by directors as a corporation or trust,
- offer transferrable shares,

- not be a financial institution,
- have at least a hundred shareholders,
- have at least 95 percent of income from interest, dividends, and property,
- pay dividends that are at least 90 percent of the REITs taxable income,
- have at least 75 percent of its assets invested in real estate,
- get at least 75 percent of gross revenue from real estate.

An equity REIT invests in property, while a mortgage REIT provides real estate financing. A hybrid REIT does both. REITs do for real estate what mutual funds do for other assets. They provide investors with a way to invest with more liquidity and diversity and with comparatively lower transaction costs.

Another way to invest in the real estate market is to invest in the real estate financing rather than the actual real estate. **Mortgage-backed securities (MBS)** are bonds secured by pools of mortgages owned by large financial institutions or agencies of the federal government.

It is difficult to price mortgage-backed securities—to gauge their present and future value and their risk. Like any bond, mortgage-backed securities are vulnerable to interest rate, reinvestment, and inflation risk, but they are also particularly vulnerable to economic cycles and to default risk. If the economy is in a recession and unemployment rises, mortgage defaults will likely rise. When mortgage defaults rise, and the value of mortgage-backed securities falls.

Because they are complicated and risky, mortgage-backed securities are appropriate only for investors with a large enough asset base and risk tolerance to support the investment. MBS investors are usually institutional investors or very wealthy individuals.

Key Takaways

- Direct investments in real estate involve controlling ownership and management of the property.
- Indirect investment involves owning a share of a company that owns and manages the real estate.
- Indirect investments may be structured as
  - a syndicate,
  - a limited partnership,
  - a real estate investment trust (REIT).
- A REIT is designed as a mutual fund of real estate holdings.
  - An equity REIT invests in property.
  - A mortgage REIT invests in real estate financing.
  - A hybrid REIT does both.
- Mortgage-backed securities are another way to invest in a real estate market by investing in its financing, but they are considered too risky for individual investors.

Exercises

1. View the video “Top Eight Real Estate Investment Mistakes” at www.5min.com/Video/Top-Eight-...takes-24084962. According to the speaker, based on eight common mistakes that real estate investors make, what eight things should you do to succeed? The same speaker gives advice on how to be a landlord at www.5min.com/Video/What-Does-...dlord-27579055. What five points does she identify as most important?
2. What have been your experiences as a landlord or as a tenant? Collaborate with classmates to develop two lists: advantages and disadvantages of direct investing in rental property and of being a tenant in a residential or commercial space. Have you had any experience with developing or “flipping” property for resale? What is your opinion of direct investing in foreclosed homes to flip for profit? For perspectives, see the 2009 Money Talks videos on this subject, such as “Vulture Investing” at www.youtube.com/watch?v=rXF1d...fs&feature=fvw. According to the MSN article “Flipping Houses Is Harder than It Looks” at http://realestate.msn.com/article.aspx?cp-documentid=13107725, why is flipping houses so challenging?
3. Are you already invested in real estate? Record in My Notes or your personal finance journal information about your investment and/or your strategy for including real estate in your investment portfolio. Will you invest directly, indirectly, or both? What is your plan and timetable for executing your strategy? Choose one of the REITs listed at “In Reality” at

www.inrealty.com/restocks/linmrt.html to track and to consider hypothetically as an investment. What might be some advantages and risks of investing in this or another REIT as part of your investing strategy?

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15.3: Commodities and Collectibles

Learning Objectives

1. Define and describe the characteristics and uses of derivative contracts.
2. Explain the roles of precious metals in an investment portfolio.
3. Describe the methods available to individual investors in making commodities investments.
4. Compare and contrast the advantages and disadvantages of using collectibles in an individual investment portfolio.

Some investors prefer to invest directly in the materials that are critical to an industry or market, rather than investing in the companies that use them. For example, if you think that the price of oil is going to rise, one way to profit from the higher price would be to buy shares of oil companies that profit by refining oil and selling gasoline, fuels, and other petroleum products. Another way is to buy the oil itself as a commodity.

Commodities are raw materials—agricultural products, metals, energy sources, currencies, and so on—that go into producing goods and services. Investing in commodities is a way to profit directly from the raw material rather than from its products. As discussed in Chapter 12, commodities trading is not new—the first commodities exchange in the United States was established in 1848.

Because they are or rely on natural resources, commodities have a largely unpredictable supply. They have inherent risk, because they are exposed to changes in weather or geology or global politics. Commodities trading began as a way for commodity producers and consumers to manage their risks. These traders are managing risks going forward; that is, they hedge by buying and selling commodities that they expect to exist in the future. This trading is done using future and forward contracts—types of derivatives, discussed in the Chapter 12.

Investing in commodities involves transaction costs and a time limit on realizing your gains (or losses), because derivatives are time-sensitive contracts created with an expiration date.

Commodity investing is risky business, because it is done through derivatives—assets whose value depends on the value of another asset. For instance, the value of a contract to buy or sell soybeans at some time in the future depends on the value of the soybeans. When you invest in a derivative, you are taking on the risk of both contract and the asset that it depends on. One strategy to manage this risk is to invest in both, creating a situation in which one investment can act as a hedge for the other. The way this works is if the underlying asset (the soybeans) gains value, you'll lose on the derivative (the futures contract on soybeans); but if the asset loses value, you can gain on the derivative.



Figure 17.3.1 . © 2010 Jupiterimages Corporation

One example of this is the “prebuy” offer common in regions where homes are heated by oil. When you heat your home with oil, you are exposed to the risk of volatility in the price of oil. This volatility can upset your household budget and, since heat is a necessity, can take away from your other spending needs. You could guarantee your winter’s cost of oil by buying it all in the summer, but you would need a huge oil tank to store all that oil until winter. As an alternative and to attract customers, some heating oil suppliers offer a prebuy deal. During the summer, customers can buy their winter’s supply of oil at a set price, and the oil company will then deliver it as needed over the winter months.

If the price of oil goes up, the customer is protected and gains by not having to pay the higher price. The oil dealer loses the extra profit it could have had. On the other hand, if the price of oil goes down, the dealer is assured its profit, while the customer pays more than necessary without the prebuy deal.

In the language of commodities trading, the customer is “short” oil, that is, needs it and seeks to lock in a price through the prebuy deal. The oil dealer is “long” oil, that is, has a supply and wants to sell it and so seeks to lock in the sale of a certain quantity at a

certain price. The customer wants to lock in a low price, while the dealer wants to lock in a high price. Each is betting on what will be “low” and “high” relative to what the real price of oil turns out to be in the future. The hedge of the prebuy deal relieves both the customer and the dealer of the uncertainty or risk. The deal creates its own risks, but if those are smaller than the risk of oil’s price volatility, then the dealer will offer the prebuy, and the customer will take it.

When you trade commodities, you are also exposed to the risks of trading in the commodities markets. Another reason that commodities investing is risky for individual investors is because professional commodity investors often take speculative positions, betting on the future price of derivatives without holding investments in the underlying assets. Speculators can influence that future price, which after all is just the market’s consensus of what that price “should” be. For individual investors, the risks of commodities trading often outweigh the advantage of whatever diversification they bring to the portfolio.

Gold, Silver, and Precious Metals

Historically, gold and silver have been popular investments of individual investors. For thousands of years, gold and silver have been used as a basis for currency value, either minted into coins or used to back currency value. When a currency is backed by gold, for example, or is “on the gold standard,” there should be a direct relationship between the value of the currency and the value of the gold.

In times of inflation or deflation, investors worry that the value or purchasing power of currency will change. They may invest in gold or silver as a more stable store of wealth than the currency that is supposed to represent the metal. In other words, if investors lose faith in the currency that represents the gold, they may trade their money for the gold.

Most currencies used today are not backed by a precious metal but by the productivity and soundness of the economy that issues them. For example, the value of the U.S. dollar is not related to the value of an ounce of gold, but to the value of the U.S. economy.

When economic or political turmoil seems to threaten the health of an economy and hence the value of its currency, some investors choose to invest in the gold or silver that seems to retain its value. For that reason, gold or silver has historically been regarded as a hedge against inflation.



Figure 17.3.2 . © 2010 Jupiterimages Corporation

How exactly do you buy gold? Gold bullion is sold as bars or wafers in units of one kilogram or 32.15 troy ounces. Metal dealers and some banks will sell bars or wafers ranging from 5 grams (or 0.16075 troy ounces) to 500 ounces or more. Transaction costs are relatively high, between 5 percent and 8 percent, and there is the cost of storing and securing the gold bars or wafers.

A more popular way to buy gold is as coins, which are more easily stored and secured. Gold coins are minted by several countries, including the United States, and may be bought from banks, brokers, and dealers for a fee of about 2 percent.

Commodity Indexes and Exchange-Traded Funds

As with stocks, bonds, and real estate, the most popular way for individual investors to invest in any commodities—including precious metals—is through open-end mutual funds or exchange-traded funds (ETF). The fund may invest in a variety of contracts, diversifying its holdings of the commodity. It has professional managers who understand the pricing of such contracts and can research the market volatility and the global economy. Using a fund as a way of investing in commodities thus provides both diversification and expertise. It can also give you more liquidity as fund shares can be quickly traded into the market.

For example, if you expect inflation and want to buy gold, instead of trying to buy gold bars, you could invest in a fund (iShares), an exchange-traded fund (Comex Gold), or mutual funds (Fidelity Select Gold or Vanguard Precious Metals). These funds allow you to "own" gold but also to get diversification, expertise, and liquidity, reducing your risk.

There are mutual funds or exchange-traded funds for nearly every commodity that is traded. There are also passively managed commodity index funds, similar to stock or bond index funds. Investing in commodities can be a way to achieve asset diversification in your portfolio, because often a commodity such as gold is countercyclical to the economy, and therefore is countercyclical to your stock and bond holdings as well. Commodities may also add significant risk to a portfolio, however, so the advantage of adding them as a diversification strategy may be canceled out by the additional risk.

Collectibles and Unique Investments

Any asset that is tradable may become an investment; that is, it may be purchased and held with the expectation that it can be sold when its value increases. So long as there is a market for it—a buyer—it potentially may be sold at a gain.

Collectibles and unique investments include the following:

- Antique furniture
- Stamps
- Coins
- Rare books
- Sports trading cards
- Vintage cars
- Vintage clothes
- Vintage wines
- Vintage vinyl
- Fine art
- Musical instruments
- Jewelry
- Historical curios
- Other ephemera

As investments, collectibles cannot be standardized in the way that stocks, bonds, or even real estate and used cars can be. Each asset has attributes that make it more or less valuable, even among similar assets. Its value is hard to judge, and therefore it is harder for buyer and seller to agree on a price.

Professional appraisers are knowledgeable about both the item and the market and are trained to evaluate such assets. Theirs is a better-educated guess, but it is still just an estimate of value. Individual investors also consult books on collectibles and may purchase professional market research, pricing indexes, and auction records.

Sometimes one person's trash is another person's treasure. It is fun to think that you may unearth a rare "find" at a garage sale or flea market or that some family heirloom has more than sentimental value. Usually, however, your ability to cash in on your luck is limited by your ability to convince someone else of its worth and to sell when its market is trendy.

Collectibles, including "ephemera" such as antique letters and photographs, are usually sold by dealers or collectors or through a private sale arranged between buyer and seller. The dealers may establish a gallery to showcase items for sale. Auction houses such as Christie's or Sotheby's organize auctions of many items or "lots" to attract buyers and provide catalogues with details on the items for sale, such as their "provenance" or ownership history.

The advantage of unique assets as investments is that you may enjoy collecting and having the items as well as watching their value appreciate. If you are a guitarist, for example, having and being able to play a vintage guitar may mean more to you than the fact that it may be a good investment. For some, collecting becomes a hobby.

The disadvantages of investing in collectibles are

- high probability of mispricing, as markets are inefficient;
- lack of liquidity;
- lack of earnings, as there are no dividends or interest;
- holding costs of the investment.

Unless you are knowledgeable about your item and its markets (and even if you are), it is common to suffer from mispricing. Collectibles' markets are relatively inefficient because trading partners vary widely in their knowledge about pricing. Both buyers and sellers try to persuade each other of an asset's rarity and value. It is easy to be misled and to make mistakes in this market. Online sales and auctions of collectibles at sites such as eBay may be fun for hobbyists, but they typically are not good venues for investors.

If you are trading through a dealer, you can check the dealer's reputation through professional organizations, local business bureaus, and Internet blogs and Web sites, especially where customers can provide a rating or critique. You should also always try to find comparable items to compare prices. If feasible, get a second opinion from an independent appraiser. Knowledge is an important bargaining chip. The more you know, the more likely you are to be satisfied with your investment decision, even if you ultimately walk away from the deal.



Figure 17.3.3 . © 2010 Jupiterimages Corporation

Unique investments may not be readily saleable, or their markets may be subject to trends and fashions that cause price volatility. This means that your investment may ultimately be a source of gain but that you cannot count on it as a source of liquidity. If you have foreseeable liquidity needs, it may not be appropriate to tie up your wealth in a Chinese vase, autographed baseballs, vintage action figures, or Navajo rugs.

There are no dividends or interest paid while you hold collectibles, so if you have income needs you should choose a more useful investment. There are also other costs, such as storage, security, maintenance, and insurance. Your investment actually returns a negative net cash flow—costs you more than it brings in—until you realize its potential gain by selling it.

Collectibles can be a source of joy and a store of wealth, and you may realize a healthy return on your investment. In the meantime, however, they create costs so that your eventual return will have to be large enough to compensate for those costs to make them a really worthwhile investment.

Summary

- Commodities are raw materials and agricultural products.
- Commodities are used to produce other goods and so are traded forward using derivative contracts.
- Derivative contracts can be used to hedge an investment in an asset, or to speculate on the price volatility of the commodity.
- Because of their volatility, commodities markets are riskier than asset markets.
- Precious metals, especially gold, are often used to lower portfolio risk by providing a hedge against inflation.
- Individual investors can invest in commodities using index funds and exchange-traded funds.
- Collectibles and unique assets may appreciate in value, acting as a store of wealth, but the disadvantages of using them as investments are
  - high probability of mispricing,
  - illiquid markets,
  - illiquid returns or no returns until the asset is sold,
  - holding period maintenance costs.

Exercises

1. View Bloomberg's commodities and futures charts at http://www.bloomberg.com/markets/commodities/cfutures.html. Choose one or two commodities to track and find out all you can about investing in those commodities. Read an article on how to read a commodities price chart at http://www.thegraintrader.com/chart- patterns/how-to-read-a-commodity-price-chart.html. Create an annotated drawing to apply the information about reading a commodities chart to an example of a chart taken from the Bloomberg's Web site. Write an interpretation of the chart in My Notes or your personal finance journal.
2. Read Investopedia's article on investing in gold and silver at http://www.investopedia.com/articles/optioninvestor/06/goldsilverfutures.asp. According to this source, who should consider investing in gold and silver and for what reason? What are examples of other precious metals in the futures market? How do investors offset futures contracts before their delivery dates?
3. Sample the collectibles listed on eBay at popular.ebay.com/ns/Collectibles.html. Are there any that interest you that you would consider investment grade? Why or why not? What has been your experience with buying and selling collectibles? In what circumstances might you consider adding investments in a collectible to your portfolio? What would you collect? Research this collectible to determine current pricings, locate markets, and identify dealers and experts. What would you have to sacrifice to invest in this collectible? How much could you make in the future?

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CHAPTER OVERVIEW

16: Career Planning

16.1: Choosing a Job
16.2: Finding a Job
16.3: Leaving a Job

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16.1: Choosing a Job

Learning Objectives

1. Describe the macroeconomic factors that affect job markets.
2. Describe the microeconomic factors that influence job and career decisions.
3. Relate life stages to both microeconomic factors and income needs.
4. Describe how relationships between life stages, income needs, and microeconomic factors may affect job and career choices.

A person starting out in the world of work today can expect to change careers—not just jobs—an average of seven times before retiring.U.S. Department of Labor, Bureau of Labor Statistics, "National Longitudinal Survey of Youth," www.bls.gov/nls/nlsy79r19sup1.pdf (accessed July 23, 2009). Those career changes may reflect the process of gaining knowledge and skills as you work or changes in industry and economic conditions over several decades of your working life. Knowing this, you cannot base career decisions solely on the circumstances of the moment. However, you also cannot ignore the economics of the job market.

You may have a career in mind but have no idea how to get started, or you may have a job in mind but have no idea where it may lead. If you have a career in mind, you should research its **career path**, or sequence of steps that will enable you to advance. Some careers have a well-established career path—for example, careers in law, medicine, teaching, or civil engineering. In other occupations and professions, career paths may not be well defined.

Before you can even focus on a career or a job, however, you need to identify the factors that will affect your decision making process.

Macro Factors of the Job Market

The job market is the market where buyers (employers) and sellers (employees) of labor trade, but it usually refers to the possibilities for employment and its rewards. These will differ by field of employment, types of jobs, and geographic region. The opportunities offered in a job market depend on the supply and demand for jobs, which in turn depend on the need for labor in the broader economy and in a specific industry or geographic area.

The economic cycle can affect the aggregate job market or employment rate. If the economy is in a recession, the economy is producing less, and there is less need for labor, so fewer jobs are available. If the economy is expanding, production and its need for labor are growing.

Typically, a recession or expansion affects different industries in different ways. Some industries are cyclical and some are countercyclical. For example, in a recession, consumer spending is often down, so retail shops and consumer goods manufacturers —in cyclical industries—may be cutting jobs. Meanwhile, more people are continuing their education to improve their skills and the chances of getting a job, which is harder to do in a recession, so jobs in higher education—a countercyclical industry—may be increasing.

For example, it would have been a bad time in the spring of 2009 to think about a career in auto manufacturing in the United States with Ford, General Motors, and Chrysler all announcing massive layoffs, plant closings, and facing bankruptcy. The industry may survive, but it probably won't be able to rebuild that fast.

Global events such as an outbreak of war, the nationalization of a scarce natural resource, the price of a critical commodity such as crude oil, the collapse of a vital industry, and so on, may also cause changes in the global economy that affect job markets.

Another macroeconomic factor is change in technology, which can open up new fields of employment and make others obsolete. With the advent of digital cameras, for example, even single-use conventional cameras are no longer being manufactured in great quantity, and film developers are not needed as much as they once were. However, there are more jobs for developers of electronic cameras and digital applications for creating images and using digital images in communications channels, such as mobile phones.



Figure 18.1.1 : Workers in the Vacuum Cleaner Factory at Reedsville, West Virginia

A demographic shift also can change entire industries and job opportunities. A historical example, repeated in many developing countries, is the mass migration of rural families to urban centers and factory towns during an industrial revolution. Changes in the composition of a society, such as the average age of the population, also affect job supply and demand. Baby booms create demand for more educators and pediatricians, for example, while aging populations create more demand for goods and services relating to elder care.

Social and cultural factors affect consumer behavior, and consumer preferences can change a job market. Demand for certain kinds of products and services, for example, such as organic foods, hybrid cars, clean energy, and “green” buildings, can increase job opportunities in businesses that address those preferences.

Thus, changes in demand for a product or service will change the need for labor to produce it. On a larger scale, economies typically shift their focus over time as different industries become “growth” industries, that is, the drivers of growth in the economy. In the mid-twentieth century, the United States was a manufacturing economy, driven by the production of durable and consumer goods, especially automobiles. In the 1990s, the computer/internet/tech sector had a larger role in driving growth in the U.S. economy due to technological breakthroughs. Currently, education and health care services are the growing sectors of the economy due to demographic and political changes and needs.U.S. Department of Labor, Bureau of Labor Statistics, “Industries with the Fastest Growing and Most Rapidly Declining Wage and Salary Employment, 2006–16,” in “Industry Output and Employment Projections to 2016,” *Monthly Labor Review*, November 2007, www.bls.gov/emp/empfastestind.htm (accessed August 5, 2009).

If you are entrepreneurial and intend to be self-employed, your job opportunities may be affected by the ease with which you can start and maintain a business. Ease of entry, in turn, may be affected by macro factors such as the laws and regulations in the state where you intend to do business and the existing competition in the market you are entering.

The labor market is competitive, not just at an individual level but on a global, industrywide scale. As transportation and especially communication technology has improved, many steps in a manufacturing or even a service process may be outsourced, done by foreign labor. That competition affects the U.S. job market as jobs are moved overseas, but it also opens new markets in developing economies. You may be interested in an overseas job, as American companies open offices in Asian, South American, African, and other countries. Globalization affects job markets everywhere.

Micro Factors of Your Job Market

Whether you are employed or self-employed, whether you look forward to going to work every day or dread it, employment determines how you spend most of your waking hours during most of your days. Employment determines your income and thus your lifestyle, your physical well-being, and to a large extent your satisfaction or emotional well-being. Everyone has a different idea about what a “good job” is. That idea may change over a lifetime as circumstances change, but some specific micro factors will weigh on your decisions, including your

- abilities,
- skills,

- knowledge,
- lifestyle choices.

Abilities are innate talents or aptitudes, what you are capable of or good at. Circumstances may inhibit your use of your abilities or may even cause disabilities. However, you often can develop your abilities—and compensate for disabilities—through training or practice. Sometimes you don't even know what abilities you have until some experience brings them out.

When Tomika says she is "good with people" or when Bryon says that he is a "natural athlete," they are referring to abilities that will make them better at some jobs than others. Abilities can be developed and may require upkeep; athletic ability, for example, requires regular fitness workouts to really be maintained. You also may find that you lack some abilities, or think you do because you've never tried using them.

Usually, by the time you graduate from high school, you are aware of some of your abilities, although you may not be aware of how they may help or hinder you in different jobs. Also, your idea of your abilities relative to others may be skewed by your context. For example, you may be the best writer in your high school, but not compared to a larger pool of more competitive students. Your high school or college career office may be able to help you identify your abilities and skills and applying that knowledge to your career decisions.

Your job choices are not predetermined by your abilities or apparent lack of them. An ability can be developed or used in a way you have not yet imagined. A lack of ability can sometimes be overcome by using other talents to compensate. Thus, ability is a factor in your job decisions, but certainly not the only one. Your knowledge and skills are equally—if not more—important.

Skills and knowledge are learned attributes. A skill is a process that you learn to apply, such as programming a computer, welding a pipe, or making a customer feel comfortable making a purchase. Knowledge refers to your education and experience and your understanding of the contexts in which your skills may be applied.

Education is one way to develop skills and knowledge. In secondary education, a vocational program prepares you to enter the job market directly after high school and focuses on technical skills such as baking, bookkeeping, automotive repair, or building trades. A college preparatory program focuses on developing general skills that you will need to further your formal education, such as reading, writing, research, and quantitative reasoning.

Past high school or a year or two of community college, it is natural to question the value of more education. Tuition is real money and must be earned or borrowed, both of which have costs. There is also the opportunity cost of the wages you could be earning instead.

Education adds to your earning power significantly, however, by raising the price of your labor. The more education you have, the more knowledge and skills you have. The smaller the supply of labor with your particular knowledge and skills, the higher the price your labor can command. This relationship is the rationale for becoming specialized within a career. However, both specialization and versatility may have value in certain job markets, raising the price of your labor.

More education also confers more job mobility—the ability to change jobs when opportunities arise, because your knowledge and skills make you more useful, and thus valuable, in more ways. Your value as a worker or employee enables you to command higher pay for your labor.

Statistics show a consistent relationship between education and earnings. Over a lifetime of work, say about forty to forty-five years, in the United States a person with a college degree will earn over a million dollars more than someone with a high school diploma. According to a recent study,

"There is a positive correlation between higher levels of education and higher earnings for all racial/ethnic groups and for both men and women…The income gap between high school graduates and college graduates has increased significantly over time. The earnings benefit is large enough for the average college graduate to recoup both earnings forgone during the college years and the cost of full tuition and fees in a relatively short period of time."Sandy Baum and Jennifer Ma, *Education Pays: The Benefits of Higher Education for Individuals and Society* (Princeton, NJ: The College Board, 2007).

Not only are you likely to earn more if you are better educated, but you are also more likely to have a job with a pension plan, health insurance, and paid vacations—benefits that add to your total compensation. Although it may seem quite expensive to you now, your college education is definitely worth it: worth the opportunity cost and worth the direct costs of tuition, fees, and

books.Sandy Baum and Jennifer Ma, *Education Pays: The Benefits of Higher Education for Individuals and Society* (Princeton, NJ: The College Board, 2007).

Your choices will depend on the characteristics and demands of a job and how they fit your unique constellation of knowledge, skills, personality, characteristics, and aptitudes. For example, your knowledge of finance, visual pursuit skills, ability to manage stress and tolerate risk, aptitude for numerical reasoning, enjoyment of competition, and preference to work independently may suit you for employment as a stockbroker or futures trader. Your manual speed and accuracy, verbal comprehension skills, enjoyment of detail work, strong sense of responsibility, desire to work regular hours in a small group setting, and preference for public service may suit you for training as a court stenographer. Your word fluency, social skills, communication skills, organizational skills, preference to work with people, and desire to lead others may suit you for jobs in education or sales. And so on.



Figure 18.1.2 . © 2010 Jupiterimages Corporation

Lifestyle choices affect the amount of income you will need to achieve and maintain your lifestyle and the amount of time you will spend earning income. Lifestyle choices thus affect your career path and job choices in key ways. Typically, when you are beginning a career and have few, if any, dependents, you are more willing to sacrifice time and even pay for a job that will enhance your skills and help you to progress along your career path. As a journalist, for example, you may volunteer for an overseas post; or as a nurse you may volunteer for extra rotations. As a computer programmer, you may assist in the development of open source software.

As you advance in your career, and perhaps become more settled in your life—maybe start a family—you are less willing to sacrifice your personal life to your career, and may seek out a job that allows you to earn the income that supports your dependents while not taking away too much of your time.

Your income needs typically increase as you have dependents and are trying to save and accumulate wealth, and then decrease when your dependents are on their own and you have accumulated some wealth. Your sources of income shift as well, from relying on income from labor earlier in your life to relying on income from investments later.

When your family has grown and you once again have fewer dependents, you may really enjoy fulfilling your ambitions, as you have decades of skills and knowledge to apply and the time to apply them. Increasingly, as more people retain their health into older age, they are working in retirement—earning a wage to improve their quality of life or eliminate debt, turning a hobby into a business, or trying something they have always wanted to do. Your life cycle of career development may follow the pattern shown in Table 18.1.1 .

Table 18.1.1 : Lifecycle Career Development

Life Stage	Career Concerns
Exploration and establishment	Develop your skills, acquire knowledge, explore jobs, start earning income, gain experience
Growth	Advance your career, leverage knowledge and skills, increase earnings
Accomplishment	Achieve your goals, maximize earnings, build on success and reputation
Late career	Redirect knowledge and skills, contribute, mentor successors

Regardless of age, your lifestyle choices will affect your job opportunities and career choices. For example, you may choose to live in a specific geographic region based on its

- rural or urban location,
- proximity to your family or friends,
- differences or similarities to where you grew up,
- cultural or recreational offerings,
- political characteristics,
- climate,
- cost of living.

Sometimes you may choose to sacrifice your lifestyle preferences for your ambitions, and sometimes you may sacrifice your ambitions for your preferences. It's really a matter of figuring out what matters at the time, while keeping in mind the effect of this decision on the next one.

Summary

- Macroeconomic factors affect job markets, including
  - economic cycles,
  - new technology or obsolescence,
  - demographic changes,
  - changes in the global economy,
  - changes in consumer preferences,
  - changes in laws and regulations.
- Job markets are globally competitive.
- Microeconomic factors influence job and career decisions, including
  - abilities or aptitudes,
  - skills and knowledge,
  - lifestyle choices.
- Microeconomic factors and income needs change over a lifetime and typically correlate with age and stage of life.
- Job and career choices should realistically reflect income needs.

Exercises

1. Record in My Notes or your personal finance journal your work history and current thoughts about your future work life. What jobs have you held? In each job, what experience, knowledge, or skills did you acquire or develop? What are your future job preferences, and why do you prefer them? Do you have a planned career path? What potential advantages and opportunities do your preferences or plans offer? What potential disadvantages and costs may your preferences or plans entail?
2. Go online to find out the differences in definition between an occupation and a vocation, profession, trade, career, and career path. Which combination of concepts best describes the approach you plan to take to satisfy your needs for income from future employment? Sample the links at http://www.rileyguide.com/careers.html. Choose and record or bookmark the three best online sources of career information for you.

3. Take a free online career development aptitude test, such as the one at http://www.careertest.us/Career_Aptitude_Survey.htm. (Note that sites offering free aptitude, personality, or job preference tests often require online registration. You should evaluate the reliability, credibility, and security of any site you use to explore your career preferences.) What personality attributes and personal aptitudes are micro factors that may affect your career choices or your chances of success in a particular job? View the kinds of assessments you may be asked to take as a job applicant or employee at www.ppicentral.com/Pdf/Employ...ude_Survey.pdf. What aptitudes are included in the battery of tests that make up the Employee Aptitude Survey? How might an employer use the test results?
4. In My Notes or your personal finance journal, list your most important job skills, aptitudes, and preferences on which you plan to expand or build a career. Then list the specific job skills you feel you need to develop further through additional education or experience. How and where will you get those skills and at what cost? Next, describe the lifestyle you hope to support through income from future employment. What aspects of that lifestyle would be easiest for you to modify or sacrifice for your career or income goals?

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16.2: Finding a Job

Learning Objectives

1. List and describe venues for finding job opportunities.
2. Explain the value of networking.
3. Trace the steps in pursuing a job opportunity, specifically your cover letter, résumé, and interview.
4. Identify the critical kinds of information that should be provided in a job offer.

A job search is a part of everyone's life, sooner or later. It may be repeated numerous times throughout your career. You may initiate a job search in hopes of improving your position and career or changing careers, or you may be forced into the job market after losing your job. Whatever the circumstances, when you look for a job you are seeking a buyer for your labor. The process of having to "sell" yourself (your time, energy, knowledge, and skills) is always revealing and valuable.

Finding a Job Market

Before you can look for a job, you need to have an idea of what job market you are in. The same macro factors that you consider in your choice of career may make your job search easier or harder. Ultimately, they may influence your methods of searching or even your job choice itself. For example, as unemployment has increased in the wake of the most recent financial crisis, the labor market has become much more competitive. In turn, job seekers have become much more creative about advertising their skills—from broader networking to papering a neighborhood with brochures on windshields—and more accepting of job conditions, including lower compensation. A good place to start is the U.S. Department of Labor's "Occupational Outlook Handbook."See, for example, U.S. Department of Labor, Bureau of Labor Statistics, www.bls.gov/oco, and "Tomorrow's Jobs," www.bls.gov/oco/print/oco2003.htm (accessed July 20, 2009). The handbook is updated annually. For hundreds of industries and specific jobs it tells you the training and education you need, what you will earn and what your job prospects are, what the work entails, and what the working conditions are like. The site also offers valuable tips on conducting job searches.

Knowing the job classification and industry name will focus your search process and make it more efficient. Once you understand your job market, look at the macro and micro factors that affect it along with your personal choices. For example, knowing that you are interested in working in business, transportation, or the leisure and hospitality industry, you are ready to research that field more and plan your job search.

You are looking for a buyer of your labor, so you need to find the markets where buyers shop. One of the first things to do is find out where jobs in your field are advertised. Jobs may be advertised in

- trade magazines,
- professional organizations or their journals,
- career fairs,
- employment agencies,
- employment Web sites,
- government Web sites,
- company Web sites,
- your school's career development office.

Figure 18.2.1 describes these venues in more detail.

Trade magazines	Publications that have classified ads listing jobs in your field or area of interest.
Professional organizations	Associations that run ads or postings for jobs via their journals, Web sites, and discussion lists.
Career fairs	Employers gather to recruit job applicants, often in a particular industry or region.
Employment agencies	Businesses that work as "headhunters" for employers, who pay the agency a fee for finding and screening a good recruit.
Employment Web sites	Places where employers and job seekers post and respond to information about job opportunities and work availability. You will find evaluations of employment Web sites at http://www.employmentwebsites.org (the International Association of Employment Web Sites).
Government Web sites	Career information and current listings for state and federal government jobs. Listings for federal jobs are at http://federaljobs.net/federal.htm and http://www.usajobs.gov. State government jobs may be found at http://www.statelocalgov.net/50states-jobs.cfm.
Company Web sites	Current job listings posted by a company's human resource personnel on the company's Web site.
College career development office	Job placement services on campus for graduates and alumni, run by career counselors.

Figure 18.2.1 : Sources of Information about Jobs

Consider Sandy, for example, who is graduating with a bachelor's degree in hospitality management. Her dream job is to work at an inn or bed and breakfast in a resort location. The Professional Association of Innkeepers International (PAII) offers a Web site and journal—good places to start reading and learning about the industry. It also lists upcoming trade conferences that may be a good opportunity for Sandy to meet some people in the industry.The Professional Association of Innkeepers International, http://www.paii.org (accessed July 23, 2009).



Figure 18.2.2 . © 2010 Jupiterimages Corporation

Browsing online, Sandy learns about a big job fair coming to her region, sponsored by the PAII in association with a chamber of commerce and an economic development agency. This is her chance to meet recruiters in her industry and find out about actual opportunities. Each prospective employer will have a table, and Sandy will go from table to table, getting information, dropping off her résumé, and possibly setting up interviews.

She also plans to register with an employment agency that specializes in hotel management for smaller hotels and inns. The agency will screen her application and try to match her with appropriate jobs in its listings. For a specified time it will keep her résumé on

file for future opportunities.

Sandy's strategy includes posting her résumé on employment web sites, such as Monster.com, and Careerbuilder.com. Browsing jobs online, Sandy discovers there is a strong seasonal demand for hospitality workers on cruise ships, and this gives her an idea. If the right choice doesn't come up right away, maybe a summer job working for a cruise line would be a good way to develop her knowledge and skills further while looking for her dream job in management.

Sandy needs to research destinations as well as businesses and wants to talk with people directly. She knows that cold calls—calling potential employers on the phone as a complete unknown—is the hardest way to sell herself. In any industry, cold calling has a much lower success rate than calling with a referral or some connection—otherwise known as networking.

Networking is one of the most successful ways of finding a job. It can take many forms, but the idea is to use whatever professional, academic, or social connections you have to enlist as many volunteers as possible to help in your job search. According to popular theory, your social networks can be seen as assets that potentially help you build wealth. That is, the number and positions of people you can network with and the economically viable connections you can have with them are a form of capital—**social capital**.Robert Putnam, *Bowling Alone: The Collapse and Revival of American Community* (New York: Simon & Schuster, 2000).

Word of mouth is a powerful tool, and the more people know about your job search, the more likely it is that they or someone they know will learn of opportunities. Sandy's strategy also includes joining online career networking sites, such as LinkedIn, and discussion lists for people in the hospitality industry. Sandy finds a helpful Yahoo! group called The Innkeeper Club and posts a query about what employers look for in a manager.



Figure 18.2.3 . © 2010 Jupiterimages Corporation

While Sandy was in college getting her degree in hospitality management, her best friend from high school was happily styling hair in a local salon. Sandy never thought to network through her friend, but it turns out that one of her friend's clients has a sister who owns a country inn with her husband, and they are thinking about hiring someone to manage their enterprise. After driving several hours to meet them, Sandy learns they have changed their minds and are not hiring now. However, they know of two other innkeepers who may be looking for help. Since they are impressed with Sandy, they are happy to pass along her name and résumé.

That's how networking works—you just never know who may be helpful to you. The obvious people to start with are all the people that you know: former professors, former employers, friends, family, friends of family, friends of friends, family of friends, and so on. The more people you can talk with or send your résumé to (i.e., impress), the greater the chances that someone will make an offer.

Another good networking strategy is to call or e-mail people working in the industry, individuals who are currently in or just above the position you'd like to have, and ask to talk with them about their work. If you make it clear that you are not asking for or expecting a job offer from them, many people will be happy to take a half hour to discuss their jobs with you. They may have valuable tips or leads for you or be willing to pass along your name to someone else who does.

Selling Yourself: Your Cover Letter and Résumé

To get a job you will have to convince someone who does not know you that you are worth paying for. You have an opportunity to prove that in your cover letter and résumé and again in your interview.

The cover letter, whether mailed or an e-mailed, is your introduction to your prospective employer. You have three paragraphs on one page to briefly introduce yourself and show how you can make a profitable contribution to the company. The objective of the cover letter is to get the reader to look at your résumé with a favorable impression of you created by the letter.

Your first paragraph should establish your purpose in making contact, the reason for the letter. You should make it clear what job you are applying for and why you are making this particular contact. If someone referred you, mention him or her by name. If you met the addressee previously, remind him or her where and when that was, for example, “It was great to chat with you at the Jobs Fair in Cleveland last week.” The more specifically you can identify yourself and separate yourself from the pool of other job seekers, the better.

The second paragraph of your cover letter should summarize your background, education, and experience. All this information is on your résumé in more detail, so this is not the place to expound at length. You want to show briefly that you are qualified for the position and have the potential to make a contribution.

Your third paragraph is your opportunity to leave the door open for further communication. Make it clear where and how you can be reached and how much you appreciate the opportunity to be considered for the position.

The **résumé**, the summary list of your skills and knowledge, is what will really sell you to an employer, once you have made a good enough impression with the cover letter to get him or her to turn the page. A good résumé provides enough information to show that you are willing and able to contribute to your employer’s success—that it is worth it to hire you or at least to talk to you in an interview.

List the pertinent facts of where and how you can be reached: address, phone number, e-mail address. Your qualifications will be mainly education and experience. List any degrees, certificates, or training you have completed after high school. Be sure to include anything that distinguishes your academic career, such as honors, prizes, or scholarships.

List any employment experience, including summer jobs, even if they don’t seem pertinent to the position you are applying for. You may think that being a camp counselor has nothing to do with being a radiology technician, but it shows that you have experience working with children and parents, have held a position where you are responsible for others, and that you are willing to work during your school breaks, thus showing ambition. If you are starting out and can’t be expected to have lots of employment experience, employers looks for hints about your character—things like ambition, initiative, responsibility—that may indicate your success working for them.

Internships that you did in college or high school are also impressive, showing your willingness to go beyond the standard curriculum and learn by working—something an employer will expect you to continue to do on the job, too. While you are in school, you should recognize the value added by experiential learning and the positive impression that it will make. An internship can also give you a head start in networking if your supervisor will be a good reference or source of contacts for you. The internship may even result in a job offer; you may not necessarily want to accept, but at the very least, having an offer to fall back on takes some of the pressure off your search.

For each job, be clear about the position you held and the two most important duties or roles you performed. Don’t go into too much detail, however. The time to expand on your story is in the interview.

If you have done internships or volunteer work or if you are a member of civic or volunteer organizations, be sure to list those as well. They are hints about you as a person and may help you to stand out in the pool of applicants.

A common mistake is to list too much extra information on your résumé and to focus too much on what you want. For example, stating an objective such as “to obtain a great position in hotel management.” Your employer cares about what you can do for the company, not for yourself. The following are some tips for developing your résumé:

- Avoid adjectives or adverbs when describing your past performance. If you were an achiever in school, that will be reflected in your grades, degrees, honors, and awards. “Hype” can sound boastful; besides, you can discuss your performance in detail at the interview.

- Be honest and state your case without exaggeration. It is easier than ever for employers to check on your history, and they will. Falsification of information on your résumé may become grounds for dismissal, if you are hired.
- Don’t include personal details unless they are strongly relevant to the job you are seeking. Employers typically do not want to know that you love dogs, were raised in Singapore, or are a single mother.
- Be correct. Proofread your résumé and have someone else proof it as well. This is your opportunity to make a good impression. Any error indicates not just that you made an error, but that you are sloppy, lazy, or willing to let your work go public with errors.
- Keep it to one page, if possible. Employers typically are looking at many résumés to fill one position, so make it easy and quick for the reader to see how qualified you are.

A myriad of sample résumés and sample cover letters may be found online, but be wary of templates that may not fit you or your prospective job. Employers in your field may have particular expectations for what should be on your résumé or how it should be structured. Maybe you should list your skills or perhaps your education first. Perhaps it would be preferable to list your past employment experiences in reverse chronology (with your most recent job first). Advice is plentiful about how to write a résumé, but there is no one right way or best way. Choose an appropriate style and format for your job category that will present you in the best possible light as a prospective employee.

Many employers want you to fill out an application form independently of or instead of a résumé. They may also ask for references, especially from former employers who are willing to recommend you. Be aware that hirers and human resources department personnel routinely follow up on references and letters of recommendation. Find out more about filling out employment applications at About.com at http://jobsearch.about.com/cs/jobapplications/a/jobapplication.htm and other sites.

There are many resources available in print and online to help you write a good résumé. In addition, résumé writing workshops and short courses are often held at community colleges or adult education centers.Ellen Gordon Reeves, *Can I Wear My Nose Ring to the Interview?* (New York: Workman Publishing, 2009).

Selling Yourself: Your Interview

The interview—a face-to-face conversation with a prospective employer—is your chance to get an offer. You want to make a good personal impression: dress professionally but in clothes that fit well and comfortably. Be polite and cordial but also careful not to assume too familiar a tone.

You may be asked a series of predetermined questions, or your interviewer may let the conversation develop through open-ended questions. The interviewer may let you establish its direction in order to learn more about how you think. However the conversation is guided, you want to be able to showcase your suitability for the job and what you bring to it. Figure 18.8 identifies some questions employers commonly ask in job interviews.

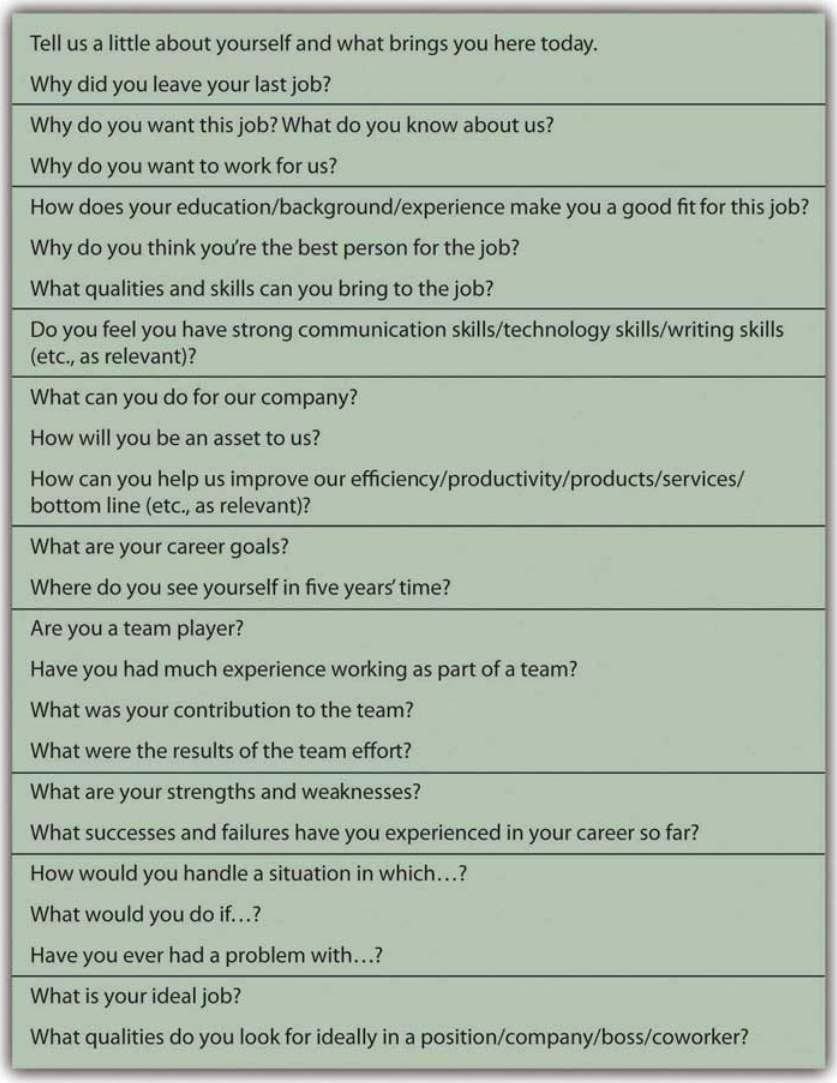


Figure 18.2.4 : Questions Prospective Employers Commonly Ask

Be prepared for interviewers who prefer to focus on general behavioral questions rather than on job specific questions. **Behavioral interviews** emphasize your past actions as indicators of how you might perform in the future. The so-called **STAR Method** is a good approach to answering behavioral questions, as it helps you to be systematic and specific in making your past work experiences relevant to your present job quest. The STAR MethodThe STAR Method: http://web.mit.edu/career/www/guide/star.html, www.drexel.edu/SCDC/resources...R%20Method.pdf, www.officearrow.com/home/arti...294/p142_dis/3 (accessed August 5, 2009). is a process of conveying specific situations, actions, and outcomes in response to an interviewer's question about something you did.

- **S**ituation: Give specific details about the situation and its context.
- **T**ask: Describe the task or goal that arose in response to the situation.
- **A**ction: Describe what you did and who was involved.
- **R**esult: Describe the (positive) outcome.

For example:

Question: We are looking for someone who is willing to take initiative in keeping our office systems working efficiently and who can work without a lot of direct supervision. Does that describe you?

Answer: Absolutely. For example, in my last job I noticed that the office supply system was not working well. People were running out of what they needed before letting me know what to order (**S**ituation). I thought there needed to be a better way to anticipate

and fill those needs based on people's actual patterns of use (**T**ask). So, I conducted a poll on office supply use and used that information to develop a schedule for the automatic resupply of key items on a regular basis (**A**ction). The system worked much more smoothly after that. I mentioned it in my next performance review, and my boss was so impressed that she put me in for a raise (**R**esults).



Figure 18.2.5 . © 2010 Jupiterimages Corporation

There are some questions employers should *not* ask you, however. Unless the information is a legal requirement for the job you are interviewing for, antidiscrimination laws make it illegal for an employer to ask you your age; your height or weight; personal information such as your racial identity, sexual orientation, or health; or questions about your marital status and family situation, such as the number of children you have, whether you are single, or if you are pregnant or planning to start a family.

It is also important for you to have questions to ask in an interview, so you should prepare a few questions for your interviewer. Questions could be about the company's products or services, the company's mission or goals, the work you would be doing, who you would be reporting to, where you would be located, and the opportunities for advancement. You want your question to be specific enough to show that you have already done some research on the company, its products, and markets. This is a chance to demonstrate your knowledge of the job, company, or industry—that you have done your homework—as well as your interest and ambition.

Unless your interviewer mentions compensation, don't bring it up. Once you have the job offer, then you can discuss compensation, but in the interview you want to focus on what you can do for the company, not what the company can do for you.

You can also use the interview to learn more about the company. Try to pick up clues about the company's mission, corporate culture, and work environment. Are people wearing business attire or "business casual"? Are there cubicles and private offices or a more open workspace? Are people working in teams, or is it more of a conventional hierarchy? You want to be in a workplace where you can be comfortable and productive. Be open-minded—you may be able to work quite well in an environment you have never worked in before—but think about how you can do your best work in that environment.

After your interview, send a thank you note, and follow up with a phone call if you don't hear back. You may ask your interviewer for feedback—so that you can learn for future interviews—but don't be surprised and be gracious, if you don't get it. Always leave the door open. You never know.

Accepting an Offer

A job offer should include details about the work you will be performing, the compensation, and the opportunity to advance from there. If any of that information is missing, you should ask about it.

In many jobs, you may be asked to do many things, especially in entry-level jobs, so the job description may be fairly vague. Your willingness to do whatever is asked of you (within the law and according to ethical standards) should be compensated by what you stand to gain from the job—in pay or in new knowledge and experience or in positioning yourself for your next job. Some jobs are better looked at as a kind of graduate education.

Your **compensation** includes not only your wages or salary but also any benefits that the employer provides. As you read in previous chapters, benefits may include health and dental insurance, disability insurance, life insurance, and a retirement plan. Compensation also includes time off, sick days, and vacation days. You should understand the company's policies and flexibility in applying them.

Know what your total compensation will be and whether it is reasonable for the job, industry, and current job market. Asking around may help, especially on online discussion groups with relative anonymity. People often are reluctant to disclose their compensation, and companies discourage sharing this information because it typically reveals discrepancies. For example, people hired in the past may be receiving less (or more) pay than people hired recently for the same position. In addition, gender gap—in which men receive higher pay than women in the same position—is often a problem.

To gauge how reasonable a job offer is, you can research professional associations about pay scales or find statistical averages by profession or region. Online resources include simple salary comparison calculators, such as the one at http://monster.salary.com. You also will find data and related articles linking salaries to specific job titles, area codes, states, educational levels, and years of work experience, for example, at http://www.payscale.com/research/US/Country=United_States/Salary.

Realistically compare the job offer to your needs. Different geographic areas have different costs of living, for example, so the same salary may afford you a very different lifestyle in Omaha than in New York City. Your employment compensation is most likely an important source—perhaps your only source—of income. That income finances your plan for spending, saving, and investing. A budget can help you to see if that income will be sufficient to meet your financial goals. If you already have financial responsibilities—student loans, car loans, or dependents, for example—you may find that you can't afford the job.

You can negotiate your compensation offer; many employers expect you to try, but some will just stand by their offer—take it or leave it. Your ability to negotiate depends in part on the number of candidates for that particular job and how quickly the employer needs to fill it. You will find guidelines online for evaluating job offers and negotiating your compensation, for example, among the useful links at http://www.rileyguide.com/offers.html. Another resource includes the simple "Job Offer Checklist" at http://www.collegegrad.com/offer.

In some cases, your employer may offer you a contract, a legal agreement that details your responsibilities and compensation and your employer's responsibilities and expectations. As with any contract, you should thoroughly understand it before signing. If you will be employed as a member of a trade union or labor union under a **collective bargaining** agreement, the terms of the contract may be applicable to all union members and therefore not negotiable by individual employees.

It is exciting to get a job offer, but don't let the excitement overwhelm your good sense. Before you accept a job, feel positive that you can live with it. You never really know what a job is like until you do, but it is better to go into it optimistically. When you are just starting a career or trying one out, it is most important to be able to learn and grow in your job, and you may have a period of "paying your dues." But if you are really miserable in a job, you won't be able to learn and grow, no matter how "golden" the opportunity is supposed to be.

Summary

- Venues for finding jobs include
  - trade magazines,
  - professional organizations or their journals,
  - career fairs,
  - employment agencies or "headhunters,"

  - employment Web sites,
  - company Web sites,
  - government Web sites,
  - your school's career development office.
- Networking is a valuable way to expand your job search.
- Selling your labor to a prospective employer usually involves sending a cover letter and résumé, filling out an application form, and/or having an interview.
  - The cover letter should get a prospective employer to read your résumé.
  - The résumé should get the employer to offer you an interview.
  - The interview should get the employer to offer you the job.
- A job offer includes information on the
  - job;
  - compensation, including benefits;
  - opportunities for advancement.
- Accepting a job offer may involve
  - evaluating the offer in relation to your needs,
  - examining a job contract, or
  - negotiating the compensation.

Exercises

1. Read "Tomorrow's Jobs" at the Bureau of Labor Statistics Web site at www.bls.gov/oco/oco2003.htm. What job categories are showing the greatest growth? Which job categories show negative growth? In what sector of the economy or in what industry will you seek a job or develop your career? Record or chart your thoughts in My Notes or your personal finance journal. What are the reasons for your choices? What education, knowledge, skills, aptitudes, preferences, and experiences do you bring to them?
2. In My Notes or your personal finance journal, list all the individuals and groups you can think of to tell about your job search or career development quest. Include their contact information. Write a message you could adapt, as needed, for each audience to send when you are ready. Then go online to research other individuals and groups you could include in your networking or could go to for more information about job opportunities. Read up on developing your practical networking skills online at Boston.com ("Flex Your Networking Skills," http://www.boston.com/jobs/bighelp2009/january/flex_your_network). Make a fact-finding appointment with a contact you find through networking and record your thoughts on the outcomes. Were you able to practice key networking skills? What did you learn?
3. Write or revise your résumé and draft a general cover letter you could adapt for different job openings. Network with classmates to get critiques and ideas for clarifying or improving these tools to attract a prospective employer. What other supporting documents could you include in your job application?
4. How will you prepare for a job interview? Read a *New York Times* interview with the CEO of Cisco Systems, John Chambers, about corporate leadership and recruitment at http://www.nytimes.com/2009/08/02/business/02corner.html?th&emc=th. In the second half of the article, the interviewer asks, "How do you hire?" What qualities of new recruits to corporate management does this CEO look for? Read the articles on interviewing at the following Careerbuilder.com URLs:
   - http://www.careerbuilder.com/jobposter/small-business/article.aspx?articleid=ATL_0174INTERVIEWBLUNDERS
   - http://www.careerbuilder.com/jobposter/small-business/article.aspx?articleid=ATL_0089INTERVIEWSTYLES
   - http://www.careerbuilder.com/jobposter/small-business/article.aspx?articleid=ATL_0087INTERVIEWNO-NOS
   - http://www.careerbuilder.com/jobposter/small-business/article.aspx?articleid=ATL_0082INTERVIEWQUESTIONS
5. Anticipate the questions you may be asked in an interview. For example, what could you say in a behavioral interview? Prepare your answer using the examples found at webatl02.officearrow.com/job-...-107/view.html. For edification and fun, collaborate with classmates to do role-plays of job interviews. Videotape your interviews. View the videos and read the twenty tips on "How to Nail an Interview" at http://www.howtonailaninterview.com/#vid. Also see the Vault.com videos of interviews at http://www.youtube.com/watch?v=S1ucmfPOBV8. As an employer, would you hire yourself? What interviewing preparations and skills do you think you need to work on?

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16.3: Leaving a Job

Learning Objectives

1. Describe the processes of voluntary job loss.
2. Describe the processes of involuntary job loss.
3. Identify the financial impacts of an involuntary job loss.
4. Identify major federal legislation that addresses employment issues and describe its importance in labor markets.

Statistically, it is almost impossible for you to expect to have one job or career for your entire working life. At least once and possibly many times, you will change jobs or even careers. You will have to leave your current or former job and find another. Handling that transition can be difficult, especially if the transition is not what you would have preferred. How you handle that transition may affect your success or satisfaction with your next position.

You may leave your job voluntarily or involuntarily. When you leave voluntarily, presumably you have had a chance to make a reasoned decision and have decided that the net benefits of moving on are more than the net benefits of staying.

Leaving Voluntarily

You may decide to leave a job and move to another for the following reasons:

- move to a position with more responsibility, opportunity to advance, or compensation
- be in a more compatible work environment or corporate culture
- learn a new skill
- become self-employed by beginning an entrepreneurial venture
- make a transition from a military to a civilian job

In other cases, you may leave employment permanently or temporarily because of the following reasons:

- further your education
- assume family care, for example of a child or parent
- take time off for recreation
- retire

Whatever your motivation for leaving your job, your decision should make sense; that is, it should be based on a reasoned analysis of how it will affect your life. If you have dependents, you will have to consider how your decision may affect their lives too.

Since your job is a source of income, leaving your job means a loss of that income. You need to consider how you can maintain or change your current use of income (i.e., spending and saving levels) with that loss.

If you are changing jobs, your new job will replace that income with new income that is more than, equal to, or less than your old paycheck. If it is equal to or more than your former income, you may maintain or even expand your spending, saving, and investing activities. Extra income will provide you with more choices of how to consume or save. If it is less than your former income, you will have to decrease your spending or saving to fit your current needs. Your budget can help you foresee the effects of your new income on your spending and saving.

If you are leaving employment, then there will be no replacement income, so your spending and saving activities should reflect that loss, unless you have an alternative source of income to replace it. If you are going on to graduate school, perhaps you have a fellowship or scholarship. If you are assuming family care responsibilities, perhaps another family member has offered financial support. If you are retiring, you should have income from invested capital (e.g., your retirement savings) that can be used to replace your wages or salary.

If you are initiating the job change, be sure you try to cause the least disruption and cost to your employer. Let your employer know of your decision as soon as is practical, and certainly before anyone else in the company knows. “Two weeks notice” is the convention, but the more notice you can give, the less inconvenience you may cause. Offer to help train your successor or be

available to provide information or assist in the transition. The more cordially you leave your job, the better your relationship with your former employer will be, which may reflect well on you in future networking.

If you participated in a defined contribution retirement plan you own those funds to the extent that you are vested in your employer's contributions and have contributed your own funds. You can leave those funds as they are invested, or you can transfer them to your new job's plan and invest them differently. There may be some time limits to doing so, and there may be tax considerations as well, so be sure you consult with your former employer and understand the tax rules before moving any funds.

The decision to leave a job and perhaps to leave employment means leaving nonincome benefits that can create opportunity costs, including

- intellectual or emotional gratifications of the work,
- enjoyment of your colleagues,
- opportunities to learn.

If you have had a negative work experience, leaving may allow you to reduce boredom, eliminate job dissatisfaction, end conflict, avoid unwanted overtime, or reduce stress, but these are reasons for leaving a job that you probably should not share with a new or prospective employer.



Figure 18.3.1 : Unsplash License; Elisa Ventur via Unsplash)

Surveys reported in 2005 had this to say about job satisfaction in the United States:Job Satisfaction

- Job satisfaction generally declined since 2000.
- Forty-five percent of workers say they are either satisfied or extremely satisfied with their jobs.
- Twenty percent feel very passionate about their jobs.
- Thirty-three percent believe they have reached a dead end in their career.
- Twenty-one percent are eager to change careers.
- Older workers are the most satisfied and the most engaged in their work.
- Younger workers are the most distressed and feel the least amount of loyalty to their employers.
- Small-firm employees feel far more engaged in their work than their corporate counterparts.
- Job security, health care coverage, and professional development are valued above additional compensation.

According to a 2009 Salary.com survey, only around 15 percent of workers said they were "extremely satisfied" with their jobs. Working retirees and those in the health care and Internet industries were the most satisfied, while workers under thirty and those working in finance-related fields were the least satisfied. At the time of the survey, about 60 percent of workers were looking around for another job, despite most claiming they were generally satisfied with their wages or salaries. Many were worried about being laid off in a down economy.

As you can see, many micro and macro factors may enter into a decision to leave a job. You spend many of your waking hours working, and deciding to change jobs is about much more than just income. It is still a decision about income, however, so you

should carefully weigh the effects of that decision on your personal financial well-being.

Leaving Involuntarily

If you leave your job involuntarily, you will have to make adjustments for a loss of income that you were not planning to make. That may be difficult, but not so much as you think.

Involuntary job loss may be due to your employer's decision, an accident or disability, or unexpected circumstances, such as the acquisition, merger, downsizing, or closing of the company you work for. Your employer also may decide to lay you off or fire you. A layoff implies a temporary job loss due to a circumstance in which your employer needs or can afford less labor.

If the layoff is due to an economic recession when there is less demand for the product you create, then it may be affecting your entire industry. That would mean you would have a harder time finding a similar job. If layoffs are widespread enough, however, there may be federal, state, or local government programs aimed at helping the many people in your situation, such as a retraining program or temporary income assistance.

You may get laid off because your employer is no longer as competitive or profitable and so has to cut costs or because the company has lost financing. If the layoffs are specific to your employer, you may be able to find a similar position with another company or you may be able to establish your own competitive business in the same industry.

When you are fired, the employer permanently terminates your employment based on your performance. Involuntary **termination**, or getting fired, will cause a sudden loss of income that usually requires sudden adjustments to spending and saving. You may have to use your accumulated savings to finance your expenditures until that income can be replaced by a new job.

An injury or illness—to you or a dependent—may create a temporary or permanent involuntary job loss. It usually also means a period of unemployment. Depending on the circumstances, your employer may be willing to help ease the transition, perhaps by offering you a more flexible schedule, adjusting your responsibilities, or providing specialized equipment to enable you to do a job.

By law, employers may not discriminate against people with disabilities so long as they are able to do a job. A **job accommodation** is any reasonable adjustment to a job or work environment that makes it possible for an individual with a disability to perform or continue to perform job duties.

If you become disabled and unable to work, you may be able to replace some or all of your wage income with insurance coverage, if you have disability insurance that covers the specific circumstances (as discussed in Chapter 10). If your disability is permanent, you may qualify for federal assistance through Social Security. If someone else is liable for your disability, in the case of an accident or through negligence, his or her insurance coverage may provide some benefit, or you may have a legal claim that could provide a financial settlement.

If your employer initiates your job change, be sure to discuss his or her obligations to you before you leave. Some employer responsibilities are prescribed by law, as shown in Figure 18.11. Other responsibilities are prescribed by union contract, if applicable, and some are conventions or courtesies that your employer may—or may not—choose to extend.

Severance is compensation and benefits offered by your employer when you are fired. Your employer is not obligated to offer any severance, but "two weeks pay" is the convention for wages. Your employer is also not required to "pay" for your remaining sick days or vacation days or to extend your benefits, including retirement contributions or life insurance, unless specified in a contract. In most cases, your employer is required under federal law to offer you the opportunity to remain covered under your employee health insurance plan if you assume the cost. This continuation of health coverage is provided by COBRA, the Consolidated Omnibus Budget Reconciliation Act of 1986 (discussed in Chapter 10). Employers must also provide proof of "insurability," which enables unemployed workers to purchase private health insurance, if they wish, without having to undergo medical exams.

Employment Protection

Federal and state laws govern relationships between employers and employees. A large part of employment law addresses hiring and firing issues as well as working conditions. You should be familiar with the laws that apply where you work (as they differ by state and sometimes by county) so that you understand your responsibilities to your employer and your employer's obligations to you. Major federal legislation that addresses these issues is outlined in Table 18.3.1 .

Table 18.3.1 : Major U.S. Employment Legislation. U.S. Department of Labor, “Summary of the Major Laws of the Department of Labor,” www.dol.gov/opa/aboutdol/lawsprog.htm (accessed July 21, 2009).

Legislation	Regulation	Applies to
National Labor Relations Act, 1935	Prevents employees who engage in union activity from being fired	Employers whose business is engaged in interstate commerce
Fair Labor Standards Act, 1938	Established minimum wage and overtime	All private employees, amended in 1974 to include state and local employees
Title VII, The Civil Rights Act, 1964	Prohibits discrimination on the basis of race, color, religion, sex, or national origin	Employers with at least 15 employees
Age Discrimination in Employment Act, 1967	Prevents discrimination on the basis of age against employees who are over 40 years old	Employers having at least 20 employees
Americans with Disabilities Act, 1990	Prevents discrimination against disabled employees	Employers having at least 15 employees
Family and Medical Leave Act, 1993	Guarantees a 12-week unpaid leave for illness, childbirth, or to care for an ill relative	Employers having at least 50 employees
Health Insurance Portability and Accountability Act, 1996	Limits exclusion from employersponsored coverage because of preexisting condition or medical history	All employers that offer employer-sponsored health insurance

These laws cover all aspects of employment: hiring, negotiation, working conditions, compensation, benefits, and termination. Workers can sue a company for **wrongful discharge**—for being fired for any reason barred by an employment law. Employers often seek to protect themselves from suits by requiring terminated employees to sign a form releasing the company from liability.

Companies have ethical standards for dealing with the hiring and firing of employees, but they also may have informal practices for encouraging unwanted employees in good standing to leave. Employment laws cannot protect workers against some unethical practices, but they have clauses that prohibit **retaliation** against employees who invoke those laws or enlist government assistance to enforce them. The laws also protect **whistleblowers** who report employer infractions to government authorities.

The federal government provides unemployment compensation insurance through the Federal-State Unemployment Insurance Program to employees who “lose their jobs through no fault of their own.”U.S. Department of Labor, “Unemployment Insurance,” www.dol.gov/dol/topic/unemplo...ance/index.htm (accessed July 21, 2009). You must meet eligibility requirements to qualify, and the benefits are limited, although they may be extended in certain circumstances. Benefits were extended in February 2009, for example, to as long as seventy weeks in many states, as the number of unemployed workers rose to six million.

Your job and eventually your career will play many roles in your life. It will determine how you spend your time, who you spend your time with, where you live, and how you live. It will probably be a primary determinant of income and therefore of how much you can spend, save, and invest. How you chose to spend, save, and invest is up to you, and your financial decisions can have far-reaching consequences. The more you know and the more you understand, the more you can make decisions that can satisfy your dreams.

KEY TAKEWAYS

- You can expect to leave a job at least once in your career.
- You can leave a job voluntarily or involuntarily.
- You may leave voluntarily to change jobs or to leave employment, temporarily or permanently.
- You may leave a job involuntarily through a
  - layoff,
  - disabling accident or injury,

- firing.
- Leaving a job involuntarily means a sudden loss of income.
- Involuntary job loss may be compensated with
  - severance,
  - employment insurance,
  - continuation of health and other benefits.
- Federal, state, and local laws address employment issues, including hiring, working conditions, compensation, and dismissal. Laws exist to protect workers.

? Exercise 16.3.1

What do you look for in a job? Record in My Notes or your personal finance journal the characteristics of a job that you value most when seeking a job and the characteristics that bother you the most or would cause you to consider leaving a job voluntarily. Take an online job satisfaction survey or collaborate with classmates to develop questions for a job satisfaction survey that you can administer to other students. What do you find are the top ten characteristics of a great job offering a lot of job satisfaction?

? Exercise 16.3.2

View the list of "Red Light" reasons for leaving a job—reasons you should not use in a job interview in which you are asked why you left your last job—at https://www.snhu.edu/about-us/newsro...-leaving-a-job. Have you ever cited one of those reasons as the reason you left your job? For each item on the list, brainstorm with classmates why it would be better not use it in a job interview. What does the item say about you as a worker or as an employee? What could you possibly do differently to prevent each "Red Light" item from being the reason you leave a job?

? Exercise 16.3.3

Record in My Notes or your personal finance journal the outcome of every job you have held. For each job, have a column for listing your reason(s) for taking it and another column listing your reason(s) for leaving it. Also, note what you liked most and least about each job. Do you notice any patterns emerging in the data about your job history? Is there anything about those patterns that you would like to change?

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