

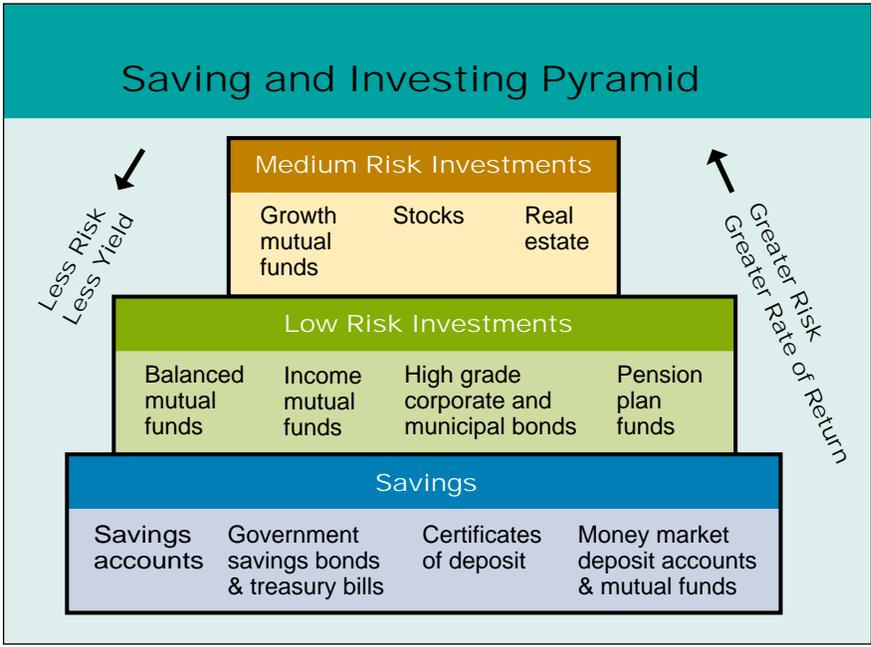
# Savings Basics

*Joan E. Witter, M.S., Program Leader, Extension Family Resource Management*

Americans are saving less of their disposable income (income after taxes and employer withholdings) now than ever before even though savings provide critical coverage for short-term emergencies and long-range security. Just like exercising for physical fitness, saving money requires discipline and must be done regularly to get results. This publication will help you distinguish between saving and investing. In addition, you'll learn ways to locate savings dollars and tips for choosing the best place to keep them.

## Saving and investing — yes, there is a difference

Many people use the words “saving” and “investing” interchangeably to describe actions with their money. They might say, for example, “I’m saving for retirement in a mutual fund,” or, “I just invested \$3,000 in a CD.” Although the lines between savings and investing products have definitely blurred in recent years because of deregulation, distinct differences still exist.



**Savings**  
Savings provide funds for emergencies and purchases in the relatively near future. The primary goal of savings is to store funds and keep them safe. This is why savings dollars are generally placed in interest-bearing

*(Saving and investing, continued on page 2).*



(Saving and investing, *continued from page 1*).

accounts that are safe and liquid (easily turned into cash). The downside is that savings products generally have lower interest rates and yields than longer term investments. Your principal is safe, but it earns a lower rate of return. Examples of savings options include bank and credit union savings accounts and money market deposit accounts, certificates of deposit (CDs) and money market mutual funds.

## Investing

For most people, the goal of investing is to increase net worth and work toward long-term goals (3-10 years or more). However, investing involves risk. Although earnings are usually higher than on savings options, they are not guaranteed. In addition you could lose some of your principal.

Examples of investments include stocks, bonds, real estate, and growth or income mutual funds.

Before you consider investing, be sure that you have:

- an emergency fund saved to cover expenses for 3 to 6 months
- some savings for short-term goals
- adequate insurance
- your credit use under control
- a retirement plan
- and possibly, equity in a home.

## The rule of 72

This is a tool that you can use to determine how fast your savings deposits will double. You can use the rule in two ways.

- 1) To determine the number of years it will take to double your money, divide 72 by the **interest rate** you expect to earn.

Example: Let's assume you are going to be earning **6% interest** on your money.

$$\frac{72}{6\%} = 12 \text{ years to double your money}$$

- 2) To determine the interest rate you will need to earn if you want your money to double by a specific year, divide 72 by the **number of years** available.

Example: If there are 8 years until you need your money to double

$$\frac{72}{8 \text{ years}} = 9 \text{ percent interest rate to double your money}$$

## How much should I save?

The amount of money you need to save depends on three closely related factors:

1. Your goals and their cost.

It's important to put an approximate price on every goal. What will the vacation that you want to take in two years cost? The car you want to purchase? How much do you need to provide an emergency fund equivalent to 3-6 months of income?

2. Time available until the money is needed.

The more time between today and when the money is needed, the less you will need to deposit into a savings vehicle thanks to the power of compounding interest. This happens when your money earns interest when left on deposit. Future calculations involve earning interest on interest. The longer the time period, the greater the gain.

3. Interest rate on your savings dollars.

The higher the interest rate you receive, the more quickly your savings dollars will grow. Whenever possible, seek an interest rate that is higher than the rate of inflation so that you are moving ahead rather than losing buying power.



## Safe options for holding savings dollars

### Savings accounts

Commercial banks, savings and loan associations, and credit unions offer insured savings accounts. These accounts are very liquid (cashable), but interest rates are generally low and may not keep pace with inflation. Transactions can be made by mail, in person, or often at an ATM machine.

### Certificates of deposit (CDs)

CDs are offered by the same institutions that offer savings accounts. They are federally insured and usually pay a higher interest rate than savings accounts. Money must be kept in CD accounts for a specific period of time, usually six months or

longer. In general, the longer you tie up your money, the higher the rate of interest you receive. (Example: 6-month CD rate — 5%; 12-month CD rate — 5.75%.) The tradeoff is that you give up liquidity because you generally pay a substantial penalty for withdrawing funds from CD accounts before they have matured.

### Money market deposit accounts in financial institutions

These accounts are sold through banks, savings and loan associations, and credit unions and are federally insured. Interest rates vary with changes in economic conditions. Money can be withdrawn easily.

Generally a limited number of check-writing transactions are allowed each month. Fees and minimum balances vary among institutions.

### Money market mutual funds

Money market mutual funds may be purchased at some banks, from private brokerage companies, and directly from mutual fund investment companies. Money from many investors is pooled and is used to purchase securities such as treasury bills, bank CDs, and commercial paper. Interest rates vary with changes in the economy. Money can be easily withdrawn and limited check-writing privileges are generally available. Fees and minimum balances vary among institutions. Money market mutual fund accounts are NOT insured by any federal agency, but are considered very safe.

## Choosing a financial institution

In order to earn interest on your savings dollars, they MUST BE placed in an interest-bearing account and NOT in a box under your bed! Here are key questions to ask as you shop for places to hold your savings.

Is the safety of your funds guaranteed by the U.S. government?

Look for institutions that offer federally insured accounts.

What is the interest rate (APY) you will earn?

Interest rates vary depending on the risk level involved, the length of your commitment, and the institution. Shop for the highest annual percentage yield (APY). This is the interest earned on a yearly basis expressed as a percentage.

Are there fees or penalties associated with your account?

Is there a fee to open an account? Are

there service or maintenance fees or transaction costs for making deposits or withdrawals? Early withdrawals may mean loss of interest or penalties on some savings products.

What is the minimum amount you can deposit?

Some accounts and certificates of deposit have minimum dollar requirements.

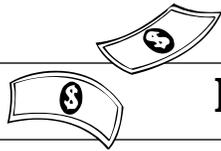
What services and conveniences are available?

Can transactions be made by phone? On the Internet? What about convenience of ATMs, banking hours, parking, etc?

### Savings bonds

The most classic example is the U.S. Government SERIES EE Savings bonds. They can be purchased for one-half of the face value through employer payroll deduction plans or from some federally insured financial institutions in denominations from \$50 to \$10,000. The interest rate is based on the average yield on Treasury securities and is subject to change twice a year. Interest paid is exempt from state and local income taxes and is federally tax deferred until the bonds are cashed.

A variation of the Series EE bond is the new Series I bond. The overall interest rate for I bonds is tied to changes in the rate of inflation as measured by the consumer price index.

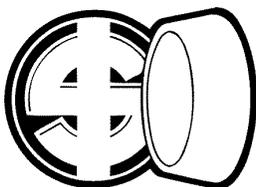


## Finding dollars to save?

Hard-to-find savings dollars can be generated in three ways!

- 1) Increasing income
  - Find a higher paying job.
  - Take on a second job.
  - Enter or return to the workforce.
- 2) Cutting expenses
  - **Pay less for credit.** Eliminate the need to use costly credit to pay irregular expenses (e.g. utilities) by working with your providers to establish an equal-monthly-payment plan. Your anticipated annual expense will be divided by 12, an amount that is easier to budget and manage.

Look for a credit card with a lower interest rate.
  - **Don't lend \$\$ to the IRS.** Check your tax withholding level. If you're continually getting large (over \$1,000) tax refunds, you're giving Uncle Sam a very attractive interest-free loan. Instead, adjust form W-4 with your employer so less money is withheld from you pay, and put the difference into your own interest-earning account.
  - **Switch, Stop, or Swap.** Switch to brands with acceptable quality, but lower prices. This could apply to food, clothing, insurance, cars, etc. Stop purchasing items that are really "wants"...not necessities. Swap your skills and talents for needed services that would otherwise cost you money.



- 3) Redirecting current resources
  - **Pay your savings account first.** Add money to your savings account each month through automatic payroll deductions. "It's hard to miss what you never had!"
  - **Refinance your mortgage or adjust payments.** In periods when interest rates are declining, some people will find it advantageous to refinance their mortgage in order to obtain a lower interest rate and payment. (Even with refinancing fees, a 1% decrease in your mortgage interest rate could save you money.) You can compare new mortgages to your current loan on the Internet at [www.financenter.com](http://www.financenter.com)

Another option is to switch to a biweekly mortgage payment plan. With this approach, 26 biweekly payments (equivalent to 13 monthly payments) would be made in 12 months. Alternatively you could send in one extra monthly payment a year designated for application to the mortgage principal. Be sure to check out the impact of these options carefully before making changes.
  - **Add all "found money" to your savings account.**
    - Save "bonus" income, e.g. tax refunds, overtime pay, gift money, refunds, and rebates.
    - Put "coupon money" in your savings account.
    - Collect loose change from pockets and your wallet, place in a jar and deposit once a month.

## Websites to check:

[www.money.com/101](http://www.money.com/101)  
(Money Magazine)  
*Interactive Course on Managing All Your Finances.*

[www.jumpstartcoalition.com](http://www.jumpstartcoalition.com)  
(Jump Start Coalition)  
*Hit "resource clearinghouse" for free personal finance publications suitable for youth and adults.*

[www.dol.cob.dol/pwba](http://www.dol.cob.dol/pwba)  
(U.S. Department of Labor)  
*A "Savings Matters" booklet and accompanying fact sheet to help people plan and save for retirement.*

[www.pueblo.gsa.gov](http://www.pueblo.gsa.gov)  
(Federal Consumer Information Center)  
*A consumer information catalog listing free or inexpensive government publications on numerous consumer topics, including money.*

For further information, please contact your Michigan State University county Extension office found under local government in your telephone book, or on the Internet at:  
<http://www.msue.msu.edu>.