CJE Guide to

Financial Literacy for Wage Earners

CJE SeniorLife
Jewish values for positive aging

WELCOME
to the CJE Guide to Financial Literacy.

The goal of this guide is to start you off on the path to understanding finances. Doing so will empower you to move forward independently and with better decision making. This guide will give you the tools to ask questions and invest with confidence. Financial planning can feel daunting for many people. This is especially true if only one member of your household has been managing the finances, and that person is not you. Breaking it down into sections will make understanding your finances more manageable.

We can't predict the future, so all planning has to account for some uncertainty. We can't know what life events may come our way such as, major illness, unplanned retirement, inheritance, or widowhood. The *average* age of widowhood in the United States is 59 years old. Often, only one household member understands and takes care of the finances for the household. Financial literacy can help lead to **security, independence, freedom, safety, preparedness and confidence.**

This guide is designed for individuals who have some money to save and invest. Financial literacy has not been a priority in the educational system. Historically, women have taken a back seat. Whether you are single, married, divorced or widowed, this knowledge is the first step to financial freedom.

I. Projecting income and expenses

Understanding your income and expenses helps you spend with **confidence**.

A. Income

Understanding income is the first step to managing your money. What are the possible sources of income? Your salary, or your spouse's salary are the most obvious source of income. The typical sources of income are salaries, salaries with bonuses and commission-based income. If you are in a commission-based job, look at the last several years and take an average. Do the same with bonus and take an average over the last several years. Some investments and insurance products provide income as well. These will be discussed in the next section.

B. Expenses

Tracking expenses is tedious, but a crucial part of your financial big picture. By understanding amounts coming in and going out you will be able to save, spend, and build wealth with confidence. Some expenses have a fixed amount and occur regularly, like rent or mortgage. Others fluctuate with both amount and frequency, like grocery bills. In general, expenses fall into two categories:

Fixed expenses are those that recur with regularity each month. A mortgage payment and student loan repayments are examples of fixed expenses. Some fixed expenses occur less frequently but are still fixed, such as car insurance which is typically paid twice a year. It is possible to lower fixed expenses but not immediately. For example, you could buy a less expensive car, refinance into a lower interest rate for your mortgage, or find less expensive rent.

Variable expenses change month to month. Your gas bill might be higher in the winter and lower in the summer. Groceries, personal care, and home and car repairs are all examples of variable expenses. It is much easier to lower variable expenses such as eating out less frequently or using public transportation in the event an unexpected repair bill is needed. However, planning for expenses by setting aside a monthly amount in preparation for the expense means you don't have to cut back.

Major expenses, such as a new car, can come at irregular times. For example, you may know that you want to buy a car in 3 years. To ensure that the expense of the new car will align with your budget, it is important to project what the cost will be, and save a portion of that amount monthly. That way, when the times arrives for the purchase, the money will be ready and allocated. A similar savings plan is important for home repairs and maintenance. Each year there will be some home or car repair needed. Project what that amount will be over the course of the year and make that a listed expense each month.

Expenses will also include money set aside for **saving and investing.** Some of those expenses may have an end date such as money saved for college or a wedding. Others will be ongoing, such as money saved for retirement.

INSURANCE

Adequate insurance provides safety and security from losses you cannot afford.

Adequate insurance is a unique expense. Some insurance is mandatory such as car insurance, or homeowner's insurance if you have a mortgage. Other examples of insurance to consider are life insurance, health insurance and long-term disability insurance.

In general, **life insurance** pays a pre-set amount of money to the beneficiaries when the policy holder dies. The "expense" part of life insurance is the cost of the premium, usually paid monthly or annually. Some companies offer life insurance as part of the compensation package. This is usually a very small amount of insurance. Life insurance products can also act as investments. Such investments are outside the scope of this guide. When thinking about how much life insurance coverage to buy, consider how much money the beneficiary would need in the event the policy holder died. Next, consider the cost of the insurance premium and what you can afford.

Health insurance provides coverage for treatment of physical (and often mental) health conditions. Health insurance options vary greatly. The first question most people need to decide is whether to choose an HMO or a PPO. Thinking about the following questions will help you decide which type of health insurance is best for you. How much is the premium? The premium is the amount you pay each month for the insurance. Does the policy require referrals to see specialists? Does the policy have a high deductible? If yes, you will have to pay the cost of medical visits until the deductible is met. Do I have prescription drug coverage? What are the exclusions to this policy?

Long-term disability insurance provides money in the event you become disabled and unable to work for longer than six months. One key to finding the right disability policy for you is looking for a policy that provides benefits in the event you can't do *your* job. These are often called an "own occupation" policies. Some policies only provide benefits in the event you can't do *any* job. These are often called "any occupation" policies. For example, if a surgeon had an "any occupation" policy, and lost her hand, she might still be able to do some job and so the policy would not pay her. However, if she had an "own occupation" policy and she lost her hand, she would be paid. Elimination periods, the amount of time you must wait until the insurance begins, vary from policy to policy.

Insurance policies are nuanced and require careful consideration. Some questions to ask yourself:

- Are you willing to accept a higher deductible for a lower premium? The deductible is the amount you have to pay out of pocket only when you make a claim.
- What do I want my car insurance to cover? Insurance can cover the damage caused to the other person's car and belongings only (liability), or it can include damage caused to my vehicle as well (collision).
- Do I need this insurance? It may not make sense to insure a diamond worth $2000 for the cost of $300 per year. Instead, set aside $300 per year knowing that if the diamond was lost, you could simply pay to replace it.
- Does the amount of this insurance make sense to cover my needs?
- What are the exceptions and exclusions from this insurance policy?

With all of these types of expenses, what is the best way to figure out what you are actually spending? Tracking every purchase and expense is the only way to know what you are really spending. You can use an app, pen and paper, or exclusively use a debit or credit card and categorize each expense. The daily coffee, occasional birthday gifts, and minor home repairs all need to be included to get an accurate understanding of expenses.

Expense	Month:	Month:	Month:	Total
Rent/Mortgage				
Food				
Internet				
Prescriptions				
			Add column on right and enter Total	
			Divide Total by 3	÷ 3
			Average Monthly Expenses	

Click here to download a full budget tool.

In general, keeping track for three months can give you a pretty good average for spending. If you spend a lot for holiday gifts, that should be averaged over the year so that the money is accounted for. Money paid out just twice a year for car insurance, should also be averaged over the year. This is a tedious process, but it is the only way to truly know where your money is going.

By understanding the money coming in and going out, you can plan and save for the future.

C. Managing a major life change:

Income and expenses should be re-evaluated on a regular basis. In addition, reviewing income and expenses is critical in the face of a major life change. Job loss, major illness, divorce, and widowhood are all events that necessitate a financial review. First, assess the changed income. Second, look carefully at which expenses are essential and which can be reduced during the transition period. Once you see which expenses are necessary, review the investments to see what changes might be necessary given the new circumstances.

II. Understanding investments: how (and why!) we use money to make money

Your paycheck comes in regularly, weekly, bi-weekly or monthly most likely. You pay the mortgage, credit cards, utilities, and other bills. Now what? What is the best use for the rest of the money? You can save it or invest it. Investing means allocating resources, usually money, with the expectation that the investment will generate income or profit.

A. Saving

Before you start investing, make sure you have an emergency fund with 6 months of monthly living expenses saved up. If you lose a job or face a major life change, this savings will be imperative. Saving 6 months of living expenses takes time and may seem daunting. Some people find it easier to *pay yourself first* each month. This means that each month, or each paycheck, you take a specific amount and put it into a savings account before any discretionary spending.

Your emergency fund should be kept in an FDIC insured account. The Federal Deposit Insurance Corporation (FDIC) insures deposits in banks up to $250,000. Money in an FDIC account is safe even if the bank closes or is bought by another bank. Look for a savings account that earns interest. Even if the interest rate is low, at least your money is earning something for sitting there.

Completing a budget will help you figure out what 6 months of living expenses totals. Keep in mind that 6 months of living expenses may be less than 6 months of expenses listed in your budget. Your budget includes amounts for saving and investing. In the event of a job loss or major life change, you won't be investing during that period.

B. Methods of investing: Stocks and Bonds and Funds oh my!

Understanding investments prepares you to have **confidence** in your choices.

Investing money is a way to help your money grow faster. With the possibility of growth comes risk of loss. Different types of investments come with different levels of risk and reward. Carefully thinking about when and how you will use your money can help determine which investments are best for you.

When starting to invest, you need to ask yourself about values, goals, and risk tolerance. Your values may include things like giving to charity. Goals may include vacation or a new home. Your risk tolerance is the amount of change in investment returns you are willing to withstand. Will you be able to tolerate large losses while keeping your eye on the ultimate goals you have set? Your risk tolerance may guide you into or away from certain types of investments.

Risk tolerance will generally vary with the time frame of the investment. For example, the longer you have to invest, the more risk you may be willing to take. In general, with the possibility of greater return comes the possibility of greater loss.

Short term goals, such as, travel or a new car, require investments that are lower risk. Long term goals, such as, retirement planning and college savings planning may include some higher risk options. Let's start by looking at low risk options for the short term.

1. CERTIFICATE OF DEPOSIT (CD)

For money you won't need immediately, a certificate of deposit or CD offers a way to earn interest that is slightly higher than a savings account. Like savings accounts, CDs are FDIC insured up to $250,000. With a CD, you deposit money in the bank for a fixed amount of time (also called the "term"). In exchange, the bank pays you interest at the end of the agreed upon term. If you need a low risk way to save money for a fixed amount of time, say 2-3 years, a CD is one option.

Simple interest is calculated based on the amount of money in the savings account or the amount of money invested in a CD. However, compound interest is a way to grow money even faster. Some CDs earn compound interest which means that from time to time, the interest is added to the initial investment amount. New interest is earned on the initial investment PLUS interest added.

Compound Interest

If money is invested in a way to earn compound interest, this is how it works.

- An initial investment of $1000 earning 1% interest quarterly, would yield $10 in the first quarter.
- In the second quarter, it will earn 1% on $1010, not just the original $1000.

While the additional money may seem small at first, compound interest can really make your money grow faster over time.

$1000 CD that pays 6%, keeping it for 4 years

Simple interest: investment would make $60 per year for 4 years, totaling $240.

- 240/1000 = 24% rate of return

Compound interest:

- Year 1 – $1000 x 1.06 = $1060
- Year 2 - $1060 x 1.06 = $1123.60
- Year 3 - $1123.60 x 1.06 = $1190.16
- Year 4 - $1190.16 x 1.06 = 1262.47

What is the Rate of Return?

- 262.47/1000 = 26.24%

C. Ready to invest with more risk but also possibly more reward? Let's talk about stocks and bonds.

1. STOCKS

When you buy a stock, you own a small piece of the company, entitling you to a share of the company's profits. In financial lingo, you may hear that you have equity or ownership in the company of the stock you own. If the value of the company goes up, so does the value of the share you own. That also means that if the value of the company goes down, the value of your share likewise goes down. When you buy a stock, you hope that the value of the stock increases.

There are two ways to make money with stocks. First, if your stock increases in value, you can sell it or hold it. When an investment increases in value but hasn't yet been sold, you have an *unrealized* gain. Until the investment is sold, the profit only exists on paper. Once sold, the profit (or loss) is *realized*.

Second, some stocks pay dividends which are payments to shareholders. These payments are comprised of a distribution of the company's profits.

There are also two ways to lose money when buying stocks; if the company loses value or if the company goes out of business completely. For these reasons, it is important to diversify the types of stock investments you have. We will discuss diversification in detail below.

In general, the value of stocks increases over time. Some investors choose to hold on to stocks even when their prices go down because the investor believes the stock will ultimately go back up. Others look for companies that are expanding quickly and may provide short term price increases. Money invested in stocks should have a long-term time frame such as, three to five years. The reason for this is that markets fluctuate and we don't want to be forced to sell at the wrong time.

Value Stock: A value stock received its name because investors believe the company's stock is priced below the amount it ought to be, thus making it a good value. Investors look at its history and market share and determine that the stock price is likely to increase. Value stocks are often associated with well-established companies, and they often pay dividends.

Growth Stock: Growth stocks are issued by companies that are, you guessed it, growing! The company is expanding, sometimes rapidly, and sometimes in a new industry. In a growth stock, the company often uses cash to reinvest in the company rather than paying dividends. Investors choose to buy growth stocks because of the potential for *future* earnings. Like in all areas of investing, the greater the potential gain also means the greater the potential loss.

2. BONDS

While owning stock means owning a piece of the equity in the in the company, owning a bond is owning a piece of the debt of the company. Essentially, when you buy a bond, you are loaning money to an entity such as a government, an entity that issued the bond or a bank.[1] The corporation pays you an amount, called interest, on the money you loan. The interest on a bond is paid at a set time, often semi-annually, and the full amount of the bond is redeemed at the maturity date, the date at which your original investment is returned.

Bonds

If you buy a $10,000 bond you will receive interest based on that amount while you hold the bond. You will get the $10,000 back at maturity.

1 A CD is a type of bond. It is a loan to a bank with interest payable by the bank rather than a corporation.

Bonds are called fixed-income securities because you know in advance the amount of interest that will be paid and the date (or dates) on which it will be paid.

There is an inverse relationship between the price of bonds and interest rates. As interest rates go up, the value of the bond decreases. That happens because if my bond pays 2% interest and rates increase to 5%, my bond is worth less than a new bond paying a higher rate. Likewise, if my bond is paying 5% and interest rates drop to 2%, my bond becomes more valuable.

Not all bonds have the same level of risk. There are low risk bonds and higher risk bonds, often called junk bonds. Be sure that you understand the quality of the bond before you invest in it.

D. Diversification

Owning a variety of investments is essential to weathering the rise or fall of one sector or investment type. For example, if you are invested only in tech stocks and there is a negative news report about technology, your entire portfolio of stocks could decrease. If, however, you are invested in a variety of sectors, negative news on technology will only affect that one area of your investment portfolio.

1. MUTUAL FUNDS:

You can diversify by purchasing individual stocks in several sectors. You can also diversify using stock *funds*; often called mutual funds. A mutual fund is a basket of stocks in one fund. An investor purchases a share of that fund, thus owning a portion of all of the stocks in the fund. This is an easy way to diversify with a minimum amount of money. Some mutual funds represent a grouping of stocks called an index. Some indices are very broad, such as the S&P 500.

- Owning an S&P index fund means that you own a share in a fund that is comprised of stocks from each of the 500 companies in the S&P.
- The composition of the fund is designed to track the rise (and sometimes fall!) of the index.
- Mutual funds that track an index are called *passive* mutual funds.

Actively managed funds use a portfolio manager to buy and sell stocks as necessary to maximize return. A diversified mutual fund may have over 100 different stocks in it representing several industries and several company sizes. However, an actively managed mutual fund may only focus on one sector and simply give diversification within that sector.

- For example, a healthcare fund may incorporate stocks from many healthcare companies.

Similarly, bond funds (a category of mutual funds comprised of bonds instead of stocks) are managed by portfolio managers. Unlike an individual bond, a bond fund generally pays interest monthly. There is no specific maturity date or interest rate for a bond fund. As such, the principal amount invested may fluctuate from time to time. Also, since the interest payments are made based on the mix of bonds in the fund, income distribution may change from month to month. Like with stocks, some bond funds are comprised of only one type of bond, for example, government bonds. Others have a mix of types of bonds.

Note: The security of an individual bond is knowing the interest rate and the date on which your money will be returned (maturity date). A bond fund eliminates that security. A bond fund often offers more interest because it carries more risk.

All funds charge fees. Some funds charge an upfront commission called a load. Others do not. Learning about the fees associated with investments is important. It is also important to stress that mutual funds should be a long-term investment. Asking your financial professional about fees before making any investments is an important part of understanding your complete financial investment.

2. EXCHANGE TRADED FUNDS (ETFS)

ETFs are like mutual funds in that they are a pooled investment. They are like individual stocks because ETF shares can be traded like stocks and can be bought and sold throughout the day at fluctuating prices on the stock exchanges like any other stock. Therefore, you can choose the time and/or price at which you want to buy or sell. Like mutual funds they can be passive or actively managed. One key difference is that mutual funds are only priced at the end of the market trading day. Therefore, when you purchase a mutual fund you don’t know the exact price that you are paying until the end of the day. It is the same when you sell it. This is one potential downside of a mutual fund. If the market is fluctuating greatly and you want to get in or out at a specific price, a mutual fund does not offer this option. An ETF would offer the ability to buy and sell at a specific time and price.

3. MANAGED MONEY:

For higher net worth individuals, managed money may be an additional option to diversify. Generally, money managers require an initial investment between $50,000-$100,000. Money managers can be accessed through a financial advisor. With managed money the investor owns the individual securities, rather than a share of a fund. For example, you could hire a money manager to buy value stocks or growth stocks for you. Similarly, a money manager can purchase individual bonds for you. A money manager can create a diversified portfolio for you specifically.

Before you make a decision about a mutual fund verses managed money, consult your financial advisor *and* tax advisor. There may be substantial differences in the taxes for each investment.

III. Useful Investment Concepts:

Smart investing leads to **financial independence**.

Investing money, rather than simply saving money, is important for financial security. Choosing the best investments, getting clarity on risk, and evaluating investments based on timeframe are all important factors. The ideas reviewed in this section are meant to help you compare investments and get an idea of how your money will grow through investing.

A. Time Value of Money

The time value of money is the widely accepted conjecture that there is a greater benefit to receiving a sum of money now rather than an identical sum later. If you took $1000 and kept it under your pillow for a year, at the end of the year you still have the same $1000. However, if you took the sum and placed it in an interest-bearing account, you would have more than $1000.

The concept of the time value of money is important when thinking about types of investments, rate and timing of return, and taxes.

Time Value of Money

An investment that pays me $10,000 in 1 year is more valuable than an investment that pays me $10,000 in five years. That is because with the first option, I can reinvest the money after 1 year, rather than waiting five.

B. Rule of 72

The rule of 72 is a useful way to determine approximately how long it will take your investment to double in value. The simple rule is to divide 72 by the interest rate. That number is the approximate amount of time it will take for your investment to double.

Rule of 72

4 versus 8 percent

- With an interest rate of 4%, your investment will double in 72/4=18 years.
- With an interest rate of 8%, your investment will double in 72/8=9 years.

C. Rate of return

Understanding your rate of return on an investment is important because it allows you to compare investment opportunities. A rate of return is the overall gain or loss of an investment expressed as a percentage of the investment's initial cost. When calculating the rate of return, you are determining the percentage change from the beginning of the investment until the end.

Rate of return

If you invest $1000 and at the end of the investment time it is worth $1200 then you have a $200 gain. Divide $200 into the original investment which is $1000 and you get a 20% rate of return.

When looking at the rate of return for investments, be sure to compare similar time frames.

D. Lump Sum vs. Dollar Cost Averaging

Timing of investing is important. If I decide that I have $1000 to invest, should I do so all at once or spread it out? To reduce some risk out of choosing the right time to invest, you can use a strategy called dollar cost averaging. With dollar cost averaging, you would take your total investment amount and invest at different time points. For example, you might invest every month for six months or you might invest every quarter for a year. Spreading out the investment reduces the risk of investing at the wrong time. When the market is high you will purchase fewer shares and when the market is lower you will be able to purchase more shares with the same dollar amount. Therefore, you are averaging the cost of your investment over time.

Should I invest $16,000 now OR $4000/month for 4 months?

- Month 1: $55/share $4000/55=72 shares
- Month 2: $40/share $4000/40=100 shares
- Month 3: $50/share $4000/50=80 shares
- Month 4: $60/share $4000/60=66 shares

Over 4 months 318 shares purchased, average price $16,000/318 shares = $50.31.

Had you purchased all the shares in month 1, you would have paid a higher price per share.

Dollar cost averaging is a long-term investment strategy that often involves investing a set amount regardless of the market price on the day of the investment. A 401k is an example of this strategy. Each pay period, a set amount is deducted from your paycheck to invest regardless of the market price on that day. The advantage of this type of investing is that it takes human emotion out of the picture.

IV. Tax Deferred Investing

Being **prepared for the future** can come though tax deferred investing.

Tax deferred investing allows investment earnings such as interest, dividends, or capital gains, to accumulate tax free until you withdraw the money. This can produce substantial savings. For example, if you buy a stock for $1000 and you sell it when its value goes up to $1200, you have a $200 gain that can be taxed. Therefore, you have less than $200 to reinvest. On the other hand, if stock was sold in a tax deferred account, the full $200 gain can be reinvested. Money in a tax deferred account will grow faster because the earnings are not taxed until withdrawal.

A tax deferred investment designed for retirement could allow you to grow your investment for years without paying taxes. Then, during retirement when your tax bracket is likely lower, you can withdraw the money possibly paying a lower amount of taxes than you would have paid during working years.

Some employers offer a 401k (named for the section of the tax code it comes from) to help employees save for retirement. A 401k is one type of tax deferred investment. Companies sometimes offer a "match" whereby if the employee contributes a certain amount to the 401k, the company will match that amount or a similar amount. Essentially, for companies with a match, the employee is getting additional money for free by simply putting aside a percentage of her paycheck.

Deferred investing

A company might say that for every 1% the employee contributes, the company will contribute .5% up to 2% total. That means if the employee contributes 4% of her paycheck, she will get an additional 2% contributed by her company.

Investors can also use a similar tax deferred account called an IRA (individual retirement account) which is not employer sponsored. An IRA can be set up at most banks or investment institutions.

Whether your employer assists or not, tax deferred investing is an important part of planning for the future. There are limits to the amount of money you can contribute to an IRA in one year. For 2021, the maximum contribution to an IRA is $6000. If you are age 50 or older, you can contribute an additional $1000. Because the money in 401k and IRAs has not yet been taxed, it will be taxed as income when the money is withdrawn. For 401k contributions, in 2021, the maximum contribution is $19,500 for those under age 50. For those age 50 and older, you can add an additional $6500 “catch up” contribution. You should think about your tax bracket now, versus the tax bracket you will be in during retirement. Most likely, you will be in a lower tax bracket in retirement.

The “catch up” amounts which allow you to contribute extra money if you are over age 50 are important. Savings and investing doesn’t stop upon retirement. Money invested in your 50’s and 60’s will contribute significantly as those amounts may continue to grow for 30 years or more after being invested.

There are different types of retirement accounts which offer tax deferred investing. You should consult your advisor about which is best for you. If you are self-employed there are similar retirement accounts you can use.

If you have maximized your contribution to pre-tax investments, you can continue to contribute post-tax dollars into a Roth IRA. When the money is withdrawn from a Roth IRA it is not taxed because it was already taxed. Like a traditional IRA, in 2021, the Roth IRA also has a maximum contribution of $6000, or $7000 for those age 50 or older.

Tax Deferred vs. Taxable

Tax deferred investing has many advantages to grow money. Your planning strategy for saving in tax deferred versus taxable accounts should consider the following:

- There is a limit to how much you can put into a tax deferred account per year.
- There are penalties if you need to withdraw money from the account before age 59½.
- Money you may need for living expenses, healthcare or other things before age 59½ should not go into a tax deferred account.

Conclusion

This guide is meant to start you off on your independent financial journey. Understanding what you have, followed by learning how to save and invest will (hopefully!) lead you to save with care and invest with confidence. The terms and information found here are the foundation and building blocks of investing and financial independence. Use the guide to ask questions, learn what is best for you, and review concepts whenever you need.

Sources for further information:

FINRA www.finra.org

Consumer Financial Protection Bureau www.consumerfinance.gov

Money management firms offer online financial planning tools and calculators

Community college courses

3003 West Touhy Avenue | Chicago IL | www.cje.net | 773.508.1000

CJE SeniorLife® is a partner with the Jewish United Fund in serving our community. 1407.12.2022