PERSONAL FINANCE

Building Wealth

By Dr. Mike Casey, Professor of Finance, University of Central Arkansas

ARKANSAS CENTER FOR RESEARCH IN ECONOMICS
UNIVERSITY OF CENTRAL ARKANSAS

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About ACRE

The Arkansas Center for Research in Economics is an Arkansas-focused research center housed in the College of Business at the University of Central Arkansas. Our scholars and policy analysts use academic research and original analysis to educate the public on important issues of public policy in Arkansas. Our research focuses on barriers to employment, taxes and subsidies, K–12 education, property rights, and government transparency. The views expressed in this publication do not necessarily reflect those of the University of Central Arkansas.

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Pacing Guide

This module covers a lot of information and should be split into several days. It can be extended beyond four days by using additional recommended resources. The following guide is a suggestion about how to sequence the material.

Suggested Pacing Guide

01 DAY

Topic: The Importance of Setting SMART Goals

Standards:

PFM.8.E.2: Evaluate a variety of strategies for making personal financial goals to build short-term and long-term wealth
PF.5.MM.5: Examine the influences on financial planning decisions (e.g., needs vs. wants, priorities, values, stages of life, estate planning)
PF.7.SI.6: Interpret the role of goal setting as an integral part of financial planning and construct a well written goal

Essential Question: How can setting goals help me plan and save money?

Activity: Establishing SMART Goals

02 DAY

Topic: Financial Institutions & Products

Standards:

PF.5.MM.1: Compare types of banking institutions including products and services available
PF.5.MM.2: Explore the process of opening and managing different types of accounts (e.g., checking, savings)

Essential Question: What types of financial products and services are available to me?

Activity: What Type of Bank Account Should I Open?

03 DAY

Topic: Building Wealth through Saving & Investing

Standards:

PFM.8.E.2: Critique components of personal money management in order to build short-term and long-term wealth

Essential Question: How can small savings accumulate large amounts of wealth over time?

Activity: Market Analysis

04 DAY

Topic: Financial Market Regulations

Standards:

PF.7.SI.8: Understand the regulation of savings and investments

Essential Questions: How are financial institutions regulated? How do those regulations affect me?

Activity: Ethical Analysis

Content

The following pages provide instructors with the lessons, vocabulary, questions, and in-depth analysis of the unit topics. Instructors can use these passages and graphics to guide their students through the unit.

INTRODUCTION

Building Wealth

Every year, Forbes magazine compiles a list of the wealthiest people in America. Bill Gates, Meg Whitman, Warren Buffett, and Oprah Winfrey all top the list year after year. How did these people build wealth? They all started their own businesses and amassed great fortunes by providing a product or service in high demand. While most of us will never achieve their level of wealth, we can all create enough wealth over time to live comfortably during our working years and throughout retirement. Many of us have the ability to become millionaires.

When we talk about building wealth, we are talking about increasing our net worth. Our net worth is computed by adding up the value of everything we own and then subtracting the value of everything we owe. For example, you may own a car worth $5,000. If you still owe the bank $2,000 on the car, then your net worth, or accumulated wealth, is the difference between the two amounts: $5,000 – $2,000 = $3,000. Of course, this example assumes that you don't have any other assets or debts (liabilities).

Assets are anything we own, such as a car, home, or stocks. Liabilities are our debts, like the amount we still owe on our car or home loans. Net worth is the difference between assets and liabilities, so to build net worth, we can increase our assets, decrease our liabilities, or both. Most wealthy people, or people with a high net worth, built their wealth over a long time. Gates, Whitman, Buffett, and Winfrey built their wealth over many years.

Of course, some people gain wealth quickly. Professional athletes, celebrities, and people that inherit money can end up with a high net worth overnight. However, if you are not one of those people, how can you build wealth?

Most people can end up with a comfortable net worth if they apply financial discipline and have time on their side. Perhaps one of the most important factors that helps build wealth is the ability to set good financial goals and stick with them. Another key to wealth building is to identify investment options that will yield good long-term returns.

Keep in mind that you must be willing to take risk to increase your return potential. Higher-risk investments tend to generate higher returns over time. They may be more volatile in the short run, but they have historically paid off in the long run. The key is to hold these volatile investments for a decade or longer and sell at a profit.

The Importance of Setting Goals

Goal setting is one of the most powerful personal growth tools you can utilize. Speaker and author Jack Canfield lists goal setting as principle #7 in his book, The Success Principles. Crafting a good goal can transform a good idea into something specific and achievable. A popular method for doing this is to create SMART goals that are specific, measurable, achievable, realistic and time-bounded. Let's look at each of these components individually and then look at some examples of SMART goals in personal finance.

SMART Goals in Personal Finance

<u>S</u>pecific – Good goals are specific so we know exactly what we're striving for. A financial goal might include the precise amount of money you want to save this year. For example, "I want to save $1,000 over the next 12 months" is a specific goal.

<u>M</u>easurable – Good goals are measurable so that we know when we have accomplished them. It will be easy to see whether you have an extra $1,000 in your savings account 12 months from now.

<u>A</u>chievable – Good goals are achievable, which means they can actually be accomplished with focus and discipline. Is it possible for you to save $1,000 over the course of the next year? If not, what amount would be achievable?

<u>R</u>ealistic – Good goals are also realistic. While it might be possible for us to save $1,000 in one year, it might not be realistic. We may not be able to carve out enough savings to put this money aside. Or, we may not have time to get a part-time job to earn this extra money. Saving $500 might be more realistic over the next year given our constraints.

<u>T</u>ime-bounded – Good goals have a deadline to help us focus our efforts. For example, are we likely to make the daily sacrifices needed to achieve a goal of "I want to save $1,000 at some point in my life"? Human nature is such that we would likely postpone the actions needed to achieve the goal, perhaps indefinitely.

Six examples of SMART personal goals:

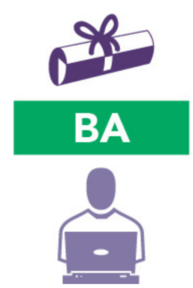
I will save $1,200 over the next 12 months to go on a graduation trip to New York City.

I will save my babysitting money for two years so I can accumulate $1,500 to buy a used car.

I will lose 20 pounds by December through replacing soda with water and eating salad daily.

I will save $400 from mowing neighbors' lawns over the next six months to buy a guitar.

I will accumulate $10,000 in my retirement account before my 25th birthday using an automated investment plan.



I will complete my bachelor's degree in the next four years by earning 15 credits per semester.

All six goals listed above are specific, measurable, achievable, realistic, and time-bounded. Keep in mind that a SMART goal for one person may not be a SMART goal for someone else. Everyone is in a different position in life and has their own unique interests, circumstances and constraints. However, all of us can benefit from developing SMART goals since they give us focus and something to look forward to achieving.

Types of Goals

Short-term goals – Short-term goals can usually be achieved in one year or less. For example, the first four example goals are short-term goals.

Intermediate-term goals – Intermediate-term goals, such as earning a bachelor's degree, have a time horizon of one to five years.

Long-term goals – Long-term goals, such as accumulating $3 million for retirement, have a time horizon that exceeds five years.

We should develop all three types of goals for ourselves. Short-term goals are, in some ways, the most important since they can be achieved within a year. When you achieve a goal, it gives you a feeling of accomplishment that helps you remain focused on your longer-term goals. If we are always setting and achieving short-term goals, we will invariably achieve intermediate- and long-term goals.

What happens if you don't achieve a goal? In most cases, you will have accomplished part of what you set out to do, so it won't be a total loss. Reevaluate the goal, and if you still believe it's a good one, then set it again. You may need to make the goal more specific or adjust the parameters to be more achievable. If you keep trying, you will accomplish your goal.

Translating Goals into Actions

At some point, you need to translate your goals into the steps you need to take to achieve them. For example, if your goal is to save $600 over the next 12 months, then you need to decide how you will accomplish that goal. One strategy would be to save $50 a month, because $600 divided by 12 months equals $50.

Now, brainstorm on ways you can save $600 in one year.

- Do you have a source of income already from a part-time job or allowance?
- If so, are you earning enough after your expenditures to save $50 a month?
- If not, can you reduce any expenditures to come up with $50 a month?
- If not, what are some ways you can earn the money? Can you...
  - mow lawns in the summer?
  - rake leaves in the fall?
  - babysit during evenings and weekends?
  - get a job in a restaurant?
  - work in a retail store?
  - do other part-time jobs?

Once you have identified the source of the money, you need to follow through. A goal is a promise we make to ourselves. When you keep that promise and accomplish your goal, it will energize you to set and achieve other goals, many of them much bigger.

Discussion Topic: Brainstorm on ways you can save $600 in one year.

Money Management Habits

The best way to begin focusing on financial goals is to develop a budget. A budget is simply a forecast of your future income and expenses.

- Start by listing all of your sources of income, such as a part-time job or allowance.
- After that, list all of your expenses, such as eating out, entertainment, clothing, and gas.

Once you have listed your income and expenses, total them up. Do you have a deficit or a surplus? A deficit occurs when you spend more in a month than you earn. A surplus occurs when you spend less in a month than you earn. To increase the surplus (or reduce the deficit), you can either reduce your spending, increase your income, or do a little of both. A surplus can help you achieve your financial goals.

Two important financial goals for everyone are establishing a rainy day fund and accumulating a retirement fund. A rainy day fund, or emergency reserve fund, is a sum we set aside for emergencies. Examples include major car repairs, unexpected housing costs, major medical bills, or even job loss. Things happen unexpectedly throughout our lives, and they often have a financial cost. If we have a rainy day fund, then the event won't push us into debt.

Financial experts recommend you save between three and six months of living expenses for your rainy day fund. This money needs to be very accessible, so most people put it in a savings account. You will earn only a small amount of interest, but the money will be there when you need it.

After you have established your rainy day fund and accumulated six months of living expenses, you can begin thinking about longer-term goals like your retirement fund. Money set aside for retirement needs to be invested in a financial asset that generates a higher return than a savings account. We will look at some higher-risk, higher-return financial assets in the next section.

Financial Institutions & Products

Let's look at some common ways that people save money. But first, let's look at the various financial institutions that will help us achieve our goal of building wealth over time.

Financial Institutions

Financial institutions are often divided into two broad categories: those that accept deposits (depository institutions) and those that do not accept deposits (non-depository institutions). Depository institutions include commercial banks, credit unions, and savings and loans (S&Ls). Non-depository institutions include investment banks, insurance companies, and mutual fund companies.

The most common depository institutions are these three:

1. **Banks** – A bank is a financial institution that can legally accept deposits and make loans.

2. **Credit Unions** – Credit unions perform the same functions as banks but are not-for-profit organizations owned by their members.

3. **Savings & Loans** – S&Ls perform the same functions as banks but specialize in mortgages and other consumer loans.

The most common non-depository institutions are these three:

1. **Investment Banks** – Investment banks buy ownership in firms and then resell that ownership to investors as stock.

2. **Insurance Companies** – Insurance companies are financial institutions that sell various types of insurance policies that protect people and businesses from the risk of financial loss.

3. **Mutual Fund Companies** – Mutual fund companies operate professionally managed investment programs that pool investors' funds and then purchase baskets of securities on investors' behalf to preserve and grow their money.

Financial Products

Financial institutions offer various financial products to help individuals meet their goals.

Savings Accounts – Savings accounts are offered by the same financial institutions that offer checking accounts. In most cases, you will electronically link your checking and savings accounts so you can easily transfer money between them. You can even link accounts at different institutions.

Certificates of Deposit – Certificates of deposit are also called bank CDs. Savers can earn slightly higher interest rates with CDs than with savings accounts. When you buy a CD, you are guaranteeing the bank that you will keep your money deposited for the length of the CD. CD lengths, or maturities, vary quite a bit, but some common lengths are six months, one year, three years, and five years. Since the bank can count on this money staying in your account, they are willing to pay a higher interest rate. The longer the CD maturity, the higher the interest rate. In exchange for the higher interest rate, however, you will have to pay a penalty for early withdrawal if you need to get your money out early.

Money Market Mutual Funds – Money market funds invest in very short-term instruments such as bank CDs or short-term US Treasury bills. Investors in a money market fund will usually earn a slightly higher interest rate than they would earn in a savings account and much less than they would earn in a bond mutual fund. The risk of a money market fund is higher than that of an FDIC guaranteed bank account but lower than that of bonds or bond mutual funds.

Bonds – Bonds are essentially an I.O.U. that bond issuers sell to investors to raise money. For example, a corporation may need $100 million and decide to issue bonds and sell them to raise the funds. Bonds typically have a $1,000 face value, which means they are sold in $1,000 increments. Each bond has a stated interest rate that the issuer pays the investor every year. This interest is called the coupon payment and is typically made twice a year (semi-annually).

Bonds also have a maturity date on which the issuer will repay the bond's face value. For example, a firm might issue (sell) a $1,000 face value bond with a 5% coupon rate that matures in 20 years. The investor who buys this bond will receive $50 a year in interest (5% coupon rate x $1,000 face value) for each of the next 20 years, and then the bond will mature and the investor will get their $1,000 back.

The US government is one of the largest bond issuers, but corporations and state and local governments (municipalities) issue bonds, too. Bonds are not guaranteed, and their interest rates vary quite a bit depending on the bond's level of risk.

Stocks – Stocks are essentially fractional ownership of a firm. For example, if a firm issues 100 shares of stock, then each share represents a 1% ownership stake in that business. Large firms that have their stock traded on major stock exchanges have millions of shares outstanding, so each share represents a tiny fractional ownership of that firm. Stocks do not pay interest and have no guarantee of return. They are riskier than the other financial products discussed here and may lose money. The upside is that they often make money for investors by appreciating in value, paying dividends, or both.

Mutual Funds – Mutual funds are professionally managed financial products that pool investors' money and then invest it according to the fund's objectives. Thousands of mutual funds are available for investors to buy into, and each will have a primary investment focus. Some invest only in stocks of a certain type, such as blue chip stocks. Other mutual funds may focus on US Treasury securities. In addition to the interest, dividends, or appreciation of their investments, investors benefit from mutual funds due to diversification. Because the fund spreads its risk across the numerous different investments it holds—often hundreds or even thousands—it can help investors avoid losing money.

Index Funds and ETFs – Some mutual funds are set up to mirror the performance of a specific stock index such as the S&P 500. These funds simply buy the same stocks tracked by a specific index and hold those stocks in the portfolio. As the index moves up or down the value of the index fund will track that same performance. These funds have very low fees since the management and administration costs are very low. ETFs, or exchanged traded funds, are very similar to index funds. ETFs are set up to mimic the performance of a stock index in the same way as an index fund. However, ETFs can be bought and sold throughout the day just like an individual stock. Index funds can only be bought and sold after the market closes each day based on the closing prices of the stocks included in the fund.

Annuities – Annuities pay their investors a fixed amount of money every period. Annuities can be for life or for a shorter term, such as twenty years. Investors who want guaranteed income often buy annuities. For example, someone might buy an annuity that will pay them $1,500 per month for the next 10 years. These products offer guaranteed returns so they have less risk. However, since the seller of the annuity is assuming the risk the returns are not as high. In most cases investors will be better served to create their own annuity by investing in an index fund and making periodic cash withdrawals from their own account.

Cash Value Life Insurance Policies – Cash value life insurance policies have a component that builds up cash value using a portion of the premium you pay. You can borrow the cash value or, once you've accumulated enough, you can use it to pay the policy's premiums for the rest of your life.

REITs – REITs, or real estate investment trusts, are companies that pool investor funds and use them to buy various commercial real estate properties or even mortgages. The REIT typically manages these properties, and its profits flow back to investors.

Investing Fees – In most cases investors pay fees to buy and sell financial products. Buying or selling stocks through many platforms, such as E*Trade or TD Ameritrade, is now possible with no fee. Other financial products do have fees. Some mutual funds fit into a category called load funds. Load funds charge a fee, typically upfront, that is a sales commission used to pay the financial advisor. Most investors should be able to find a no-load fund (no upfront fee) that performs as good or better to a comparable load fund.

Mutual Fund Management Fees – Mutual funds have professional managers and expenses associated with managing the fund. Pay attention to the fees since they reduce the return to investors. Pay attention to the fee structure of the mutual fund and try to pick one with lower overall fees. Do some comparison shopping before you invest since fees can range quite a bit. My personal rule of thumb is to avoid funds with fees exceeding 1%. Index funds will have fees much lower than 1%. In fact, the average index fund fee is less than 1/10th of 1% per year. Remember, the lower the fee the more of your money you get to keep.

Strategies to Build Wealth

The key to building wealth is to spend less than you make and invest the surplus. One of the first things you will need to do is open a checking account and a savings account.

How do I open a bank account?

To open a checking or savings account, you will need to pick a bank with convenient locations that you can easily access. Most of us bank online now, but you may occasionally need access to a physical location if you want to get cash out of your account or talk to a loan officer face to face. While many people opt for completely online banks there is still some advantage in rural states to develop a relationship with your lender.

Once you have selected a bank, you will need to provide your Social Security number or taxpayer identification number, a government-issued photo ID such as a driver's license or passport, your physical address, and your mailing address. You will also have to deposit some cash or a check to open the account. Some banks will give you 30 to 45 days to make your first deposit. While you can open a bank account with no initial deposit you cannot begin using it until it has a positive cash balance.

Once the paperwork is complete, the bank will mail you a debit card if you've opened a checking account. You will also have the option of getting checks, which may be free or may cost you a small fee.

Banks sometimes offer several different types of checking and savings accounts with different interest rates, features, and costs. Visit with the banker about which type of account is best for you. Some accounts charge fees to maintain; a free checking account is a better option. If you are considering a fully online bank do some research about the features and the experiences of current customers.

Once you have a checking or savings account, it is easy to open an investment account online. You can transfer funds from your bank account to your investment account, then purchase shares of a mutual fund. You can use this same method to set up an individual retirement account (IRA) and invest for retirement. You may also use a money market mutual fund for your emergency reserve fund if it will earn more interest than your savings account. We will discuss these options a little later.

Savings Tactics

Budgeting – One of the best ways to begin saving is to develop a budget and use it to identify ways to generate a monthly surplus. It is helpful to track your spending for a few months. Keep an itemized list of how much you spent, what you spent it on, and when. You will begin to notice spending patterns that you did not know existed. You may find you are spending far more money on sodas, or some other product, than you realized. Most of us don't realize how much money we spend on impulse buys.

After you identify where you money is going, you can decide whether you want to redirect some of that money toward achieving some of your financial goals. Cut expenses or increase income and use the difference to save. Evaluate every expenditure and postpone unnecessary spending.

Make it Automatic – It is easy to set up an automatic transfer from your checking account into your savings account or investment account. Have the same amount pulled from your checking account every month and treat it like any other regular expense. Making savings a permanent fixture and not an option forces you to save money.

Get a Piggy Bank – Have you ever dug through your car, your room, or your jacket pocket to hunt for spare change? Get a small piggy bank and begin stuffing it with your excess change and small bills. You can save several hundred dollars over the course of year. Periodically deposit the money in the bank so you can begin earning interest and take advantage of compound interest.

Round Up – Some checking accounts can be set up to round up your debit card purchases to the next dollar and route the excess into a savings account. For example, if you spend $12.32 and use your debit card, the bank will round up the amount withdrawn from your checking account to $13.00 and put the extra 68 cents into your savings account. Over time, this strategy can generate hundreds of dollars in savings. This virtual equivalent of putting spare change in a piggy bank is great for people who don't often pay with cash.

Set A Savings Goal – As we discussed earlier, goal setting is a powerful tool. You can set SMART savings goals for the short term and long term. Identify the steps you need to take to accomplish the goal and stick with it. After you achieve your first savings goal, set a bigger one and keep going.

Investing Tactics

Investing differs from saving since investing is a longer-term goal. You typically don't want to invest money that you will need in the next five to 10 years because investments are not as liquid as savings.

Liquidity refers to how fast you can convert something to cash without a significant loss in value. What happens if you need cash when the stock market is down and you don't have an emergency fund? You might have to sell your stocks at a loss. You don't want to be forced into a situation where you lose money, so investments should be for funds that you won't need in the short run. Further, it typically takes a few days to finalize the sale of an investment and get the proceeds in your account.

As we covered earlier, stocks are financial securities that represent fractional ownership in a firm. Stocks have a high level of financial risk, which means the price of most stocks is volatile, or moves up and down a lot. However, stocks also offer the highest return potential overtime. Over the period of time spanning 1926 to 2018 the annual average returnof the S&P 500 falls between 10% and 11% Let's look at an example to illustrate the impact of earning high returns over time and the power of disciplined saving and investing.

Example: Jennifer decided to begin investing $50 a month, or $600 a year, until she reaches retirement age at 67 years old. If Jennifer is 18 years old today and can earn an 11% annual return on her money, how much will she have in her investment account when she turns 67?

If you have a financial calculator, you can easily compute the amount. The calculator keys we will use for all financial calculations are;

FV = future value
PV = present value
N = number of periods
I/Y = periodic interest rate
PMT = payment
CPT = compute

The inputs for this problem are;

PMT = - $600*
N = 49
I/Y = 11%
PV = 0

*negative number to initiate money is being deposited

You'll get a result of CPT FV = $901,498, meaning Jennifer will have $901,498 by the time she turns 67 if she sticks to her plan. It's worth repeating that Jennifer had to take some risk and invest in stocks to generate this sum of money. Financial risk is the probability of losing money. Jennifer's investment in the stock market is not guaranteed and there will be some years the value of the investment falls. However, assuming future returns follow past patterns Jennifer will be much better off financially if she continues to invest whether the market is up or down. When she turns 67 she should have a substantial sum of money

Here are a few things to remember when you start investing.

Take advantage of employer matching.
Many employers encourage employees to begin saving for retirement by offering to match some portion of their retirement contributions. For example, assume you went to work for a firm that matched 100% of your retirement contributions up to 4% of your salary and you made $40,000 a year. You would contribute $1,600, or .04 x $40,000. Your employer would match that amount and you would have $3,200 a year going into your retirement account. Assuming you worked for 45 years and earned an 11% return, you would have $3,157,243 at retirement!

If you took a job without that 4% matching contribution, you would have to contribute 8% of your take-home pay to end up with the same amount; otherwise, you would only end up with half of that amount, or $1,578,622. Sometimes you are better off taking a job with a lower salary that has an employee match or better health insurance. You need to carefully evaluate your total compensation package to determine which job offer is in your best interest.

Keep in mind that both of these examples assume that your salary stays constant at $40,000. In reality, you will probably see an increase in your salary, and therefore your retirement contributions, for every year you work.

Depositing funds isn't enough. Moving money into an investment account isn't the same as actually investing it. Your employer may have default investments that your money automatically goes into, or you may have to select and purchase these investments yourself. If you're putting money in an IRA, you will have to make your own investment selections and purchases. If you let cash sit in your retirement account, your balance will not grow.

Use dollar-cost averaging. Dollar cost averaging is an investment strategy where you invest the same dollar amount every month. For example, if you set up an account where you invest in a stock mutual fund and transfer $200 a month into the fund, you will see that each month, your investment will buy a different number of shares in the mutual fund. When the price is low, you will buy more shares. When the price is high, you will buy fewer shares.

Use tax-sheltered accounts. In addition to a possible employer match, investing in a retirement account through work—or on your own—means you will pay less in taxes. That's why retirement accounts are also called tax-sheltered accounts. The government established these options to encourage people to save for retirement. Social Security alone does not pay enough for someone to live comfortably in retirement.

Putting money in most tax-sheltered accounts lowers the amount of taxes you pay in the year of the contribution and allows the invested funds to grow tax free. Why is this such a big deal?

Consider this example. If you are single and make a little over $40,000 a year, you will be in the 22% tax bracket. For every $1.00 you put in a 401(k) or traditional IRA (two common types of tax-sheltered accounts), you will lower your current taxes by 22 cents. Therefore, it will only cost you $0.78 to put $1.00 in an investment account where it will grow tax free until you retire.

When you retire, as long as you are over age 59 ½, you will pay taxes on your distributions from that account at the tax rates in place at that time. And, since most of us will have a lower income in retirement, we should be in a lower tax bracket.

Since these tax provisions were set up to encourage you to save for retirement, they do penalize you if you take the money out before you reach age 59 ½. For Roth accounts you can withdraw your contributions prior to age 59 ½ with no penalty but any earnings in the Roth account will be penalized for early withdrawal.

- **Become a small business owner.** While owning a small business has many advantages, it also has its share of disadvantages. You may find yourself working very long hours for years before you grow large enough to hire more employees. Before you seek out this path to wealth, talk to some business owners and get their advice. Would they do it over again? What advice can they give you to help you become profitable sooner? The same advantages and disadvantages apply whether you start a small business, buy and existing one, or purchase a franchise.

- **Consider buying real estate.** Some people believe that owning properties to rent out to others is a good path to wealth. There are some tax advantages of owning rentals, but there are also disadvantages. You have to make sure the property is maintained and has renters that will keep the property in good condition while you're not there. Like many small business owners, you may find yourself on call 24 hours a day. Who do the renters call when the plumbing pipes freeze? Some landlords hire management companies to deal with these tasks, but this expense may reduce profits.

Consider bringing in local business owners to talk about their work. What are the pros and cons of owning a business? Would they do it over again? What advice could they offer on being profitable sooner?

Types of Retirement Plans

There are several different types of retirement plans. All of these plans have special provisions in the tax code that allow you to either defer paying taxes until you take distributions from your plan during retirement, or pay taxes in the present and withdraw the funds tax-free during retirement.

The federal government wants you to save money for retirement, so these plans have all been created to encourage you to do just that. These plans are sometimes called personal pensions, or pension plans. A pension is essentially any fund or source of money that pays retirement income. During your working years, you will have the opportunity to establish one or more of the following retirement plans:

401(k) plan – A 401(k) plan is a retirement plan funded by either the employer, the employee, or a combination of both that allows you to defer taxes on the contributions and pay taxes only on the withdrawals. Deferring taxes allows you to have a larger amount in the account that continues to benefit from compounding until you withdraw the money during retirement. This type of plan is known as a defined contribution plan since the amount you ultimately have in your account depends on the overall contributions and their investment returns. A 401(k) plan is offered by for-profit employers.

403(b) plan – A 403(b) plan is virtually identical to a 401(k) except it is offered by non-profit organizations. It is also a defined contribution plan, with a few minor differences. Both plans allow you to invest the contributions in various mutual funds and annuities. You can also opt to buy annuities using these funds when you retire. Also, both plans allow you to designate beneficiaries such as your spouse, your children, or your favorite charity to receive any money remaining in the account when you die.

457(b) plan – A 457(b) plan is similar to a 403(b) plan since it is also an employer-sponsored, tax-favored retirement savings account. 457(b) plans are also known as deferred compensation plans. They are offered to state and local government employees such as police officers, firefighters, or other civil servants. They have essentially the same options as the previously mentioned employer sponsored plans.

Traditional Pension Plan – A traditional pension plan is known as a defined-benefit plan. Your employer contributes to the plan during your working years, and sometimes you may contribute as well. Your retirement benefit depends on a formula that factors in your average salary during your highest-earning years and the number of years you worked. This monthly benefit will be paid to you for the rest of your life when you retire.

Traditional pension plans have been phased out for many occupations, but some public-sector workers—teachers, firemen, police, and a few others—still have traditional pension plans. Many firms (and governments) who gave their workers pensions in the past did not put enough money into these accounts and now find themselves struggling to pay the promised benefits. For this reason, most have shifted to defined-contribution plans, where the employees are only entitled to the amount placed in their accounts and the earnings on those funds.

Traditional pension plans do not have a cash value when you die, so they do not benefit your heirs. However, you can accept a reduced benefit that will allow your spouse to continue receiving retirement distributions until their death if you die first.

Traditional IRAs – A traditional IRA, or individual retirement account, allows you to invest pre-tax money and defer taxes on earned income. It's similar to a 401(k), but you can set it up on your own. However, the most you can contribute each year is about one-third of the most you can put in a 401(k). Also, the tax deductibility of your contributions depends on factors such as your income, whether you have other retirement plans, and your age.

Roth Plans – IRAs, 401(k)s, 403(b)s, and 457(b)s can all be established as Roth plans that allow individuals to contribute after-tax money instead of pre-tax money. These accounts then allow the money to grow tax free like any other retirement account. However, you do not pay taxes on the funds you withdraw during retirement. These accounts are usually attractive to people in a lower tax bracket. As your tax rate increases you may be better off financially to invest in a plan that lowers your current tax liability instead of paying taxes on the money now as you do in a Roth plan.

That said, no one can predict what their tax rate will be in retirement. Your retirement income could be higher or lower than you expect, or the government could change the tax rates. For these reasons, many people like to contribute to both Roth and traditional retirement accounts. Either way, you'll be getting tax-deferred growth, which helps your money grow faster than it would outside of a retirement account.

Self-Employed Plans – Other than IRAs, there are a number of other retirement plans available to self-employed individuals. These include self-employed 401(k) plans, SEP-IRAs, SIMPLE IRAs, and others. Each has different features that may be attractive to different individuals, but they all help defer taxes until a later date when you retire.

How much more can you save with a tax-deferred account?

	Regular Investment Account	Retirement Account
Monthly Contribution	$100 at end of each month	$100 at end of each month
Average Annual Return	8% (compounded monthly)	8% (compounded monthly)
Years to Grow	30	30
Federal Tax Bracket	25%	25%
State Tax Bracket	6%	6%
Expected Inflation Rate	3%	3%
Result	**$93,805**	**$149,036**

Finally, it's important to know that for all traditional retirement accounts, if you withdraw any funds before you reach age 59½, you will pay a 10% penalty, in addition to the taxes owed, on that withdrawal. The exception is if you use the funds for certain purposes or under certain circumstances (such as high, un-reimbursed medical expenses or total and permanent disability). The IRS determines what qualifies. Because of the tax penalty and the opportunity cost of removing money from your retirement fund, an early withdrawal should be a last resort.

Financial Market Regulation

The last topic we will cover in this module is how financial markets are regulated. After all, when money is at stake, someone needs to be monitoring the people that manage and invest that money. Regulators also make and enforce rules that decide how financial professionals can market investment products and manage your money.

The key regulators are as follows:

FDIC – The Federal Deposit Insurance Corporation insures bank accounts for up to $250,000 per account owner, per bank, as long as the bank is a member of the FDIC (most are). This insurance means your money is not at risk if your bank fails. If bank failure occurs, the FDIC will step in and give you your money back, up to the insured limit.

NCUA – The National Credit Union Administration protects credit union account holders in the same way that FDIC insurance protects bank account holders.
https://www.ncua.gov/files/press-releases-news/NCUAHowYourAcctInsured.pdf

SIPC – The Securities Investor Protection Corporation insures investors for up to $500,000 worth of securities (including up to $250,000 in cash) at SIPC-member brokerage firms. This coverage protects investors against losing money if their brokerage firm fails. It does not protect against losses from securities declining in value.
https://www.sipc.org/for-investors/what-sipc-protects

SEC – The Securities and Exchange Commission is a federal government agency that protects investors from securities fraud and other illegal practices, such as insider trading. Insider trading is the buying or selling of financial assets with knowledge that is not publicly available. The SEC mandates certain reporting requirements for publicly traded firms and also monitors insider trading.
https://www.nytimes.com/2000/09/21/business/sec-says-teenager-had-after-school-hobby-online-stock-fraud.html

One example of securities fraud involved 16-year-old Jonathan Lebed. Beginning at age 14, Lebed engaged in a "pump and dump" scheme and made huge profits. He would buy an obscure stock and then go through various investment chat rooms on the Internet and make false positive statements about the stock using multiple aliases. In other words, he pumped up the stock's price. Then he would sell the stock, or dump it, at the inflated price for a huge profit. He settled with the SEC in early 2000 and had to repay his profits, plus interest, for a total of $285,000. Lebed did not admit or deny guilt in the settlement.

FINRA – The Financial Industry Regulatory Authority is a private, self-regulatory organization that helps protect securities investors by creating and enforcing rules that guide the behavior of certain investment professionals. For example, you can use FINRA's free BrokerCheck website to see a financial advisor's employment history and disciplinary record. BrokerCheck can help you determine whether a financial professional is trustworthy before you allow them to manage your money.

Consumer Financial Protection Bureau – The CFPB is a government agency that makes sure banks and other financial institutions do not take advantage of consumers. A recent example is the CFPB's legal settlement with a major credit bureau, Equifax, which gives consumers free credit monitoring services or payments if they were a victim of the 2017 Equifax data breach.

Consumers can file complaints with the CFPB when their attempt to resolve a problem directly with their financial institution has not succeeded. These complaints may lead the CFPB to take legal action against an institution that receives numerous complaints. Recent cases have involved student loan debt relief companies and student loan servicers.

- https://www.consumerfinance.gov/complaint/
- https://www.consumerfinance.gov/about-us/newsroom/bureau-announces-action-against-student-loan-debt-relief-operation/
- https://www.consumerfinance.gov/about-us/newsroom/cfpb-sues-nations-largest-student-loan-company-navient-failing-borrowers-every-stage-repayment

Bank Regulators – Several government agencies regulate banks, S&Ls, and credit unions. These include the Federal Reserve, the Office of the Comptroller of the Currency, the FDIC, and the Office of Thrift Supervision. State regulators such as the Arkansas State Bank Department also monitor banks. Consumers can file complaints about a bank or financial institution through various avenues with these regulators.

Summary

While we've covered a lot of information, we've only scratched the surface of the topic of building wealth. However, some key takeaways include these eight points:

- You do have the ability to build wealth and be financially secure.
- Use the power of goal setting to accomplish your dreams.
- Set up a budget and find money to put in savings.
- Create a rainy day fund to pay for unforeseen expenses.
- Invest retirement money in riskier assets, such as stock funds.
- Take advantage of legal provisions to tax shelter your money, such as retirement accounts.
- Let time and compounding work in your favor to grow your savings.
- Time is money, especially if you have it working for you and not against you.

If you begin doing these things now, you will all be able to retire as millionaires. However, while you want to become disciplined savers and investors, you also want to enjoy the journey. Set aside time for family, friends, and new experiences. The primary reason to become financially independent and create wealth is so you can live the life of your dreams.

Assessment Materials

The following assessments can be used in multiple ways. Instructors can use these materials to facilitate classroom discussions, group projects, or individual student assignments. Every activity can be completed without Internet access or other outside resources.

Exercise #1 | STUDENT VERSION

Establishing SMART Goals

(30–45 minutes)

Name ____ Date:______________________ Class Period: ___________

Establishing good goals is essential to building wealth over time. However, it takes some practice to begin drafting good goals. Also, it's important to write your goals down and post them where you can see them and review them every day. Reminding yourself of your goals will help you achieve them.

Look at each of these goals and identify whether it is a good goal. If it is not a good goal, identify the problem. What's wrong with it? How could you improve it?

1. I want to lose a lot of weight this year.

2. I intend to begin saving money in the next two years.

3. I will accumulate $10,000 in my savings account by the end of five years.

4. Someday I will learn to play the piano.

Exercise #1 | TEACHER VERSION

Establishing SMART Goals

(30–45 minutes)

PFM.8.E.2 - Evaluate a variety of strategies for making personal financial goals to build short-term and long-term wealth

PFM.8.E.2 - Critique components of personal money management in order to build short-term and long-term wealth

PF.7.SI.6 - Interpret the role of goal setting as an integral part of financial planning and construct a well written goal

Establishing good goals is essential to building wealth over time. However, it takes some practice to begin drafting good goals. Also, it's important to write your goals down and post them where you can see them and review them every day. Reminding yourself of your goals will help you achieve them.

Look at each of these goals and identify whether it is a good goal. If it is not a good goal, identify the problem. What's wrong with it? How could you improve it?

1. I want to lose a lot of weight this year.

This goal is not specific. It could be improved by including a time frame or a specific amount of weight.

2. I intend to begin saving money in the next two years.

This goal is not timely. There is no clear goal setting over the long period, To improve this goal, add in small savings goals over the course of two years.

3. I will accumulate $10,000 in my savings account by the end of five years.

This goal meets most of the smart goals but could be improved by increasing measurements and achievability. For example, you could set quarterly goals to make sure you're on track to meet that larger ten year goal.

4. Someday I will learn to play the piano.

This is not specific or timely. Someday is today if you make a plan! This goal could be improved by including specific goals and a timeframe to measure success: I will sign up for bi-weekly piano lessons to learn to play scales and chords.

Exercise #2 | STUDENT VERSION

What Type of Bank Account Should I Open?

(30–45 minutes; requires internet access)

Name ____ Date:____________________ Class Period: __________

There are numerous types of savings and checking accounts. Sometimes it can be overwhelming to decide what you want or need. Spend a few minutes brainstorming the features you want in a bank account. Fee or no fee? Does it pay interest? Does it have a debit card? Are there branches or in-network ATMs near you? What is the purpose of this account? Now spend time researching three different types of bank accounts and compare and contrast their features.

Information:	Local Bank	National Bank	Online Bank
Name of Institution:			
Fees:			
Interest Rates:			
Debit card?			
How many times can I withdraw per month?			
Other account features? Add your own.			
Other account features? Add your own.			
Other account features? Add your own.			

Exercise #2 | TEACHER VERSION

What Type of Bank Account Should I Open?

(30–45 minutes; requires internet access)

PF.7.SI.4 Analyze the relationship between risk and return

PF.7.SI.7 Research different types of investments and consider the importance of diversification: annuities, bonds, money market funds, mutual funds, real estate, stocks

There are numerous types of savings and checking accounts. Sometimes it can be overwhelming to decide what you want or need. Students will spend a few minutes brainstorming the features you want in a bank account. Fee or no fee? Does it pay interest? Does it have a debit card? Are there branches or in-network ATMs near you? What is the purpose of this account? Then they will research three different types of bank accounts and compare and contrast their features.

Students will research local, national, and online bank accounts to compare and contrast what they offer to consumers. Encourage students to work alone or in groups depending on their preferences. As they work, walk around the room and answer any questions students have. Once most of the students have completed their worksheets, ask students to share what they have researched and create a “Big Board” using your white board or PowerPoint to add interesting student information. Use this big board of ideas to reinforce the standards and learning objectives for the day.

Exercise #3 | TEACHER VERSION

Stock Market Analysis

UNIT ACTIVITY

(30-45 minutes)

PF.7.SI.4 - Analyze the relationship between risk and return

PF.7.SI.7 - Research different types of investments and consider the importance of diversification: annuities, bonds, money market funds, mutual funds, real estate, stocks

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In-Class Procedures

Many people enjoy trying to pick stocks that will increase in value. Research the various methods of evaluating stocks and then pick a stock you think will increase in value. Monitor that stock throughout the semester. While some investors believe in their stock picking ability the research shows that most people would be better if they invested in index funds.

Arkansas Stock Market Game

The Stock Market Game™ is a national program of the SIFMA Foundation that allows students and teachers the opportunity to invest a virtual $100,000 in stocks, bonds and mutual funds throughout an engaging 13-week simulation each semester. A year-long session is also available that begins in September and ends in April. Economics Arkansas has been the facilitator of this program in Arkansas since 1999. Teachers can sign up their classes and students compete throughout the semester for scholarships and prizes. Learn more about the Arkansas Stock market and how to sign up by visiting the Economics Arkansas website.

ECONOMICS ARKANSAS
Education for Real Life

Exercise #4 | STUDENT VERSION

Ethical Analysis

(30-45 minutes)

Name ____ Date:______________________ Class Period: ____________

The financial sector is often in the news for ethical issues. For example, Wells Fargo foreclosed on almost 400 homes due to a computer glitch and had to make the situation right when it was uncovered. Sometimes you see allegations of insider trading and fraud for a particular firm or individual. A worthwhile exercise involves looking at some of these cases and discussing them in class.

You will be assigned to a team. With your team members, work together to research an assigned individual who committed some type of fraud. Create a poster or presentation about the person and their ethical issue. Take detailed notes using the space provided on this worksheet.

Exercise #4 | TEACHER VERSION

Ethical Analysis

(30-45 minutes)

PF.7.SI.8 - Understand the regulation of savings and investments

The financial sector is often in the news for ethical issues. For example, Wells Fargo foreclosed on almost 400 homes due to a computer glitch and had to make the situation right when it was uncovered. Sometimes you see allegations of insider trading and fraud for a particular firm or individual. A worthwhile exercise involves looking at some of these cases and discussing them in class.

Create student teams. Each team is assigned one of the individuals listed below to research. Create a poster or presentation about the person and their ethical issue. Take detailed notes using the space provided on this worksheet.

- Bernie Madoff: https://hbr.org/2009/06/what-did-bernard-madoff-do
- Michael Milken: https://www.washingtonpost.com/business/2020/02/18/michael-milken-pardon/
- Nick Leeson: https://www.theguardian.com/business/from-the-archive-blog/2015/feb/24/nick-leeson-barings-bank-1995-20-archive
- Charles Ponzi: https://www.smithsonianmag.com/history/in-ponzi-we-trust-64016168/
- Samuel Israel: https://www.businessinsider.com/samuel-israel-the-ponzi-schemer-you-may-not-remember-2012-6
- Marc Dreier: https://www.cnbc.com/id/42572204
- Scott Rothstein: https://abcnews.go.com/Blotter/scott-rothstein-50-years-12-billion-ponzi-scheme/story?id=10868086
- R. Allen Stanford: https://www.forbes.com/sites/nathanvardi/2012/03/06/allen-stanford-convicted-in-7-billion-ponzi-scheme/#205d3c745388

Some of these individuals are more famous than others, but all committed serious financial crimes. Teach students to use these episodes as a cautionary tale as they invest their money. When something sounds too good to be true, it probably is.

4

Additional Materials

The following materials will provide instructors with additional information and activity suggestions to expand on the topics presented in this unit. Some of these materials may require Internet access. These materials were created by various other organizations and were included in this module for their connections to Arkansas standards.