chapter one

RAINY DAY FUNDS AND SUNNY DAY SAVINGS

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Prepare for an Emergency
Understand Asset Allocation
Build a Financial Plan

Do you keep an emergency fund? You can be fairly certain of three things in life: death, taxes, and rainy days. Accidents happen. Companies move or close. Illnesses strikes. Like they say about your computer's hard drive, it's not a question of *if* it will fail, but *when*.

People definitely know that having an emergency fund is important. In Bankrate's surveys, 93 percent agree it's necessary, with 71 percent of people saying it's very important to keep at least three months' living expenses on hand. Yet despite the likelihood that they will need to tap some cash to get through a rough patch, only 44 percent of Americans have established an emergency fund.

This is hardly their only monetary worry.

- 45 percent fear that they will not be able to put away enough money for retirement.

- 34 percent worry their employer will decrease their benefits.
- 33 percent fear they will lose their job.
- 32 percent lose sleep over real estate concerns, worried the value of their home will decrease.
- 30 percent worry they will not be able to pay their mortgages or rent.
- 29 percent fear they will not be able to pay their credit card bills.

When creating an emergency fund, the rule of thumb is to stow between three and six months' worth of income someplace where it earns interest until you need it. "Need" means that you're facing a financial sickness, not a mere hiccup. It does not mean that a piece of jazzy technology has suddenly caught your eye.

At Bankrate, we recommend starting with small steps. For example, saving just $50 each pay period (assuming biweekly pay) in a money market account will build to more than $2,600 in two years. The most important thing is to take the plunge: Pay yourself first and start saving.

An emergency fund should be part of your savings plan, but by no means the only part. After all, saving is not just about putting money aside: It's about collecting interest. Interest is what a borrower pays a lender for the use of the lender's money. This is what you get when you deposit money in a savings account: You lend that financial institution your money so it can make loans to someone else. For this privilege the bank or other financial institution pays you interest.

What is interesting about this are the terms "rate" and "yield." The rate is the stated interest rate on your investment—say, three percent on a certificate of deposit (CD). The annual percentage yield (APY) includes the effects of compounding and is determined by how often interest is paid.

Assume that your CD is invested at three percent APY for six months. You can figure out the interest by multiplying the amount invested by three percent and by the fraction of a year the money is

invested, (in this case half a year). If a $10,000 investment pays interest semiannually you'll earn $150 interest. ($10,000 × 3 percent × ½ year.) The more often interest is paid, the higher the yield because the principal compounds and starts earning interest along with the invested principal. Got it? The annual percentage yield reflects the total interest to be earned based on an institution's compounding method, assuming funds remain in the account for a year.

So forget about the mattress or kitchen freezer. We may stow a few bills there, but when it comes to building *real* savings, you need to turn elsewhere. Here are some places to park the good (and, we hope, plenty) and still keep your finances liquid, meaning that they are easy to withdraw:

- CDs are not just about beautiful music (though jumbo CDs do sound awfully sweet). They're certificates of deposit and they're safe enough for even the most risk-averse investor. The posted APYs let you compare CDs that mature the same day but will leave you with different-sized nest eggs. Some CDs come with bump-up clauses where the bank increases your rate on a predetermined agreement. Some let you cash in your CD before its maturity date, without penalty, to buy CDs that pay higher interest. Others come with flexible rates that allow you to make additional deposits and, occasionally, some withdrawals during the term of the CD. Be sure you know the terms of the CD before you buy it. Bankrate.com's "100 High" list provides the names, phone numbers, and rates of financial institutions that pay the highest rates in the United States. And Bankrate.com's "Safe and Sound" rating system assesses the financial health of 22,000 institutions, so you can check on the stability of any financial institution before making your deposit.
- Financial advisers suggest "laddering" your investments. Take a CD ladder as an example. A CD ladder works in increments: Instead of buying one $50,000 CD, you buy a $10,000 one-year

CD, a $10,000 two-year CD, and so on, staggering them until your last $10,000 buys you a five-year CD and (hopefully) increases your rate of return. Consider each increment a rung on the ladder. After each increment (say, your one-year CD matures) you reach up to the next "rung"—reinvest that money in a five-year CD because by that time your five-year CD has four years left until it matures. As each year's CD comes due, you roll it into a five-year CD.

- Interest-bearing negotiable orders of withdrawal (or NOW accounts) are essentially interest-bearing checking accounts. Many let you "sweep" money from related accounts into them to take advantage of their higher yields.
- A Christmas Club is designed to let you set aside money for holidays or any special savings goal but it comes with a penalty for early withdrawals and often doesn't pay competitive rates.
- Annuities are regular, periodic payments made by an insurance company to a policyholder for a specified period. Fixed annuities provide a guaranteed return and grow tax-sheltered until you withdraw the money. But they're not the place to plunk your tax-advantaged retirement accounts such as 401(k) plans or Individual Retirement Accounts, (IRA) and they're not "emergency" money. If you withdraw your money from an annuity in the first six to eight years, you will pay a hefty surrender charge.
- Money market mutual funds invest in short-term corporate and government debt securities and earn a variable interest rate that is often comparable to the interest earned on CDs. You may withdraw money at any time without penalty.
- Credit unions have their own version of a savings account called a Share account. Their Share account certificates are like bank CDs and their share draft checking accounts are like a bank's checking account.

- A money market account (MMA) pays a higher interest rate than a standard savings account, usually requires a minimum balance, limits check writing and often charges a monthly service fee if the minimum balance is not maintained. The Federal Deposit Insurance Corporation (FDIC) insures these accounts.
- A passbook savings account is an interest-bearing savings account where the saver records transactions in a small book. Most banks have moved away from these accounts and substituted statement savings accounts, in which monthly statements replace the passbooks.
- Bonds are debt security, meaning you're lending money to a company or government that gives you essentially an IOU. Interest is paid either at specific periods during the life of the bond or when the bond matures. The principal or face value is repaid at maturity. If a bond with a $1,000 face value matures on December 31, 2006, for example, you will receive $1,000 on that date no matter what is happening in the market and as long as the issuer does not default on this obligation. Bonds issued by the United States Treasury are free from any risk of default.
- Savings bonds earn tax-deferred interest. You buy one at a deep discount compared to its face value. This discount is actually the interest that will accumulate during the life of the bond. A zero-coupon bond (also called a "zero") pays zero interest during the life of the bond, but pays the full face value on the bond's maturity date. Most people buy zeros issued by the U.S. government or state and local municipalities. Make sure your zero-coupon bond is noncallable—one that the issuer cannot make you redeem before the maturity date. Most Treasury and municipal zeros are noncallable. If you need to cash the bond prematurely, you may be stuck. You'll be selling it on the open market in competition with new bonds that may be cheaper.

If your assets were a pie, the biggest slice would probably be your home. Over a lifetime it's the No. 1 wealth builder for most Americans. But just where else you put your money depends a great deal on your personality and age—or how close you are to retiring. Historically, the stock market has been the best long-term investment vehicle. But in the short term, it's more of a roller-coaster ride. If your stomach lurches every time the Dow Jones Industrial average hiccups you probably should put more money into bonds or other less risky places. Know your emotional and numerical willingness for risk. Do not invest money in the stock market that you're not willing (or can't afford) to lose.

Once you have established a three-month emergency fund, you can give yourself a freedom fund—the freedom to walk out if your boss turns into a nerd or the company you spurned to go work for your current one acquires yours. At Bankrate, we cannot emphasize strongly enough the psychological benefit of a freedom fund, even if you never use it. Figure out what you would need to go six months without a job and build from there. Consider adding your income tax refund to your emergency fund; this will help bolster your savings from a three-months emergency fund to the full six-months "freedom fund" more quickly.

Start saving soon to take advantage of compounding. As Einstein famously said, compound interest is the most powerful force in the universe! The sooner you begin, the more money you'll have.

So an emergency fund is money you set apart from your portfolio and apart from assets you have allocated to various (and, hopefully wealth-building) investments. In addition to an emergency fund, you also need to save for retirement, for a down payment on a home, and for your children's education. When it comes to your long-term goals, asset allocation can be the difference between a really good portfolio and one that keeps you up at night. The right mix of stocks, bonds,

cash, and alternative investments such as real estate, futures, and commodities can help you and your portfolio ride out the bad times intact.

In the financial arena, the letters IRA stand for Individual Retirement Account, and it is a great way to save for your future. Many workers may be eligible to set up a Roth IRA account which uses after-tax dollars. When you take money out in a qualified distribution, however, you pay no federal tax. A traditional IRA is funded with pre-tax dollars. You can open an IRA bank account, brokerage account, or mutual fund account and you can move the account around at will.

Taking advantage of your employer's 401(k) plan is also important for providing for your future financial security. In addition to accumulating tax-deferred assets, many companies will make contributions to your account if you do. This is free money! How often does that happen?

What should you invest in with your IRA or 401(k)? The most important factors to consider are how liquid is the investment, how long you will hold it, the expected return, inflation, and your risk tolerance.

For instance, if you have more than 15 years left in the workforce, some experts suggest putting as much as 75 percent of your capital in stocks, the rest in bonds, and none in cash. Depending on your comfort level, you can put more money in stable blue chip stocks and some money in risky technology stocks, and a high percentage of your government bonds in instruments with an intermediate time frame, say five to ten years. A stock portfolio should be diversified, or spread out according to the type of stock. Stocks are typically put in categories according to the size of the company and the relative value of the stock. There are Small-, Mid- and Large-Cap stocks. Cap is short for Market Capitalization, or the number of shares outstanding multiplied by the price of the stock. When you buy a stock at a certain price you are not

only paying a price per share but all of the shares that everyone owns of a certain company added up equals the real price all of the investors are paying for the company. Next when you compare that market capitalization to the revenues, earnings, profitability, or book value of the company you see that you are either buying a company because it is growing, or a "growth" company, where you typically pay a high price. Or, you can buy "value" companies—companies selling for a price closer to what the company's assets are worth. And all of these categories can be either domestic or international companies that do business in long established markets like the United States and Europe, or "emerging" markets like China, Singapore and Chile. (One rule of thumb is that investors should expect about 8 percent average annual return on stocks and a 5 to 6 percent return on bonds, depending on inflation and the immediate past returns on stocks and bonds.) In general, experts agree that a well diversified portfolio provides the lowest volatility and the highest rate of return.

One big mistake many people make is looking at how an asset class did last year—and expecting a similar performance in the year ahead. Another is not reviewing their asset allocation at least once every year—paring back on stocks and putting more into fixed income bonds as they near retirement. Knowing when to rebalance your portfolio is just as important as knowing what types of investments to carry. A systematic rebalancing of assets can boost returns and lower risk at the same time. For example, let's say that you started a year with a portfolio of 50 percent large-cap stocks, 25 percent international stocks, and 25 percent small-cap stocks. If at the end of the year you find yourself with 60 percent large-cap, 20 percent international, and 20 percent small-cap, you should sell enough of the large-cap, and buy international and small-cap so that you return to the original percentages. Rebalancing should begin, as much as possible, in tax-advantaged accounts such as those of a 401(k) or IRA because there are no tax consequences to moving different funds around.

Rather than selling what you already have to purchase something else, experts recommend that you rebalance the mix by shifting your purchases. If a favorable market has made your portfolio stock-heavy, rebalance by purchasing more bonds. If you sell the stocks to get money to buy bonds for a quick fix, you will end up paying capital gains taxes on the stocks you sold. Most experts urge people to avoid overreacting to market dips. Instead of following the "10 hottest funds" trumpeted in magazine headlines, they advise investors to adopt a more disciplined strategy based on sound theory. And instead of focusing on one particular investment that may be faltering, they suggest looking at the portfolio's overall performance. A word of caution: There are tax consequences to selling stocks that have performed well. Selling losers to offset taxes from winners is the best strategy.

At Bankrate.com, our calculators help you determine how much you should be saving for retirement, college, and emergencies. By answering a few simple questions, you can get a savings plan tailored to your specific situation.

Teaching Tactics Time Line

It's never too early to start teaching kids about money. Plunking pennies into a piggy bank is a good start, but teaching them to save often begins by setting a good example. Seeing you budget each week shows them good savings habits—and that money doesn't grow on trees.

A piggy bank is a great place for three- and four-year-olds to keep their savings. You can help your kids find pictures of the toys or items they want to save for, then tape them to the side of the bank to remind them why they're saving money. And you can teach little ones about money by separating coins into piles by color and size and discuss their value.

Elementary-age kids *can* understand how interest is earned on a savings account, how store coupons work, and how to budget for

something they want. They can appreciate how businesses operate and how investors buy and sell stocks. You may want to teach them about stocks by making a game where all family members pick a company and invest $100 phantom or real money and track the stocks' daily progress through the newspaper's financial section.

Preteens can shift a third of their allowances or earnings to satisfy instant, "gotta have it now" urges, a third into short-term savings for a new bike or CD player, and the last third into long-term savings—such as for college.

Many banks let children start savings accounts in their own names with as little as $10. Most will waive penalties for small balances. You might want to match the amount that your child contributes to the account to encourage regular deposits. If you use online banking, you can schedule a weekly or monthly deposit into separate money market accounts for your children. This way, they are less tempted to spend the cash and more likely to learn about interest.