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Investing On a Shoestring

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Everyone should put money away for future use. When money is put away for future use, the intent is that it will increase in value. In addition to helping pay for emergency needs, it can be invested for more long-term needs such as retirement, a child's education, and long-term care.

Investing usually refers to placing money in something that will produce income or increase in value. Often people think that investing is only for the rich. This is a myth. Even people with small amounts of money to put aside for future benefit or value can be investors. The purchase of a Certificate of Deposit (CD) or a regular savings account is often the investment vehicle of choice. This is because it carries a low risk of loss and is something with which almost everyone is familiar. Money in a savings account or CD is easily converted to cash if you need it for an emergency fund. For long-term investing, the interest rate paid is usually less than the annual rate of inflation. Money held over longer time periods in these accounts loses purchasing power. That translates into a monetary loss for the investor.

future

It is important to understand where the appropriate place is to place your money for income and growth, to know the difference between stocks and bonds, and to be aware of your comfort with investment risks. At the very least, you should be comfortable talking with a financial adviser and be willing to take responsibility for your money decisions. Otherwise, it could mean a loss of purchasing power or create the possibility of someone taking advantage of you and your money.

There are investment vehicles in which you can regularly place small amounts of money to either generate income or increase its value over time. Even people who think they have no money for investments can find a place to invest small dollar amounts on a regular basis that will provide additional money in the future.

The following six types of investments are discussed in more detail:

- Tax-deferred employer retirement plan
- Individual Retirement Account (IRA)
- Stock
- Fixed-income investment
- Unit Investment Trust (UIT)
- Mutual fund

Tax-Deferred Employer Retirement Plan

If you are still gainfully employed, this is an excellent place to begin. Employers who offer retirement plans usually take a small percentage of money from your gross pay each pay period. This amount is placed in either a defined benefit plan or a contribution plan. Most employers contribute an amount that equals a certain percentage of your gross pay. This is called a match.

If this plan is offered, you should sign up for it as soon as possible. Think of the employer matching contribution as a bonus to your paycheck or, better yet, as free money. Another advantage is that the employee contributions can be deducted from your paycheck before your income tax payments are calculated. Thus, contributions to your retirement plan reduce your taxable income. For example, if you earn $35,000 a year and you put $3,000 into an employer plan, your taxable income is only $32,000 a year. Employers also offer a Roth type of retirement plan where the employee pays taxes on the money put into the plan but the plan grows tax-free. The easiest part is that employers usually offer automatic payroll deductions for this benefit. You will be paying yourself first without any effort.

If you are already contributing to an employer retirement plan, you can save more in supplementary funds by raising your contribution a notch. The most painless time to find extra money for your retirement fund is when you receive a pay raise or pay off a consumer debt. Contributing just 1% more of your pay can mean thousands of dollars more for retirement. Younger workers and those at higher salary levels stand to accumulate the most by contributing 1% more of their salary. Here are some examples of how an additional contribution can grow.

- If a person age 35 with an annual salary of $40,000 contributes $4,000 (1% of salary) to a retirement fund, by age 65 he or she will have an additional $74,200 for retirement [$48,000 contributed plus $26,240 interest earned].
- At age 45 with an annual salary of $50,000 – 1% more per year ($5,000) will grow to $33,000 by age 65.

These examples assume 8% average annual return on investments and 4% annual pay increases. [Source: 401(k) Booster Calculator by Advantage Publications, (800) 323-6809.]

IRA

This acronym stands for Individual Retirement Account. The IRA was established by Federal legislation to encourage individuals with no retirement plan to save money for retirement. The regulations for a traditional IRA protect the investor from easily withdrawing the money before age 59½. A traditional IRA is also a tax-deferred investment. The contributions to a traditional IRA can reduce your

retirement

taxable income the same as an employer retirement plan contribution. Tax deductibility is determined by access to a qualified retirement plan and your adjusted gross income.

The maximum annual IRA contribution limit is $4,000 in 2005 through 2007 and $8,000 in 2008. After 2008, the amount that can be contributed will be indexed. The $3,000 does not have to be invested all at once. Contributions can be less than $3,000 and still made to an IRA. A contribution of $58 each week for 52 weeks adds up to $3,000. If you are paid monthly, the amount is $250 per month. People over 50 can contribute an additional $500 in 2005 and $1,000 in 2006 through 2008.

Roth IRAs receive contributions on taxed earnings but grow tax-free.

Stock

When you purchase a share of stock, you become part owner of a company. Most shares of stocks are purchased through a stockbroker. Many brokerage firms require a minimum dollar amount to open an account and purchase shares for you. It is possible to purchase just one share of a company stock with many corporations. Many companies will sell shares of stock directly to shareholders without going through a stockbroker. Be sure you understand the stock you are purchasing. Diversify your purchases among several industry sectors (e.g., financial services; consumer staples such as food; and consumer cyclicals such as automobiles, technology, energy, utilities, transportation, entertainment, and pharmaceuticals).

If you own a single share of stock in a company, you can continue to invest money in that company through a Dividend Reinvestment Plan (DRIP). Companies that use this type of plan allow investors to reinvest stock dividends and/or make cash purchases of stock. If you do not have enough money to purchase a full share of a company stock, this type of investing allows you to purchase a fraction of a share of stock. This plan is good for people who want to invest in stocks but have only a small amount of money to contribute each month. Many investors do "dollar cost averaging" in their investing. This means that they contribute the same amount of money each month to an investment account.

One advantage of a DRIP is that you can become an investor with a small initial investment. Some companies allow initial investments of $10. There are no broker commission fees with this type of investment. Thus, you allow for greater profits over time. This method requires more homework on your part. Instead of receiving advice from a broker, an investor must research the stock information on his own. Money invested in a DRIP is more difficult to liquidate, so an investor needs to think of this as a long-term investment.

Another low-cost stock purchase option is to join an investment club. Most investment clubs consist of a group of local people interested in investing. They meet on a regular basis. Members of the group contribute the same amount of money to a "kitty" of money. The club members research various stocks that are of interest to the group and then decide as a group what stocks to buy and sell.

Another low-cost stock purchase option is to do online investing through an online investing account. This can minimize your fees. Again, you are on your own for researching which stocks to buy and sell. However, to do online investing, you still need to open an account with a brokerage firm. The convenience is that you can make your application online. You will still need to transfer money to that brokerage firm to pay for your transactions. Many firms charge smaller fees for online trading.

Full-service stockbrokers can help you purchase stocks and bonds. Some brokers will open an account with a minimum $1,000 to $2,000 investment. While brokers charge commissions for buying and selling the stock for you, sometimes this is the most convenient way to make a purchase or sale. They also have research information available on stocks and bonds. If you have a financial adviser/stockbroker, that person can know your investment risk tolerance and needs. Thus, you can receive advice without paying a high price for the information. Remember that the decision on what to buy or sell is still yours. The consequences of your decisions rest on you.

Fixed-Income Investments

Most fixed-income investments are "loanership" investments. The investor is loaning money to a corporation or a government entity. The result is that the investor is repaid interest for the use of his money. This type of investment provides a fixed income on a regular basis. The most common types of fixed-income investments are backed by the U.S. Government, state, or municipalities or by corporations in the form of bonds.

U.S. Government-backed securities are called Treasury securities and include Treasury bills (T-bills), Treasury notes (T-notes), and Treasury bonds (T-bonds). All Treasury securities now have a $1,000 minimum investment. The interest rates paid on Treasury securities are determined at periodic auctions. Income from government-backed securities is exempt from state and local income tax. Treasury securities can be transferred, so they are available to buy and sell on the securities market. This type of investment is easily liquidated if you need cash. There are no fees unless your account is greater than $100,000.

T-bills are short-term investments. They mature in one year or less from their issue date. A T-bill is purchased at less than face value. When it matures, the U.S. Government pays the investor the face value of the T-bill. The difference between what was paid for the T-bill and the face value at maturity is the interest received for the use of the investor's money.

T-notes mature between one and 10 years. T-bonds mature in 10 years or more. Most T-notes and T-bonds are purchased for face value, and the U.S. Government pays interest to the investor every six months. The investor can purchase either a fixed-principal or an inflation-indexed Treasury security. The advantage of an inflation-indexed Treasury security is that the interest is adjusted to reflect inflation as measured by the Consumer Price Index. Semiannual interest and maturity payments are based on this inflation-adjusted principal value of the security. This is an advantage to investors concerned about inflation eroding their purchasing power.

liquidated

U.S. savings bonds are issued as Treasury securities. You can purchase a savings bond for as little as $25. Savings bonds can earn interest for up to 30 years. However, you can cash them after six months if you need to liquidate some money. There are two types of savings bonds available for cash purchase – Series EE and Series I bonds. Savings bonds are not transferable to another person.

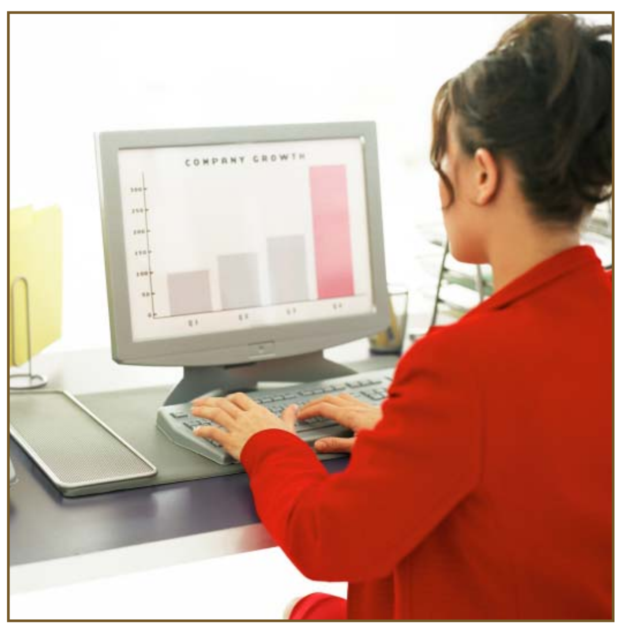
An investor who wants to purchase a Treasury security can contact a Federal Reserve Bank, a financial institution, or a government securities broker or dealer. Kentucky is represented by two Federal Reserve Board Districts. Eastern Kentucky is served by the Cleveland Federal Reserve Board [www.clevelandfed.org, P.O. Box 999, Cincinnati, Ohio, 45201-0999, (800) 432-1343]. Western Kentucky, including Louisville, is served by the St. Louis Federal Reserve Board [www.stls.frb.org, P.O. Box 32710, Louisville, Ky., 40232, (502) 568-9200 or (800) 292-3596 in Kentucky]. To open an account, you will need to submit with a Treasury Marketable Securities Tender Form, or a New Account Request form. For more information, call the Federal Reserve Board, or to download tender forms go to www.treasurydirect.gov. Once you establish an account with the Treasury, you can purchase Treasury securities over the phone.

Other fixed-income investments include municipal bonds, corporate bonds, and zero-coupon bonds. Municipal and corporate bonds are purchased through a stockbroker. A minimum investment for a municipal bond is $5,000. Minibonds are municipal bonds that come in small denominations. If you are interested in investing in bonds for a smaller amount of money, refer to the UIT section in this publication. Bonds come in different face value amounts. The interest rates and length of maturity terms for bonds also vary. Longer term bonds tend to have higher interest rates. Many investors who invest in bonds try to "ladder" their bonds. This means that they mature at different intervals and give the investor some flexibility in reinvestment or liquefying a bond holding.

Municipal and corporate bonds receive ratings from one or more of the major rating services. For example, Moody's bond ratings range from Aaa (the best) to C (the worst), with a "D" rating indicating that the bond is in default. Standard and Poor's also rates bonds. Its ratings are similar to Moody's, with AAA being the best and C-C1 the worst. The table below shows these two ratings for bonds. High-quality bond classifications that are considered investment grade are the first four listed in the table. These are the less risky bonds.

RATING SERVICE

Moody's	Standard & Poor's	Meaning
Aaa	AAA	Highest grade
Aa	AA	High grade
A	A	Upper medium grade
Baa	BBB	Medium grade
Ba	BB	Lower medium grade
B	B	Speculative
Caa	CCC	Poor to default
Ca	CC	Highest speculation
C	C - C1	Lowest quality



Zero-coupon bonds (STRIPS from U.S. Treasury is another type of zero-coupon investment) are purchased for less than face value. This type of investment does not make interest payments, but at maturity the investor is paid full face value of the bond. The difference between the purchase price and the full face value is the interest paid for the use of your money. This type of investment is good for investors who have a small amount of money to invest for a long-term need. One example where investors use this investment tool is to help pay for the college education of a child or grandchild. A zero-coupon bond can be purchased when the child is small. The bond will reach maturity when the child is 18 or 19 years old, and the full face value of the bond can help pay for college costs. Some people even purchase several of these bonds at intervals so that, at maturity, a bond will be paid in full each year of the child's college years.

Unit Investment Trust (UIT)

It is a closed-end fund than consists of a portfolio of fixed-income securities and/or stock with a specific investment objective. The investment objective may be income generation or to build equity. Each UIT is registered with the Securities and Exchange Commission, and the mix of investments is selected by professional investors (usually an investment firm). A minimum investment in a UIT is $1,000. The investor receives a portion of the principal and interest in this fixed or closed-end fund. If your investment goal is to generate income, this is an investment to consider. It pays interest monthly. When the UIT reaches maturity, the principal investment is repaid to the investor. There are annual fees with UIT funds to cover operating expenses.

One advantage of this investment device is that it is a less expensive way to purchase bonds. A UIT investment must be purchased through a broker. UIT investments are for the long-term investment. If you need to liquidate your money from this investment before maturity, you may take a loss on the principal amount you invested.

There are several choices of UIT investments. Be sure you know the composition of the UIT before you purchase shares of it. Know the maturity date and how the interest payments are made. The interest income from some UIT funds is taxable on income tax.

Mutual Fund

A mutual fund provides an avenue for purchasing a mixture of stocks and bonds that are professionally managed. Each mutual fund has an investment objective. The investment objectives vary from income generation to high-risk aggressive investments. Minimum investments in mutual funds vary from $250 to $25,000. Mutual funds are sold as shares of the fund. Each share carries a Net Asset Value (NAV). The number of shares you purchase at any one time will depend on the NAV. Each mutual fund also carries different fees. Some mutual fund fees are a one-time charge for opening and/or closing an account. Other fees are annual or monthly fees for the expense of managing the fund. Give careful consideration to the fee structure of a mutual fund before you invest.

Mutual funds can be purchased through a broker. Some mutual funds can be purchased directly from the company managing the fund. Shares of mutual funds can be sold at any time if you need to liquidate your investment.

self-employed

Other Suggestions:

If you are self-employed, invest in a self-employment plan for your retirement. This will help you with retirement savings. The IRS offers many tax advantages for reducing gross taxable income with these plans.

If you find a "windfall" of money, such as from an income tax refund, consider investing that money instead of spending it immediately.

Make investing a regular part of your spending plan by finding a regular amount of money to put aside for investments each month. This is known as dollar cost average investing.

If you are not already investing, start today. The compounding of your money is not retroactive.

Final Thoughts:

You do not need the last name of Rockefeller or Gates to become an investor. Even with small amounts of money there are places to invest.

Time is a precious commodity. It is as precious as money. The sooner you begin to invest, the more time you have to compound your money.

If you are starting late, you may need some catch-up strategies to have enough for future needs. This might include working longer before you retire, doing more aggressive investing, or changing your lifestyle.

Remember where there is a will, there is a way to invest.

Adapted from *Investing on a Shoestring* by Barbara O'Neill, Rutgers University.

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