WHAT TO DO WITH ALL THAT MONEY

Posters Encouraging U.S. Citizens to Buy Savings Bonds: 1945 and 1975

Unit Overview

Now that you know what money is, what can you do with it? In reality, people have two options when it comes to money. They can spend it, or they can save it. By saving it, individuals make funds available for others to borrow it. Companies, for example, can use these loans to expand production, while savers can receive profits through interest and dividends. This exchange makes economic growth possible, but, as with all decisions, it comes with trade-offs. Let's see how it all works.

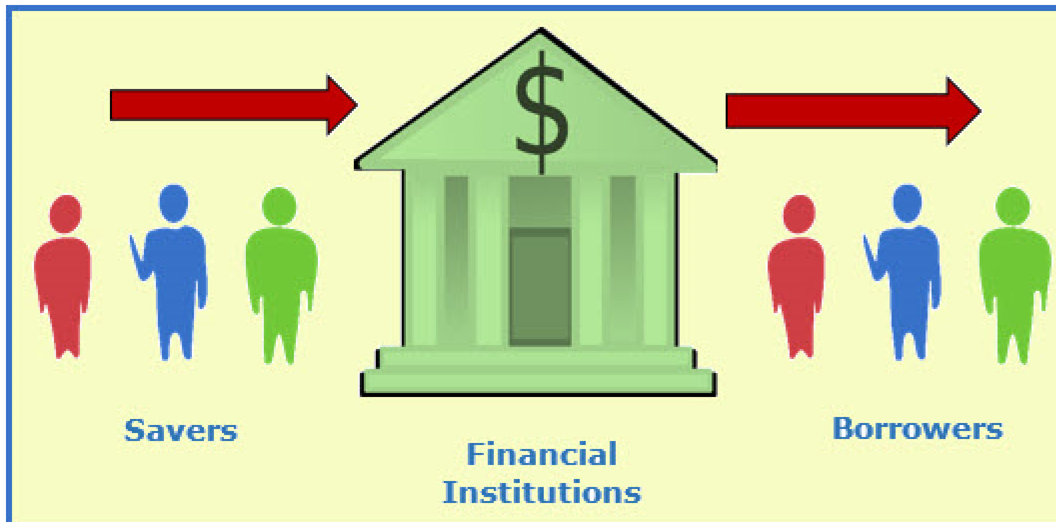
How an Economist Defines Savings

Economists define saving as the absence of spending. In other words, if one is not spending, he or she is saving. The money that accumulates from this lack of spending is called **savings**, and it is essential for economic growth in a market economy. For businesses to supply the goods and services that people need and want, they must have, along with the other factors of production, capital. This includes machinery, equipment, tools and money. When people deposit money in savings accounts, banks are able to make loans to businesses. Then, entrepreneurs have the funds that they need to create new businesses and to update old ones. Firms also have the financial means to develop advanced technology, to purchase new equipment and to create more jobs. For a saver, this becomes an **investment**, or the use of assets to earn profits. The profit that the saver makes above and beyond the initial investment is called a **return**. All investments come with a certain amount of risk. An economist defines **risk** as the chance that the actual return will differ from the expected return.

Go to Questions 1 through 3.

The Financial System

If investments are going to take place, an economy must have a **financial system** that permits savers to transfer money to borrowers. People can house their savings in a number of locations. Some may choose to open traditional savings accounts; others may purchase certificates of deposit or bonds. In each of these instances, the saver receives a document, such as a passbook, certificate or computer printout, to confirm that the transaction has taken place. In the event that the borrower does not pay back the loan, these records provide legal proof that an individual, business, or government has borrowed a specific amount of money that must be repaid.



Although savers and borrowers sometimes interact directly, they often connect through financial institutions referred to as **intermediaries**. Financial intermediaries help direct funds from savers to borrowers. The table below offers several examples:

Financial Intermediaries	
Banks, Savings and Loan Associations and Credit Unions	These institutions receive deposits from savers. Then, they lend some of these funds to individuals and businesses.
Finance companies	Finance companies make loans to small businesses and individuals, including clients who have a history of not repaying loans. To cover any losses that may result, finance companies charge borrowers higher interest rates.
Mutual funds	Mutual funds combine the savings of many clients and invest their money in a variety of bonds, stocks and business ventures. This decreases the risk for savers because they are not investing in just one company.
Life insurance companies	Life insurance companies sell policies that provide financial protection for families when policyholders die. They lend part of the payments, or **premiums**, that they collect for this service to borrowers.
Pension funds	Many retirees receive payments called **pensions** after they work a certain number of years, reach a certain age or are injured on the job. Employers often withhold a percentage of

	workers' salaries for this purpose and sometimes contribute to these funds on behalf of their employees. Pension fund managers make some of this money available to borrowers.

Although it may seem that savers and borrowers could simplify the process by dealing with each other directly, there are advantages to working through intermediaries. Intermediaries help savers to decrease risk by putting their money to work in a variety of ways. This strategy of spreading out investments is known as **diversification**. It reduces the possibility of losing everything if a single investment fails. On another front, most savers and borrowers do not have the time or the resources to research investment opportunities on their own. Because intermediaries collect and monitor financial data, they are valuable sources of information. The law requires intermediaries to publish this material in an annual report called a **prospectus**. Intermediaries also provide savers with **liquidity**, or the ability to convert their investment to cash. Let's say that you decide to invest in a mutual fund. After keeping the investment for three years, you want to sell it so you can use the money to buy a car. You can easily do that. However, suppose you had purchased several collectable sports cards instead. This would be more difficult to convert to cash because you would have to find another investor who would buy the cards.

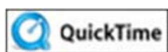
Go to Questions 4 through 7.

Saving Accounts

Banks offer a variety of options for savers. **Traditional savings accounts** are the most common and are easily opened in person or online. They are especially useful for customers who tend to make frequent withdrawals. Because there is no penalty for taking money out of the account, they are excellent places to store money for emergency purposes. Savings accounts are safe even if the bank fails because they are insured by the **Federal Deposit Insurance Corporation** (FDIC). However, they only pay a small amount of interest at an annual rate.

Federal Deposit Insurance Corporation: Arlington, Virginia

Money market savings accounts pose another alternative for savers. Because they are also federally insured, this option qualifies as low risk and pays higher interest rates in comparison to traditional savings accounts. However, interest rates for this type of savings program are not fixed but may move up or down depending on economic conditions. They generally require a **minimum balance**, or a specific amount of money maintained in the account at all times. The financial institution also limits the number of withdrawals that a saver can make. **Certificates of deposit**, commonly known as CDs, also pay higher interest rates and are federally insured. Unlike money market savings accounts, they offer a guaranteed interest rate for a certain number of years. During that time, the saver may not withdraw funds from the account without paying a penalty. In other words, the saver gives up immediate liquidity for a higher return. Money market accounts and certificates of deposit work well for savers who are storing money for the long term. The video listed below explains several things to consider when opening a savings account.

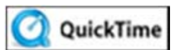


Choosing a Savings Account

Go to Questions 8 through 10.

Bonds

Sometimes corporations and governments need to borrow money to finance major projects for long periods of time. For this reason, they often issue **bonds**. A bond represents a loan that a government or company must repay to its investors. Bonds usually pay investors stated amounts of interest at regular intervals for the duration of the loan. Bonds have three basic features: coupon rate, maturity and par value. The **coupon rate** refers to the amount of interest that the issuer of the bond agrees to pay the lender. The time when the repayment of the loan itself is due is known as the bond's **maturity**. The **par value** is the amount borrowed, or the **principal**, that must be repaid to the lender upon maturity. For example, a corporation sells a $2,000 par value bond for twenty years at 5% interest paid twice a year. The bond's holder receives $50.00 twice a year (.05 times 2,000 divided by 2). After twenty years, the company pays off the debt by giving the holder of the bond the initial investment of $2,000. The video listed below explains more about how bonds work.



Bonds

Although this may appear to be a good way to profit from saved money, not all corporations and governments are equal in credit-worthiness and financial health. Unlike savings accounts, bonds are not insured, and there are no guarantees that the borrower will still be in existence when the bond matures. How do investors know which bonds are "good" and which ones are "not so good"? Fortunately, investors can rely on the research and analysis of two major companies. **Standard & Poor's** and **Moody's** rate bonds on several factors. They consider the issuer's past credit history, its ability to cover the interest payments and the likelihood that it can repay the principal. Bond ratings, listed in the graphic below, range from AAA (Aaa on the Moody's scale) to D. Those listed as BB and Ba or lower are generally the riskiest types of bonds. At this end of the scale, there is valid information to show that the interest and/or principal is less likely to be repaid when compared to those bonds at the top of the scale. Nonetheless, many bonds are considered reasonably safe investments.

Bond Classifications			
Standard & Poor's		**Moody's**	
AAA	Highest Grade	**Aaa**	Best Quality
AA	High Grade	**Aa**	High Quality
A	Upper Medium Grade	**A**	Upper Medium Grade
BBB	Medium Grade	**Baa**	Medium Grade
BB	Lower Medium Grade	**Ba**	Speculative Elements
B	Speculative	**B**	Generally Not Desirable
CCC	Vulnerable to Default	**Caa**	Poor, Possibly in Default
CC	Other Debt Rated CCC	**Ca**	Often in default
C	Other Debt Rated CC	**C**	Bonds Not Paying Income (Interest)
D	Bond in Default	**D**	Interest and Principal Payments in Default

Investors can choose from several different types of bonds, such as the ones listed below. However, they must keep in mind that rewards involve trade-offs. As the potential for higher returns increases, the amount of risk also increases.

- **Savings Bonds:** Savings bonds are issued by the federal government and have virtually no risk of **default**, or failure to repay the debt. They come in small denominations ranging from $100 to $10,000. The money raised from their sales pays for public projects like monuments, bridges and national parks. Unlike other bonds, the U.S. government does not issue payments to bond holders at regular intervals. The buyer purchases the bond for less than par value instead. For example, an investor can buy a $100 savings bond for $50. When it matures, the bondholder receives $50 as repayment for the principal and $50.00 in interest.

An Example of a United States Savings Bond

- **Treasury Bonds, Bills and Notes:** Treasury bonds, bills (T-bills) and notes (T-notes) represent other opportunities to invest through the United States Treasury Department. Investors can purchase them for a minimum of $1000. Because they are backed by the federal government, there is little risk to the investor. Treasury bonds are considered long-term investments because they mature anywhere from ten to thirty years. Since they reach their value in two to ten years, economists regard T-notes as intermediate-term investments. On the other hand, T-bills mature in three to twelve months and are labeled as short-term investments. To learn more about bonds issued by the federal government, click on the icon below.

- **Municipal Bonds:** State and local governments also sell bonds to fund new schools, to improve roads and to complete other public works. These are referred to as municipal bonds, or ***munis***. Standard and Poor's and Moody's classify these as reasonably safe investments. This is based on the fact that state and local governments have the authority to collect taxes. Therefore, these governments are likely to keep up with interest payments and to repay the loan when it matures. Any interest on these bonds is not considered taxable income, and this is an added bonus for investors. The graphic below shows a list of municipal bonds for sale along with their ratings, the number available, the coupon, maturity and price.

State	Moody	S&P	Qty	Description	Coupon	Maturity	Price
FL	A2	A	25	MIAMI-DADE CNTY FLA EXPWY	4.300	07/01/2039	106.880
KY	Baa2	BBB	50	ASHLAND KY MED CTR REV	5.000	02/01/2040	106.700
KY	Baa2	BBB	110	KENTUCKY ECONOMIC DEV FIN AUTH	5.000	02/01/2040	103.876
PR	Caa3	CC	80	PUERTO RICO SALES TAX FING	5.000	08/01/2040	72.000
VA	Aaa	AAA	115	VIRGINIA ST RES AUTH	3.500	11/01/2040	100.000
NY	.		15	RAMAPO N Y LOC DEV REV	5.000	03/15/2041	108.217
MA	Aa2	AA	80	MASSACHUSETTS ST COLLEGE BLDG	4.250	05/01/2041	104.979
IL		AA	255	ILLINOIS ST GENERAL	4.000	06/01/2041	100.000
FL		A-	85	HALIFAX HOSP MED CNTR DAYTONA	3.750	06/01/2041	96.133
MA	Aa2	AA	25	MASSACHUSETTS ST HSG FIN AGY	4.300	12/01/2041	105.473

Information Courtesy of fms,bonds inc.

- **Corporate Bonds:** Corporations sometimes raise money by issuing bonds. Unlike governments, they have no tax base to help guarantee repayment. Corporations depend on their profits from sales of goods and services to repay their debts. Sales, however, may not increase as anticipated. For this reason, most corporate bonds have moderate potential for risk. Bondholders also pay income tax on any interest payments that they receive. To eliminate fraud and other dishonest practices, the **Securities and Exchange Commission** (SEC), an independent agency of the federal government, carefully monitors companies that borrow money by offering bonds.

The United States Securities and Exchange Commission: Washington D.C.

- **Junk Bonds:** In the 1980s and 1990s, junk bonds became a popular option for aggressive investors. Investors purchase these low-rated bonds because the corporations that issue them are willing to pay higher interest rates to borrow money. They have the potential to produce a much higher return than federal, municipal or corporate bonds. However, there is also reason to believe that the company issuing these bonds will default, and the bondholder will lose his or her investment.

Go to Questions 11 through 22.

What Happens next?

Bonds represent one way that corporations raise money to produce goods and services. They may also choose to sell shares of stock in their businesses. This not only provides cash to start, maintain and expand production but also gives investors an opportunity to make a profit. As with all investments, however, buying stock comes with risk. Before exploring this topic in the next unit, review the terms found in Unit 10; then, answer Questions 23 through 32.

Go to Questions 23 through 32.