Video 5 - Get a Financial Plan

VIDEO SUMMARY

The video notes that building wealth is hard work, and outlines some key factors that affect people's ability to build wealth. These factors include: paying yourself first, starting to save early, saving regularly and managing your spending and credit. The video also focuses on the importance of developing a budget and sticking to it. This necessitates an understanding of fixed, periodic and variable expenses; interest rates; credit cards; and annual percentage rates. To make a budget, list and periodically tally up everything you spend. This will help identify your long-term expenses and estimate how much you need to save for emergencies. Once you have enough saved for emergencies, you can start to think about investing. Investing isn't just about the money – it's about how that money can enhance your life.

It is very important for young people to take advantage of investment opportunities early in their careers, when they have fewer financial obligations than later in life. Making and growing money takes careful financial planning. It is not that difficult to develop a financial plan if you take it step-by-step.

There are many kinds of investments, including the following:
- Retirement accounts
- Stocks
- Bonds
- Mutual funds
- Real estate

Even modest investments can yield substantial earnings over time. Compounding interest can work for you, but you need to be invested for the long haul and add steadily to your savings, month after month. Young people have time on their side and can benefit from a consistent investment program over the years. Investments turn today's financial goals into tomorrow's reality, enabling future expenditures on education, travel, retirement or whatever you have planned.

Lesson 5.1 - Why Should I Pay Myself First?

BACKGROUND INFORMATION

The most common reasons that people are unable to buy a house or start a business are lack of personal financial wealth and poor credit. Even people of modest means can build wealth if they have a financial plan that includes setting goals, budgeting, saving, investing and controlling debt.

Perhaps the most important thing for a person interested in financial security to get used is living below your means. A good way to begin is to open a savings account at a young age and make regular deposits. Then it is essential to increase the amount of savings as income increases. To build wealth, it is important to keep interest earnings in the account so that they will compound. Over time, interest compounding can be magical.

VOCABULARY

Saving – income not spent on current consumption or taxes

Compound interest – a situation in which interest is earned on previously earned interest in such a way that earnings accumulate more rapidly over time

Rule of 72 – offers a simple way to determine how long it will take for a principal value to double in size. Divide the annual interest rate you expect to earn into 72 to know approximately how many years it will take to double your principal.

MATERIALS

✓ Visuals 5.1.1 and 5.1.2
✓ One copy of Activity 5.1.1 for each student

PROCEDURE

Before viewing the video:

1. Display Visual 5.1.1 and ask the students to write down their answers to each statement in the visual.

2. Explain that the students will watch a video about various topics, including saving, financial investment and compound interest, after which they will discuss their answers to the statements in Visual 5.1.1.

3. Show the video.

After viewing the video:

4. Discuss the students' responses to the statements on Visual 5.1.1.

- **Statement 1:** Your best shot at accumulating $500,000 or more over a lifetime is buying a lottery ticket. *False*

Point out that the odds of winning the lottery are very low. In addition, more than 1/3 of those who win the lottery declare bankruptcy within a few years. However, even people of modest means can achieve financial security by amassing wealth – if they learn to save early and pay themselves first. According to surveys conducted by the authors of The Millionaire Next Door, 50 percent of people who have wealth of $1 million or more earn less than $131,000 in annual taxable income. Explain to the students that paying yourself first means putting money in a savings account or an investment fund, an Individual Retirement Account (IRA), a work-sponsored savings program or some other type of savings instrument before using your income for other things.

- **Statement 2:** One half of American households have accumulated less than $1,000 in financial assets. *True*

Explain that when it comes to saving,

people often behave in the same way they do with diet and exercise. Even though people know what they need to do to maintain a healthy weight, they don't necessarily do those things. Likewise, with saving, people know that they should pay themselves first, have a plan and control spending – but they don't always do those things. Whether eating or spending, many people find it difficult to delay gratification.

- **Statement 3:** Albert Einstein called compound interest one of the most amazing discoveries of all time. *True*

Explain that Einstein recognized the important benefits of compound interest to grow savings and accumulate wealth.

- **Statement 4:** If you are a saver, compound interest works for you. If you are in debt, compound interest can work against you. *True*

Savers benefit from compound interest because compound interest accelerates the accumulation of wealth. However, compound interest can hurt debtors because it accelerates the accumulation of debt.

- **Statement 5:** "Pay yourself first" and "Spend less than you earn" are two important rules for building wealth. *True*

Explain that "Pay yourself first" and "Spend less than you earn" are part of the mantra for those who are financially secure and for those who teach others how to gain financial security.

5. Tell the students the following scenario: Two cousins took two different approaches to saving. One cousin began saving at the age of 18. She saved $2,000 each year for eight years, placing the money in an Individual Retirement Account (IRA) each year. After that, she didn't make any deposits, but she left the balances in the

IRA until she was 62. The second cousin didn't open an IRA until she was 26. Then she began making $2,000 deposits each year until she was 62.

6. Ask the students which of the cousins they think would have the largest IRA balance at the age of 62, if they were both earning 10 percent interest. ***Answers will vary, but the students are likely to say that the cousin who saved $2,000 a year for 37 years would have more money than the other cousin.***

7. Distribute a copy of Activity 5.1.1 to each student. Explain to the students that this table demonstrates the interest that each cousin in the scenario would earn. Tell the students to refer to the activity as you discuss the following:

    A. How much did Cousin "A" deposit in her account? ***$16,000***

    B. How much did Cousin "B" deposit in her account? ***$74,000***

    C. At the age of 62, who has the most in her account? ***Cousin "A"***

    D. How much interest did Cousin "A" earn? ***$792,516.76***

    E. How much interest did Cousin "B" earn? ***$652,086.89***

    F. How much more interest did Cousin "A" earn than Cousin "B?" ***$140,429.87***

    G. What are the reasons for this difference? ***Cousin "A" began saving early and relied on compounding to accumulate wealth.***

8. Point out that because Cousin "A" began saving early, she reaped much greater benefits from compound interest.

9. Tell the students that there is a quick way to estimate how long it will take a savings balance to double – the Rule of 72. If people know the interest rate they are earning and divide the interest rate into 72, they will know approximately how long it will take to double their initial savings. If a person deposits $10,000 into an IRA, savings account or other fund and expects to earn 10% interest, the person

can expect to double the principal in about seven years.

10. Remind the class that they have discussed some keys that are important to building wealth. One is "Pay Yourself First." Another is "Begin Saving Early."

11. Ask the students what would have happened to Cousin "A's" wealth had she continued to save $2,000 every year until she was 62. ***She would have had even more accumulated in her retirement account.*** Explain that she would have had a balance of $1,727,371.61. Tell the students that this points to another key to building wealth, "saving regularly."

12. Explain that another key to building wealth is managing spending and credit. Remind the students that compound interest can hurt those who are in debt because it can lead to a compounding of interest owed. Read the following scenario:

    When Angela moved into her new apartment, she bought a new television. The television cost $1,500. Angela charged the television set on her credit card. She made only the minimum payment on her card each month. It took her 41 months to pay for the television. She ultimately paid $2,050 for the television. She paid $550 in interest!

13. Explain that credit cards are valuable tools, but interest charges on credit-card balances can cause consumers to pay much more for the goods and services they purchase. Another key to building wealth is controlling spending and the use of credit.

14. Display Visual 5.1.2 and review the important content of the lesson.

Visual 5.1.1 - Statements about Pursuing Wealth – True or False?

1. Your best shot at accumulating $500,000 or more over a lifetime is buying a lottery ticket.

2. One half of American households have accumulated less than $1,000 in financial assets.

3. Albert Einstein called compound interest one of the most amazing discoveries of all time.

4. If you are a saver, compound interest works for you. If you are in debt, compound interest can work against you.

5. "Pay yourself first" and "Spend less than you earn" are two important rules for building wealth.

Visual 5.1.2 - **Vocabulary**

Saving – income not spent on current consumption or taxes

Compound Interest – a situation in which interest is earned on previously earned interest in such a way that earnings accumulate more rapidly over time

Rule of 72 – offers a simple way to determine how long it will take for a principal value to double in size. Divide the annual interest rate you expect to earn into 72 to know approximately how many years it will take to double your principal.

Keys to Building Financial Wealth:
    Pay Yourself First
    Save Early
    Save Regularly
    Control Spending and Use of Credit

Activity 5.1.1 - The Miracle of Compounding

Use the data in the table to answer the questions that follow.

	Cousin A		Cousin B	
Age	$ Payment	End-of-Year Accumulation	$ Payment	End-of-Year Accumulation
18	$2,000	$2,200	$0	$0
19	2,000	4,620	0	0
20	2,000	7,082	0	0
21	2,000	9,790.20	0	0
22	2,000	12,769.22	0	0
23	2,000	16,046.14	0	0
24	2,000	19,650.76	0	0
25	2,000	23,777.42	0	0
26	0	26,155.16	2,000	2,200
27	0	28,770.68	2,000	4,620
28	0	31,647.75	2,000	7,282
29	0	34,812.52	2,000	10,210.20
30	0	38,293.77	2,000	13,431.22
31	0	42,123.15	2,000	16,974.34
32	0	46,335.46	2,000	20,871.77
33	0	50,969.01	2,000	25,158.95
34	0	56,065.26	2,000	29,874.85
35	0	61,671.69	2,000	35,062.33
36	0	67,838.96	2,000	40,768.57
37	0	74,622.86	2,000	47,045.42
38	0	82,085.15	2,000	53,949.97
39	0	90,293.66	2,000	61,544.96
40	0	99,323.03	2,000	69,899.46
41	0	109,255.33	2,000	79,089.40

Activity 5.1.1 - (continued) The Miracle of Compounding

	Cousin A		Cousin B	
Age	**$ Payment**	**End-of-Year Accumulation**	**$ Payment**	**End-of-Year Accumulation**
42	$0	$120,180.87	$2,000	$89,198.35
43	0	132,198.95	2,000	100,318.18
44	0	145,418.85	2,000	112,550.00
45	0	159,960.73	2,000	126,005.00
46	0	175,956.81	2,000	140,805.50
47	0	193,552.49	2,000	157,086.05
48	0	212,907.74	2,000	174,994.65
49	0	234,198.51	2,000	194,694.12
50	0	257,618.36	2,000	216,363.53
51	0	283,380.20	2,000	240,199.88
52	0	311,718.21	2,000	266,419.87
53	0	342,890.04	2,000	295,261.87
54	0	377,179.04	2,000	326,988.06
55	0	414,896.94	2,000	361,886.86
56	0	456,386.63	2,000	400,275.55
57	0	502,025.30	2,000	442,503.10
58	0	552,227.83	2,000	488,953.41
59	0	607,450.61	2,000	540,048.75
60	0	668,195.67	2,000	596,253.63
61	0	735,015.24	2,000	658,078.99
62	0	808,516.76	2,000	726,086.89
	Total Contribution		**Total Contribution**	
	Total Amount of Interest Earned		**Total Amount of Interest Earned**	

Activity 5.1.1 - (continued) The Miracle of Compounding

1. What was the total contribution made by Cousin A? _____

2. What was the total contribution made by Cousin B? _____

3. At age 62, which cousin has the most in her account? _____

4. What was the total amount of interest earned by Cousin A? _____

5. What was the total amount of interest earned by Cousin B? _____

6. How much more interest did Cousin A earn than Cousin B? _____

7. Why was Cousin A able to earn so much more interest? _____