Chapter- 1

**Introduction and Definitions**

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| **Objectives:** The aim of this chapter is to introduce some basic concepts and principles of financial investment through the calculation of simple and compound interest for identification of financial investment alternatives and investment decisions. For this, there is need of understanding some key words which will be used frequently during the course. |

**Introduction:**

Have you ever heard someone talking about stocks, bonds, or mutual funds and were a little confused? Does the mention of investments or financial topics seem overwhelming? Understanding some basic information about financial investments can be a great first step in learning how to invest, knowing your path to retirement, or maximizing the rate of return on your money.

The basic terminologies/ definitions/ meanings are explained below:

***Financial investment:*** A *financial investment* is an asset that you put money into with the hope that it will grow or appreciate into a larger sum of money. The idea is that you can later sell it at a higher price or earn money on it while you own it. You may be looking to grow something over the next year, such as saving up for a car, or over the next 30 years, such as saving for retirement.

How you invest these riyals can be very different. How much time you have on your side is often a key thing to consider when making a financial investment. The more time you have, the more risk you can usually take. The more risk you take, the more potential for making more money! It is important to note that there is also an economic definition of financial investments that deals with how businesses invest in products, equipment, factories, employees, and inventories. This lesson will focus on the finance definition of financial investment. Let's look at a few key terms worth knowing when it comes to financial investments.

***Appreciation***: It is the amount an investment grows in value. For example, you buy a share of stock for SR 10, and a year later it is worth SR 15; the stock has appreciated SR 5.

***Dividends:*** Dividends are usually cash payments that are paid out on financial investments based on the success and earnings of a company. For example, you invest in Microsoft stock, and it may pay you a dividend of SR 5 a share. If you owned 500 shares you would get paid 500 \* SR 5 which is SR 2,500!

***Interest:*** It is the fee a bank, institution, or government pays you for loaning them money through the purchase of a CD or bond. You can also earn small amounts of interest on a checking or savings account. For example, you may have SR 10,000 in government savings bonds that pays 5% interest annually; that adds up to SR 500 a year!

**Types of Financial Investments:**

***CDs*** stand for certificates of deposit and are certificates that earn interest over a set amount of time. They usually range from 30 days to 5 years and are issued most often by banks. These are extremely low risk.

Next, we'll cover bonds. When you purchase a **bond**, you are lending out your money to a company or government entity. They pay you interest on your money and eventually pay you back the amount you lent out. In general, these are slightly more risky than CDs but provide a better return or interest rate.

***Stocks*** are ownership interests in part of a company. When you buy stock in Wal-Mart, Google, or Starbucks, you are becoming part owner of the business. This allows you to potentially receive profits that the company allocates to its owners. Those profits are dividends. A stock can also appreciate in value, based on the success of the company. These are higher risk but have good long-term potential to make bigger profits.

***Mutual funds*** are often a pooled collection of stocks and bonds that are overseen by a professional manager. Mutual funds often usually focus on a specific type of investment, such as small companies, large companies, bonds, or real estate Mutual funds can appreciate in value and can pay dividends, as well. These can have high and low risk, depending on the type of fund you invest in.

***Gold*** is a precious metal that you can invest in. It is often a small part of a portfolio that appreciates over time. It is thought to be a form of financial protection, in lieu of cash. You can also invest in silver, copper, and other metals. Over the long-term, precious metals are fairly low risk; in the short-term, they can be very volatile in value.

***Financial Plan:*** A financial plan for a business can help managers determine if they can achieve the organization's goals. The financial plan is one of the first things created to help managers make decisions that are in the best interest of the organization.

Financial planning for a business is the task of determining how the organization will afford to achieve its strategic goals. Usually, an organization creates a financial plan immediately after the vision and objectives have been determined. The financial plan describes each of the activities, resources, equipment, and materials that are needed to achieve an organization's objectives as well as the timeframe.

**Benefits of Developing a Financial Plan:**

Developing a financial plan is critical to the success of any organization. It validates the business plan, by confirming that the objectives set are achievable from a financial point of view. It also helps the CEO to set financial targets for the organization and reward staff for meeting objectives within the budget. The following diagram shows how the financial plan fits into the overall business plan of an organization.

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| Business Plan |

**Financial Plan Example:**

A financial plan can be divided into several parts. Below is an outlined example of a financial plan that can be used by an existing organization:

***Interest****:* the reward paid by the borrower to the lender for use of the lender s money. The borrowed money is referred to as capital.

***Compound interest****:* where interest is paid on the original money (capital) and on interest arising from the original capital i.e. you get interest on interest.

***Simple interest:*** where interest is paid only on the original money (capital) but not on interest arising from that capital i.e. you do not get interest on interest.

***Time period****:* the time period selected in order to solve the problem at hand- it could be one year, a half-year, a month etc. It could even be a period of two years.

***Effective rate of interest* i over a time period (which must be stated)**: the rate of interest i which operates over that selected time period and such that SR 1 invested at the beginning of that time period accumulates to SR (1+i) at the end of the time period, where i is the effective rate of interest e.g. if the rate of interest is 6% effective per annum then SR 1 invested at the start of the year will accrue SR 0.06 interest at the end of the time period which, together with the original SR SR 1, gives SR 1.06. If the effective rate of interest is 3% effective per half-year then after one year an investment of SR 1 will have grown to SR 1.03\*1.03 = SR 1.0609. This means that an effective rate of 3% per half-year is equivalent to an effective rate of 6.09% per annum (year).

***Effective discount rate* d over a time period (which must be stated):**- the rate such that the present/discounted value of SR 1 payable at the END of the stated time period is SR (1-d) at the beginning of the stated time period. Thus if i is the effective rate of interest over the time period 1/ (1+i) = v = (1- d). If the effective discount rate per annum is 6.5% then the present value at the start of the year of SR 1 payable at the end of the year is SR (1-.065) = SR 0.935. The equivalent effective rate of interest per annum is such that (1+i) =1/.935 which gives i equal to 6.95187%

***Nominal rates of interest****:* rates of interest in name only which have to be converted into effective rates of interest over the appropriate time period.

**i(2)** :- a nominal rate of interest of **i(2)** per annum convertible half-yearly means an rate of i(2)/2 effective per half-year, which is equivalent to an effective rate of i per annum where (1+i) = (1+i(2)/2)2.

**i(4)** :- a nominal rate of interest of **i(4)** per annum convertible quarterly means an rate of i(4)/4 effective per quarter, which is equivalent to an effective rate of i per annum where (1+i) = (1+i(4)/4)4.

**i(12)**:- a nominal rate of interest of **i(12)** per annum convertible monthly means an rate of i(12)/12 effective per month, which is equivalent to an effective rate of i per annum where (1+i) = (1+i(12)/12)12.

***Nominal rates of discount*: -** rates of discount in name only which have to be converted into effective rates of discount over the appropriate time period,

**d(2)** :- a nominal rate of discount of **d(2)** per annum convertible half-yearly means an discount rate of d(2)/2 effective per half-year, which is equivalent to an effective rate discount of d per annum where v = 1/(1+i) = (1-d) = (1-d(2)/2)2.

**d(4)** :- a nominal rate of discount of **d(4)** per annum convertible quarterly means an discount rate of d(4)/4 effective per quarter, which is equivalent to an effective rate discount of d per annum where v = 1/(1+i) = (1-d) = (1-d(4)/4)4.

**d(12)** :- a nominal rate of discount of **d(12)** per annum convertible monthly means an discount rate of d(12)/12 effective per month, which is equivalent to an effective rate discount of d per annum where v = 1/(1+i) = (1-d) = (1-d(12)/12)12.

**v** :- the discount factor 1/(1+i)

***Time value of money****:* - takes account of the fact that SR 1 to-day is not the same as SR 1 tomorrow. If the effective rate of interest is 6% pa. effective, you are equally happy with SR 1 to-day or SR 1.06 in one year’s time or SR 1.061/2 in six- months time etc. This follows because SR 1 invested to-day at 6% pa. effective will be worth SR 1.06 in a year's time etc. Correspondingly you are equally happy with SR 1 in one year's time or SR 1/1.06 =SR 0.9434 now. You are equally happy with SR 1 in six- months time or SR 1/1.061/2 now.

***Equivalent payments:* -** means payments at different times but which, allowing for the **time value of money,** are identical i.e. the payments accumulate or discount to the exactly same thing at any pointof time e.g. i(2)/2 payable at the end of the first six months and again at the end of the second sixmonths is equivalent to i at the end of the year. For example the following payments are all equivalent at a rate of interest of i p.a. effective:-

i at the end of the year

i(2)/2 payable at the end of each half-year

i(4)/4 payable at the end of each quarter-year

i(12)/12 payable at the end of each month

d payable at the start of each year

d(2)/2 payable at the start of each half-year

d(4)/4 payable at the start of each quarter-year

d(12)/12 payable at the start of each month

***Hence:-***

* Two payments of ½ at the end of each half-year are equivalent to one payment of i/i(2) at the end of the year;
* Four payments of 1/4 at the end of each quarter-year are equivalent to one payment of i/i(4) at the end of the year;
* Twelve payments of 1/12 at the end of each month are equivalent to one payment of i/i(12) at the end of the year;
* A payment of 1 at the start of each year is equivalent to one payment of i/d at the end of the year
* Two payments of ½ at the start of each half-year are equivalent to one payment of i/d(2) at the end of the year;
* Four payments of 1/4 at the start of each quarter-year are equivalent to one payment of i/d(4) at the end of the year;
* Twelve payments of 1/12 at the start of each month are equivalent to one payment of i/d(12) at the end of the year.

***Accumulation factor****:* - if the effective rate of interest per time period (N.B. not necessarily a year) is *i* and there are *n* time periods plus a further fraction *f* of a time period, then the accumulation factor is (1+i)n+f .This is the amount that would be in your bank account if you invested SR 1 at an effective rate of i per time period and closed your account after (n+f) time periods.

***Discount factor****:* - The reciprocal of the **accumulation factor**. If the effective rate of interest per time period (N.B. not necessarily a year) is *i* and there are *n* time periods plus a further fraction f of one time period, then the discount factor is1/(1+i)n+f or equivalently v(n+f ). This is the amount that would need to be in your bank account now if you wished to have SR 1 to remove on closing your account after (n+f) time periods. It represents the **present value** or **discounted value** of SR 1 payable at the end of (n+f) time periods.

***Discounted cash flow****:* - cash payments whose present value (discounted value) is being calculated by applying the appropriate **discount factor** to each payment.

***Accumulated cash flow****:* - cash payments whose accumulated value is being calculated by applying the appropriate **accumulation factors** to each payment.

***Geometric series:* -** A series of the form **1+x+x2+x3…..+xn-1**. It is seen that because **(1-xn) = (1-x)\*(1+x+x2+x3 .. xn-1)** , the sum of the above geometric series is **(1-xn)/(1-x)**.

***Annuity:*** The definition of an annuity is a sum of money or an investment that is paid at regular intervals. Money that people receive regularly once they are retired is an example of an annuity.There are two main types of annuities:

***Fixed rate annuities -*** *The primary goal of the fixed rate annuity is to save money for the long term. You will make monthly payments of premiums into the annuity and upon a specified date of maturation or when you are ready you can withdraw your funds. With a fixed rate annuity, you are guaranteed a certain payout amount based on the rate that was available or agreed upon at the time you purchased your annuity. Many people that are looking for a way to invest their money that offers little to moderate risk prefer the fixed rate annuity.*

***Variable rate annuities -*** *Variable rate annuities differ from the fixed rate varieties because there is not a determined rate at which you will compensated. The rate of return fluctuates with the market. Variable rate annuities are sometimes marketed to people that are capable of handling a higher level of risk.*

Although the method of obtaining and maintaining these two types of annuities are the same, there are differences in how you will be paid in the long run. Also, the type of annuity that you choose will greatly affect the amount of money you can make in a certain period of time. Depending on your savings goals, one type of annuity may be preferable over another.

1. A specified [income](http://www.yourdictionary.com/income) [payable](http://www.yourdictionary.com/payable) at stated intervals for a fixed or a [contingent](http://www.yourdictionary.com/contingent) period, often for the [recipient](http://www.yourdictionary.com/recipient)’s life, in consideration of a stipulated [premium](http://www.yourdictionary.com/premium) paid either in prior [installment](http://www.yourdictionary.com/installment) [payments](http://www.yourdictionary.com/payments) or in a single payment. For example, a [retirement](http://www.yourdictionary.com/retirement) annuity paid to a public officer following his or her [retirement](http://www.yourdictionary.com/retirement).
2. The [right](http://www.yourdictionary.com/right) to receive such an income.
3. The [duty](http://www.yourdictionary.com/duty) to make such a payment or payments.

A financial instrument that pays out the investor’s earnings on a regular, periodic basis for a set amount of time. Annuities typically are used to provide funds for retirement. Annuities may be paid for the duration of a person’s life or may be set for a certain period of time. Annuities are tax-deferred, so the earnings from investments in these accounts grow without tax liability until the benefits are paid out.

***Annuity yearly/half-yearly/quarterly/monthly in arrear****:* - payments made at the **end** of each year/ half-year/ quarter/ month.

***Annuity yearly/half-yearly/quarterly/monthly in advance* (also called annuities-due)**:- payments made at the **start** of each year/half-year/quarter/month.

***Term of the annuity****:* - the total of the time periods for which the annuity runs.

***Deferred annuity****:* - an annuity where there is a deferred period i.e. a period of time when nothing is payable i.e. the period before the annuity comes into effect.

***Immediate annuity:* -** means an annuity where there is no deferred period.

***Perpetuity****:* - an annuity of infinite term, it just goes on being paid forever! The value is obtained by letting n go to ∞ so that, for example, a∞┐= $\frac{1}{i}$

***Equation of value:* -** An equation formed by taking the **present value** (**discounted value**) of the cash inputs and equating them algebraically to the present value of the cash outputs and solving for the effective rate of interest which gives equality between the two sides of the algebraic equation. Alternatively take the present value of all payments after allowing inputs to have a positive sign and outputs a negative sign (or vice versa) and the equating to zero. A corresponding equation can also be formed by equating the accumulated value of the inputs and outputs and this equation is equivalent to the first one and gives the same solution. Example: - you invest SR 1000 in a project and get back SR 560 at the end of the first year and SR 627.20 at the end of the second year. The equation of value is 1000=560v + 627.20v2 and the positive solution to this quadratic equation is i=.12 or 12%.

***Discounted payback period****:* - you wish to invest in a project and borrow money (a loan) from the bank in order to do so. From the monies you are paid as a result of the project being successful you gradually pay back to your banker both interest on the loan and the loan capital itself thus gradually paying off the loan. The time it takes you to pay off the loan is the *discounted payback period*and any further monies you are paid from the project thereafter are pure profit since you have no outstanding loan interest or loan capital to pay off after the **discounted payback period**. [Note: - the *payback period*is the *discounted payback period*calculated assuming you are able to borrow from the bank at 0% i.e. zero percent interest, but in reality is an almost meaningless number because you will almost always be charged interest on loans].

***Repayment schedule for a loan:*** - a table showing in full detail how a loan is repaid. The schedule will show:

* the loan outstanding just before a repayment is made;
* the amount of the repayment that is used to pay interest on the outstanding loan;
* the balance of the repayment which pays off part of the outstanding loan itself; and
* the amount of the outstanding loan after the repayment has been made.

For example if a loan of SR *an┐* is made, repayable by instalments of SR 1p.a. yearly in arrear, then the interest content of the first repayment (of SR 1) is *ian┐* or (1-vn) and the amount going to repay the loan (the capital content) is vn leaving the outstanding loan as *an-1┐* **. T**he next year the interest content of the second repayment of SR 1 is *ian-1┐*or (1-vn-1) and the amount going to repay the loan (the capital content) is vn-1 leaving the outstanding loan as *an-2┐* etc.

***Negative rates of interest****:* - normally when you invest say SR 1 you expect it to grow say to SR 1.06 at the end of a year thus giving you an effective rate of interest of 6% pa. effective. However if your investment has not been successful and is now worth only SR 0.95 pence then your effective rate of interest is negative and is -5% pa. effective.

***Linked-internal rate of return:* -** this return is produced by calculating the internal rates of return for successive periods and compounding them to give an average annual rate of return over the total period. If the total time period is n years and the rates of investment return effective over the first, second, third …….time periods (not necessarily exact years) are i1, i2, i3, ……. im then (1+i)n = (1+i1)\*(1+i2)\*(1+i3) (1+im) where *i* is the internal linked rate of return per annum.

***Money weighted rate of return (MWRR)****:*- the effective rate of interest which is the solution to the *equation of value*of the investment or project. The *MWRR*depends both on the amounts of money invested, when they are invested and the rate of investment return achieved.

***Internal rate of return****:* - the *money weighted rate of return* achieved by investing in a project.

***Time weighted rate of return (TWRR):***- a rate of interest which eliminates the effect of the amounts of money invested and which only depends on the underlying investment return achieved. The total time period considered is divided into time periods determined by the time periods between the dates when money is invested and which are not necessarily whole years. The effective rate of interest (investment return) is calculated in each of these time periods and the equivalent average effective interest rate per annum calculated. If the total time period is n years and the rates of investment return effective over the time periods (not necessarily exact years) are i1, i2, i3, im then (1+TWRR)n = (1+i1)\*(1+i2)\*(1+i3) (1+im).

***APR (Annual Percentage Rate of Charge):*-** is the effective rate of interest per annum on a financial transaction. It is calculated as the least positive root of the equation of value and is rounded to the higher 0.1%.

**A graduate glossary of investment terminologies:**

**Analyst:** person who studies an industry sector and makes BUY, HOLD and SELL recommendations. Also, a different term referring to entry-level career position in many investment banks.

**Asset:** an item with economic value that is owned or controlled by an individual, business or government.

**Bear:** investor who sells believing prices will fall.

**Bid price:** the price at which the market maker will buy.

**Bonds:** a government, or company can raise capital by issuing a bond. Bondholders receive interest (a ‘coupon’) and the capital is repaid at maturity. The difference between bonds and loans is that bonds can be traded between investors (who are lending to the issuer).

**Broker:** intermediary between a buyer and a seller, receiving commission on the trade.

**Brokerage:** the payment from the client to the broker.

**Bull:** investor who buys believing prices will rise.

**Capital markets:** the market for long-term funding, eg bonds and equity.

**Casino banking/finance:**a colloquial term used to describe an investment approach in which investors at commercial banks employ risky financial strategies to earn large rewards.

**Chinese walls:** information barriers within investment banks to manage potential compliance and conflict of interest issues.

**Clearing:**the mechanism for making transactions happen: matching the buyer and seller, making sure the buyer has the cash and the seller has the securities.

**Commodities:** goods such as oil, petrol, metal or grain.

**Credit crunch:** the term that has come into common usage to refer to a severe shortage of money or credit. The start of the global credit crunch can be dated to August 2007 when default rates on sub-prime loans in the US housing market rose to record levels.

**Credit default swap:** insurance-like contract that transfers credit risk. The buyer of the swap makes payments to the seller in exchange for protection in the event of a default. Banks and other institutions have used credit default swaps to cover the risk of mortgage holders defaulting.

**Debt capital markets (DCM):** investment bank division responsible for issuance and pricing of debt securities (eg bonds).

**Derivatives:** the group term for financial contracts between buyers and sellers of commodities or securities. Includes futures, options or swaps. Derivatives allow profit from the rise (or fall) of a commodity or security, without actually buying the underlying good.

**Equity:** otherwise referred to as shares. Shareholders own a percentage of the company, and have a share in profits, as well as control via voting rights.

**Equity capital markets (ECM):** investment bank division responsible for structuring and pricing the issuance of equities, such as at IPO (Initial Public Offering – flotation of the company on the stock exchange).

**FTSE 100/250 index:**the index of the 100/250 largest companies on the UK stock market.

**Futures:** contract between two parties to trade a commodity or security at a fixed price and a fixed future date.

**Gilts:** bonds issued on behalf of the UK government to fund spending. Known as ‘gilt-edged securities’ because the bond contracts used to have gold round the edge.

**Hard market:** a scarcity of a product or service for purchase, as opposed to a soft market, in which the product or service is readily available.

**Hedge:** strategy offsetting the possibility of loss by holding two contrary positions in different financial instruments.

**Hedge fund:** a private investment fund that uses a range of strategies to maximise returns, including hedging.

**Insider dealing:** criminal offence made by trading on knowledge of non-public information.

**Interest rates:** lenders demand interest on loans. The rate is dependent on future inflation expectations, as well as the ‘real interest rate’ – the rental cost of money. Borrowers might pay extra on top in order to compensate lenders for the credit risk.

**Investment bank:** a bank providing financial services for governments, companies or very wealthy individuals, as compared to commercial banks, which provide loans and savings accounts to the general public.

**Investment management:** the buying and selling of securities (see securities) and assets (see asset) within a portfolio to achieve investment objectives.

**Investment trust:**similar to unit trusts – collective investment but with a different structure. Investment trusts’ value fluctuates with demand for shares on the stockmarket. The price of an investment trust does not necessarily equal the price of its underlying assets.

**Leveraged buy out (LBO):** takeover of a company funded by high-risk bonds or loans.

**Leveraging:** using debt to supplement investment. An institution that has borrowed heavily in addition to its funds or equity to finance growth is said to be highly leveraged.

**Libor:** London Inter Bank Offered Rate. The rate at which banks offer money to each other.

**Liquidity:** ability of an asset to be traded quickly without changing the market price.

**Market maker:** bank that is obliged to offer to trade securities in which it is registered throughout the trading day.

**Money market:**the market for short-term funding such as certificates of deposit and treasury bills. Money market securities typically have a maturity of less than one year.

**Nice decade:**the period of non-inflationary constant expansion that followed the Government’s move to give the Bank of England the freedom to set interest rates independently, soon after the Labour landslide in 1997. In May 2008 Mervyn King, the governor of the Bank of England at the time, warned, ‘For the time being at least, the Nice decade is behind us.’

**Options:** similar to futures, but provide the buyer with the right rather than the obligation to complete the contract.

**Portfolio:**collection of securities held by an investor. Also known as a ‘fund’.

**Principal:** an investor who trades for his/her own account and risk.

**Private equity:** high risk and high return investment, holding large stakes in illiquid companies.

**Proprietory trading:** trading carried out using the firm’s capital on its own behalf.

**Pure risk:** a type of risk where the only consideration is the possibility of loss. Speculative risk in contrast offers the possibility of loss or gain.

**Risk management:**management of the pure risks to which a company might be subject. It involves analysing all possible risks and determining how to handle this exposure through trading out, or transferring the risk with derivatives.

**Secondary market:**the trading of securities. The ‘primary market’ means the launching (issuing) of bonds and equities for the first time.

**Securities:** generic term for bonds, gilts and equities.

**Securitisation:** turning something into a security, for example, combining the debt from a number of mortgages to create a financial product that can be traded. Banks owning securities that include mortgage debt receive income when homeowners make mortgage payments.

**Settlement:** once a deal has been made and clearing taken place, stock and cash transfer between seller and buyer.

**Short selling:** when investors borrow an asset, such as shares, from another investor and then sell it in the relevant market hoping the price will fall. The aim is to buy back the asset at a lower price and return it to its owner, pocketing the difference.

**Spread:** difference between bid and offer price – one way in which banks make profits.

**Stag:** speculator who buys shares at issue to sell them as soon as they trade on the market. Also called flippers.

**Stagflation:** a combination of stagnation and inflation, when economic growth slows as prices continue to rise.

**Sub-prime loans:** high-risk loans to clients with poor or no credit histories.

**Swap rates:** the borrowing rates between financial institutions.

**Toxic debt:** shorthand for types of assets that have caused severe problems for the financial institutions that held them since the onset of the credit crunch. US sub-prime mortgage debt was the original toxic debt.

**Unit trust:** the trust issues units which represent holdings of the underlying shares. The fund is divided into units which investors trade with the fund management group.

**Universal bank:** bank offering financial services typical of both investment and commercial banking to consumers and small businesses as well as corporate clients.

**Yield:**the total return on a security expressed as a proportion of its price.

**A graduate glossary of financial terminologies:**

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| **TERM** | **DEFINITION** |
| **A** |
| **Amortization** | The process by which loan payments are applied to the principal, or amount borrowed, as well as the interest on a loan according to a set schedule. |
| **Annual Fee** | The amount that credit card companies charge for the use of a credit card. |
| **Annual Percentage Rate (APR)** | The finance charge or total amount it costs per year to use credit, calculated as a percentage of the amount borrowed (percentage rate), including interest, transaction fees, and service charges. |
| **Annual Percentage Yield (APY)** | The actual interest rate an account pays per year with compounding included; calculated the same way by all banks/credit unions. |
| **Appreciation** | A rise in value or price. |
| **Assets** | What a person owns, such as cash, stocks, bonds, real estate, and personal possessions. |
| **Automated Teller Machine (ATM)** | An electronic machine that bank customers and credit union members can use to withdraw cash and make financial transactions. |
| **B** |
| **Back-end load** | A sales charge paid when investments are sold. |
| **Bait and switch** | An illegal sales technique in which sells advertise a product with the intention of persuading customers to buy a more expensive product. |
| **Bank** | A for-profit company that is owned by its stockholders and provides saving and checking accounts and other financial services to its customers. |
| **Bankruptcy** | Legal process for selling most of the debtor's property to help satisfy debts that can't be repaid, in exchange for (a) relieving debtors of the responsibility of paying their financial obligations or (b) protecting them while a plan is created and they try to repay debts. |
| **Bond** | A formal agreement where you lend money to a borrower who can then use that money for a set period of time. In exchange, you as the lender will get paid a specific amount of interest. |
| **Budget** | A plan for managing money, dividing up expected income and expenses among spending and saving options based on personal goals during a given time period. |
| **C** |
| **Capacity** | Ability to repay a loan from present income; one of three factors in credit scoring. |
| **Capital** | The value of personal items that one owns, including savings, investments, and property, one of three factors used in credit scoring. |
| **Capital Gain** | The difference between the purchase price and the selling price when an investor buys a sock and later sells it at a higher price. |
| **Capital Loss** | The difference when an investor ends up selling a stock at a lower price than the purchase price. |
| **Career** | Pattern of activities and positions involved in an individual's lifetime to work to which the person has made a long-term commitment. |
| **Cash Flow** | Movement of the money you receive and the money you spend. |
|   | A measure of the money a person received and spends. |
| **Character** | Refers to trustworthiness; one of three factors in credit scoring (e.g., paying bills on time shows financial responsibility). Creditworthiness indicating a responsible attitude towards living up to agreements. |
| **Check** | Written order directing a bank or credit union to pay a person or business a specific sum of money. |
| **Checking Account** | A bank or credit union account that allows withdrawals by writing a check. |
| **Compounding, or compound interest, Rule of 72** | Earning interest on interest. Rule of 72-how long it takes money to double in value. Divide 72 by the interest to determine the number of years it will take money to double. |
| **Consumer** | Buyer or users of goods and services for personal use. |
| **Consumer advocates** | Individuals or groups that actively promote consumer interest in areas such as health and safety, education, redress, truthful advertising, fairness in the marketplace, and environmental protection. |
| **Consumer economics** | The study of the role of the consumer in an economic system. |
| **Consumer movement** | Efforts to protect and inform the consumer by requiring such practices as honest advertising, product warranties, and improved safety standards. |
| **Contextual factors** | Personal, historical, and socio-cultural aspects of a financial situation that influence an individual or family's attitudes and behavior, including goal setting, decision making, and judgment about what to believe or how to act. |
|   | • Historical aspects of context: Each individual and family brings a unique personal history to the financial situation, and each interacts with the workplace, school, and neighborhood environments with personal norms, expectations, and social structures that have evolved over time. |
|   | • Personal aspects of context: The perceptions, values, and goals of all parties involved in the financial situation. |
|   | • Socio-cultural aspects of context: The larger social institutions (such as the media, business and industry, economy) and cultural values, folkways, mores, and language that influence financial decision making. |
| **Contract** | Legally enforceable written or oral agreement between two or more parties to do or not to do something. |
| **Cost/benefit analysis, risk/reward relationship** | Tool used to choose among alternatives involves weighing the cost of a product or service against the benefit it will provide. |
| **Coverage Limit** | The maximum amount an insurance company will pay if you file a claim. |
| **Credit** | Amount of money a creditor is willing to loan another to purchase goods and services, based on trust and the expectation that the money will be repaid as promised with interest. |
| **Credit Card** | Card that enables holder to charge expenses for purchases or to get money, often with interest; synonymous with buy now, pay later. |
| **Credit Limit** | The maximum amount of credit a lender will extend to a customer. |
| **Credit rating/score** | A measure of creditworthiness based on an analysis of the consumer's financial history, often computed as a numerical score, using the FICO or other scoring systems to analyze the consumer's credit. A creditor's evaluation of a person's willingness and ability to pay debts as judged by character, capacity, and capital; a mathematical model used by lenders to predict the likelihood that bills will be paid as promised. |
| **Credit Union** | A financial institution owned by its members that provides savings and checking accounts and other services to its membership at low fees. |
| **Creditworthiness** | A measure of one's ability and willingness to repay a loan. |
| **D** |
| **Debit Card** | A card used to pay for goods and services directly from a checking account by transferring funds electronically from one's checking account to the store's account to pay for a purchase; also called check cards. |
| **Debt** | The entire amount of money owed to lenders. |
| **Decision making** | The process of considering alternatives and analyzing information to make a choice. |
| **Deductible** | The amount of a loss you must pay out of your own pocket before the insurance company will step in and pay the rest. |
| **Delayed Gratification** | The willingness to give up something you want now in order to get something better in the future. |
| **Demand** | The quantities of a particular good or service that consumers are willing and able to buy at different possible prices at a particular time. |
| **Depreciation** | Decline in a product's value that starts the moment a product is purchased (car). |
| **Diversification** | Distributing funds among different types of investments to minimize overall risk. |
| **Dividend** | The portion of the profits paid to the shareholders of a company. |
| **Dollar Cost Averaging** | The practice of investing a fixed amount into the same investment at regular intervals, regardless of what the stock market is doing. |
| **E** |
| **Earned Interest** | The payment you receive for allowing a financial institution or corporation to use your money. |
| **Economy-global or world** | Worldwide system that results from choices of consumers, workers, business owners, manufacturers, and government officials in multiple societies and with increasing trade and cultural exchange. |
| **Employee benefits** | Additional benefits, beyond a paycheck, offered by employers (e.g., health insurance or pension plan). |
| **Endorse** | To sign the back of a check to make it payable to the specified payee. |
| **Entrepreneur** | A person who owns and operates her or his own business. A person who creates a business from scratch, based on a need or personal expertise, and puts creativity and ingenuity into action to provide a service or product. A person who organizes, manages, and takes the risks involved in creating a new product/service or developing a better way to operate a business. |
| **Entrepreneurship** | A process that involves (a) seeing an opportunity to provide product/service, (b) taking initiative to find out about competitors and what customers want from the product/service, and(c) developing plans to market the business, analyze potential profit or losses, and produce the product/service. Imagination, innovative thinking, and management skills needed to start and operate a business. |
| **Expense** | An amount of money spent to buy something or do something. |
| **F** |
| **Financial plan, financial planning** | Personal financial planning is the process of (a) setting goals, (b) developing a plan to achieve them, and (c) putting the plan into action. Ongoing thinking process to develop an orderly program or blueprint for handling all aspects of one's money, including spending, credit, saving and investing. |
| **Fixed Expenses** | Expenses that cost the same amount every time. |
| **Fraud** | Intentional misrepresentation of information with the intent to deceive or mislead. |
| **Front-end load** | A sales charge paid when investments are purchased and sometimes when dividends are reinvested. |
| **G** |
| **Goal** | Statement about what a person wants to be, do, or have, accomplished by taking certain steps; provides direction to a plan of action. |
| **Goal setting** | The process used to determine what an individual wants to be, do or have, i.e., what a person wants to accomplish. |
| **Grace Period** | On a credit card, the length of time you have before you start accumulating interest on an unpaid balance. |
| **Green products** | Products considered environmentally safe according to objective, authoritative testing. |
| **Gross Income** | The total amount of income from wages before any payroll deductions. |
| **H** |
| **High balling** | An excessively high offer for a trade-in vehicle. |
| **I** |
| **Identity Theft** | When someone uses your name, Social Security number, credit cad number, and other personal information without your permission. |
| **Implied warranty** | Unwritten guarantee that a product is of sufficient quality to fulfill the purpose for which it was designed. |
| **Impulse purchase** | A purchase made on a whim, without using a decision-making process. |
| **Income** | Any money an individual receives. |
| **Information processing** | Analyzing and organizing information for decision making. |
| **Insurance** | Risk management tool that limits financial loss due to illness, injury, or damage in exchange for its promise of protection and help. |
| **Insurance premium** | The payment a person makes to an insurance company in exchange for its promise of protection and help. |
| **Interest** | Payment for use of someone else's money; usually expressed as an annual rate in terms of a percent of the principal (the amount owed). |
| **Investment** | Setting aside money for future income, benefit, or profit to meet long-term goal; using savings to earn a financial return. |
| **J** |
| **Job** | An occupation that provides you with the basics – cash and something to do to earn it. |
| **L** |
| **Late Fee** | A penalty on all types of credit for making a payment after its due date. |
| **Liabilities** | Amount a person owes, such as unpaid bills, credit card charges, personal loans, and taxes. |
| **Lifestyle** | The way people choose to live their lives, based on values they have chosen. |
| **Liquidity** | The ease with which an asset can be converted to cash without serious loss. |
| **Loan sharks** | Unlicensed lenders who charge illegally high interest rates. |
| **Loan Term** | The length of time you have to pay off a loan. |
| **Loss leader** | Sales tactic where an item is priced at below cost to attract buyers who will then purchase other merchandise. |
| **Low-balling – repairs, new-car deals** | Advertising a service, then adding other services or repairs that are not necessary or not expected. An unrealistically low price offered by a dealer for a buyer's old car as part of a new-car deal. |
| **M** |
| **Money** | Anything that is generally accepted as payment for goods and services; a medium of exchange; legal tender. |
| **Mortgage** | Loan to buy real estate, such as land or a home. |
| **Mutual Fund** | An investment security that is actually a diversified portfolio of equities, bonds, or other securities. Investors purchase shares and can sell them at any time. |
| **N** |
| **Needs** | Essentials or basics necessary for maintaining physical life, including food, clothing, water, and shelter, sometimes called material well-being. |
| **Net Income** | Also called take-home pay; it's the amount of income left after payroll deductions. |
| **Net worth** | The difference between a person's assets and liabilities. |
| **O** |
| **Opportunity Cost** | Whenever choices are made, the cost of something expressed in terms of what had to be given up to obtain it. The resources used to satisfy one goal that cannot be used for another, i.e., weighing of one alternative against another rather than merely considering the cash price or value of a specific good or service. |
| **Origination Fee** | A charge for setting up a loan that is typically associated with home loans. |
| **P** |
| **Pay Yourself First (PYE)** | Disciplined saving or setting aside money as a regular part of the budget for later spending or investing. |
| **Payroll deductions** | Amounts subtracted from gross income that are withheld by an employer for items such as taxes and employee benefits. |
| **Personal Identification Number (PIN)** | The unique pass code number you use to get access to your savings and/or checking account. |
| **Philanthropy** | A personal or corporate interest in helping others, especially through gifts to charities or endowments to institutions. |
| **Phishing** | An identity theft tool that appears in the form of an E-mail or pop-up message; usually looks like it's from a legitimate financial institution and prompts you to provide your personal information in order to fix a problem with your account. |
| **Points-mortgage** | A one-time service charge by mortgage lenders at closing to increase the return on the loan; each point is one percent to the amount of the principal. |
| **Predatory lending** | Lending practices which promise loans that are too good to be true and pressure borrowers to take loans on the spot. Lending practices include a variety of financial abuses such as excessive fees, penalties for early pay-off of the loan, balloon payments, loan flipping, high interest rates, monthly payments the borrower can't afford, the unauthorized refinancing of loans. Examples of the practice include predatory mortgages, payday loans, overdraft loans, excessive credit card debt, and instant tax refund loans. |
| **Principal** | The amount of money someone is willing to loan you. Also, the amount that is still owed on a loan. |
| **Profit** | The difference between the costs required to create a product or supply a service that can be bought with it. |
| **Puffery** | Relatively innocent exaggerations used to sell products. |
| **Purchasing power** | The value of money measured in the amount of goods and services that can be bought with it. |
| **R** |
| **Rate of return** | How fast money in savings account or investment grows. |
| **Reasoning** | The process of making and supporting a judgment; giving reasons to defend the conclusion. |
| **Resources** | Human resources are those resources people have within themselves, such as working knowledge, skill, mental effort, motivation, energy. Non-human or external resources include money, time, and equipment. |
| **Reverse mortgage** | An arrangement in which a homeowner borrows against the equity in his/her home and receives regular monthly tax-free payments from the lender. Also called reverse-annuity mortgage or home equity conversion mortgage. |
| **Risk management** | Deliberately and systematically using various strategies for controlling against potential personal or financial loss from pure risks. |
| **Risk tolerance** | The amount of uncertainty or possibility of loss the individual can bear. |
| **Risk-investment, personal, insurance** | The probability of making a profit or losing money on one's investment; the chance an investment will decrease in value; possible losses involving income or standard of living. The possibility of a loss from perils to people or property covered by insurance. |
| **S** |
| **Savings** | Money set aside for short-term goals. |
| **Savings Account** | An account you have at a financial institution that helps you accumulate and save money and earn interest at the same time. |
| **Scam, rip-off** | Swindle or fraud, especially to cheat or swindle by a con artist in a confidence game, e.g., home repairs, cell phones, gasoline and oil stocks, Internet, telemarketing, credit card, securities, pyramid schemes. See fraud. |
| **Scarcity** | An economic condition created by an excess of human wants over the resources necessary to satisfy them; an inability to satisfy all of everyone's wants. |
| **Share Account** | The credit union term for a savings account. |
| **Share Draft Account** | The credit union term for a checking account. |
| **Shared risk-insurance principle** | Using premiums from many policy-holders to reimburse the losses of a few, so that no one suffers a financially devastating loss. |
| **Social security** | The federal government's basic program for providing income when earnings are reduced or stopped because of retirement, or disability. Income is also provided to families when the working parent(s) dies and underage children are a part of the family. |
| **Spy ware** | A bad side effect of free downloads that may be used to send you pop-up ads, redirect your computer to unwanted Web sites, monitor your Internet surfing, or record your keystrokes in an effort to steal your identity. |
| **Stock** | An investment that makes the investor a part owner of a company. |
| **Stock Market** | The place where stocks are bought and sold. |
| **Supply** | The quantities of an item that producers are willing and able to make available for sale at various prices over a given time period. |
| **T** |
| **Taxes** | A compulsory payment by individual/organizations to the government; fees placed on income, property, or goods to support government programs. |
| **Time value of money** | The relationship between time, money, and rate of return (interest), and their effect on earnings growth. The more time, money, and rate of interest, the more money yielded at the end of a period of time. |
| **V** |
| **Value judgment** | The process of reasoning to conclusion using facts and values for purpose of determining worth, quality, importance, fairness, and credibility. |
| **Value system** | A set of criteria, standards, or principles that guide an individual or group's behavior and provides a sense of direction to life. |
| **Values-personal and cultural** | Criteria, standards, or principles that individuals use when making a selection among alternatives in decision making. Prevailing beliefs and value systems of a given society passed on through social conditioning/enculturation. |
| **Variable Expenses** | Expenses that are not fixed. |
| **Volunteer service** | Working to help others or one's community without being paid. |
| **W** |
| **Wants** | Items that a person would like to have but are not essential for life. Items, activities, or services that may increase the quality of life, but one can live without them. |
| **Warranty** | A company's promise that its product or service will meet specific standards over a given period of time, or the company will repair or replace it, redo the work, or give a refund. |
| **Wealth-building** | Increasing the total value of what one owns; one's tangible assets using strategies to increase savings and personal asset accumulation, thereby promoting individual/family economic well-being and financial security. |
| **Withholding** | Employer deductions from employees' earnings to pay employees' taxes. |
| **Y** |
| **Yield** | The profit from an investment. |

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