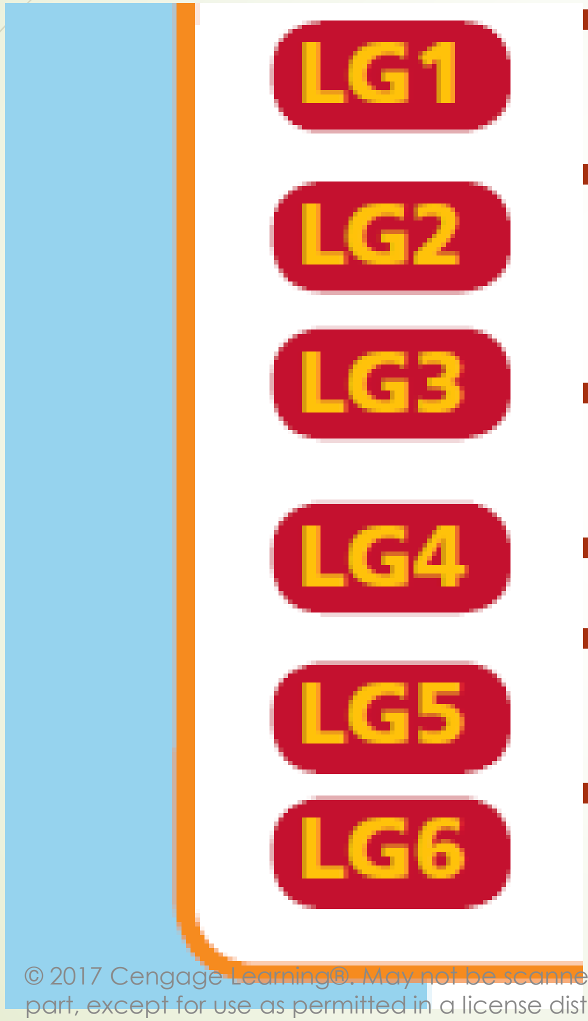
Managing Your Cash and Savings

Chapter 4

How Will This Affect Me?

- Finding the best mix of alternative cash management accounts and assets requires careful cost/benefit analysis based on your personal objectives and constraints. This chapter presents a variety of different alternatives and focuses on key characteristics that include minimum balances, interest rate returns and costs, liquidity, and safety. Cash management alternatives examined include checking and savings accounts, money market deposit accounts, certificates of deposit (CDs), money market mutual funds, U.S. Treasury bills, U.S. Series EE bonds, and U.S. Series I bonds. After reading this chapter you should be able to design an effective cash management strategy, which is an integral part of your comprehensive financial plan.

Learning Goals



- Understand the role of cash management in the personal financial planning process.
- Describe today's financial services marketplace, both depository and nondepository financial institutions.
- Select the checking, savings, electronic banking, and their bank services that meet your needs.
- Open and use a checking account.
- Calculate the interest earned on your money using compound interest and future value techniques.
- Develop a cash management strategy that incorporates a variety of savings plans.

Financial Facts or Fantasies?

- An asset is considered liquid only if it is held in the form of cash.
- Today's financial marketplace offers consumers a full range of financial products and services, many times all under one roof.
- Unlike money market mutual funds, money market deposit accounts are federally insured.
- At most banks and other depository institutions, you will be hit with a hefty service charge if your checking account balance falls even just $1 below the stipulated minimum amount for just one day out of the month.
- U.S. Series EE and I savings bonds are not a very good way to save. .

Cash Management

- The routine, day-to-day administration of cash and near-cash resources, also known as *liquid assets*, by an individual or family.
- Efficient cash management ensures adequate funds for both household use and an effective savings program

Representative Rates of Return Exhibit 4.1

Type of Account	Mid-2015 Rate
Cash	0%
Checking Account	0% - 0.37%, that is less than 1%
Savings account/Money Market	0.05% - 1.25%
Certificate of Deposit (CD)	0.33% - 1.25% (one year)
US Treasury Bill (T-bill)	0.06% (3-month)
US Savings bond (EE)	0.30%

Historically Low Rates

- Historically 5-year Treasury Notes yield 6%
- May, 2015 rate is 1.68%
- With low interest rate, stock prices tend to rise
- Low rates help fund large, long-term assets such as cars or houses
- Low rates indicate sluggish economic growth
- Increase risk of deflation
- Help federal government pay its debts
- Impact retirement income funded with investment income

Impact of Low Rates

- Discourage savings
- Encourages investors to take more risk trying to get higher return
- The inflation adjusted rate may be negative
- Penalizes people who have been saving all their life

Types of Financial institutions

- Two broad groups based on whether or not they accept deposits:
- Depository such as commercial banks, savings and loan associations, saving banks and credit unions.
- Nondepository such as stock brokerage firms and mutual funds

Depository Financial Institutions

- Commercial bank
- Offers checking and savings accounts and a full range of financial products and services; the only institution that can offer *non-interest-paying checking accounts (demand deposits).* The most popular of the depository financial institutions. Most are traditional *brick-and-mortar banks,* but **Internet banks**—online commercial banks—are becoming more popular because of their convenience, lower service fees, and higher interest paid on account balances.

Depository Financial Institutions

- Savings and loan association (S&L)

Channels the savings of depositors primarily into mortgage loans for purchasing and improving homes. Also offers many of the same checking, saving, and lending products as commercial banks. Often pays slightly higher interest on savings than do commercial banks.

- Savings bank

Similar to S&Ls, but located primarily in the New England states. Most are *mutual* associations—their depositors are their owners and thus receive a portion of the profits in the form of interest on their savings.

Depository Financial Institutions

- Credit union

A nonprofit, member-owned financial cooperative that provides a full range of financial products and services to its *members,* who must belong to a common occupation, religious or fraternal order, or residential area. Generally small institutions when compared with commercial banks and S&Ls. Offer interest-paying checking accounts—called **share draft accounts**—and a variety of saving and lending programs. Because they are run to benefit their members, they pay higher interest on savings and charge lower rates on loans than do other depository financial institutions

Nondepository Financial Institutions

- *Stock brokerage firms* offer several cash management options, including money market mutual funds that invest in short-term securities and earn a higher rate of interest than bank accounts, special “wrap” accounts, and credit cards.
- *Mutual funds*, discussed in detail in Chapter 13, provide yet another alternative to bank savings accounts. Like stockbrokers, mutual fund companies offer money market mutual funds.
- Other nondepository financial institutions include life insurance and finance companies.

Insurance on deposits

- Deposit insurance -- A type of insurance that protects funds on deposit against failure of the institution; can be insured by the FDIC and the NCUA.
- Amount: $250,000 per depositor at bank. If person has two accounts (checking account with $200,000 and savings account with $100,000) the insurance is limited to $250,000 for the depositor, thus the total of $300,000 is not fully insured. If accounts are at different banks, the full $300,000 would be insured.
- A Joint account has two depositors, thus $500,000 insurance. Same couple could have an individual account in their own name and that would be two additional depositors.

Checking Accounts

- Services available and fees depends upon type of account (See Exhibit 4.4)
- Funds added by making deposits
- Funds withdrawn by
  - Writing a check
  - Using a debit card
  - Making a cash withdrawal

Savings Accounts

- Remains on deposit for a longer time than a demand deposit, hence referred to as time deposits.
- Interest paid is higher than demand deposit, though not much

Interest Paying Checking Accounts

- NOW Accounts
  - Negotiable order of withdrawal accounts pays interest and may require a minimum balance in account
- Money Market Deposit Accounts
  - Account federally insured, has high minimum deposit requirement, pays highest rate of interest a bank pays on accounts with checking privileges. However, the monthly bank charges may be higher than the interest.
- Money Market Mutual Funds
  - A mutual fund that pools the funds of many small investors and purchases high-return, short-term marketable securities. Offers higher interest and checking privileges.

Asset management Accounts

- The AMA is a comprehensive deposit account that combines checking, investing, and borrowing activities and is offered primarily by brokerage houses and mutual funds.

Electronic Funds Transfer Systems

- Use the latest telecommunications and computer technology to electronically transfer funds into and out of your account.
- **debit cards** Specially coded plastic cards used to transfer funds from a customer's bank account to the recipient's account to pay for goods or services.
- **automated teller machine (ATM)** A remote computer terminal that customers of depository institutions can use to make basic transactions 24 hours a day, 7 days a week.

Preauthorized Deposits and Payments

- Allow you to receive automatic deposits or make payments that occur regularly.
  - Example Deposits: Regular deposit pay checks, Pensions, Social Security
  - Example Payments: Make monthly mortgage payment, car payments, regular contributions to charities, pay insurance bills, transfer funds to savings or investment accounts
- ONLINE banking does similar but it is not automatic

Maintaining a Checking Account

- Importance of regular bank reconciliation
- Bank errors must be reported timely, generally within 60 days
- If fail to report, bank does not have to take corrective actions
- See Exhibit 4.6

Starting a Saving Program

- Use automatic transfer option to move fund to a savings account
- Build an emergency fund of liquid assets equal to 6 to 9 months of after-tax income
- Continue transferring funds to build an investment fund. Purpose of investment fund is to provide flexibility to your investments and to provide the ability to readjust the mix of your portfolio. Invest!
- See Exhibit 4.7 for strategies to build up your savings

Interest

- Discount securities: security is sold at a discounted price, i.e. less than redemption value. When redeemed, the difference is interest. Example is Treasury Bills or US Saving Bonds.
- Direct Interest: Interest is added to account or paid directly.
- **compound interest:** When interest earned in each subsequent period is determined by applying the *nominal (stated) rate of interest* to the sum of the initial deposit and the interest earned in each prior period.
- **simple interest:** Interest that is paid only on the initial amount of the deposit.

Effective rate of interest

- the annual rate of return that's *actually earned* (or *charged*) during the period the funds are held (or borrowed).
- Formula:
- **Amount of interest earned / Amount of money invested or deposited**
- Example: Purchase a $1,000, 6%, bond for $950. Interest received is $60 on an investment of $950. Effective rate of interest is
  - $60 / 950 = 6.32%

Interest Paying Investments

- **Certificate of deposit (CD):** A type of savings instrument issued by certain financial institutions in exchange for a deposit; typically requires a minimum deposit and has a maturity ranging from 7 days to as long as 7 or more years.
- **U.S. Treasury bill (T-bill):** A short-term (3- or 6-month maturity) debt instrument issued at a discount by the U.S. Treasury in the ongoing process of funding the national debt.
- **Series EE bond:** A savings bond issued in various denominations by the U.S. Treasury.
- **I Savings bond:** A savings bond, issued at face value by the U.S. Treasury, whose partially fixed rate provides some inflation protection.