

# Personal Finance

Lecture 1

# Instructors

## **Professor Annamaria Lusardi**

- Denit Trust Chair of Economics and Accountancy at The George Washington University
- Founder and Academic Director of **The Global Financial Literacy Excellence Center (GFLEC)**

Web page: <http://www.gflec.org>

- Research experience in financial literacy and personal finance for over 15 years.

TA: Judy Chen

- No textbook required but a financial calculator is needed.

# Structure of the course

**We will start each class with a quiz covering what we did in the previous class.**

**Quizzes account for 30% of the grade**

**There is a total of 10 quizzes and only 8 (top grades) count for the grade**

**There is no midterm but there is a final exam, which covers the material in the course**

**The final accounts for 30% of the grade**

# Project and class participation

**Students are required to do a project. More explanation will be provided but we plan to have each student (individually or in groups) presents in class**

**The project accounts for 20% of the grade**

**There are also in-class assignments that account for 10% of the grade**

**I expect a lot of class participation and we will start each class with some class discussion**

**Class participation accounts for 10% of the grade**

# Goals of this Course



# Goals of course

- 1. Provide a rigorous framework to make financial decisions**
- 2. Cover many life-cycle financial decisions**
- 3. Provide tools to make financial decisions**
- 4. Preparation for becoming financial planners/advisors**

# What does a personal financial management course teach?

1. How to grow and protect wealth (managing assets and debt)
2. How to take advantages of opportunities offered by the economy and financial markets
3. How to be financially healthy
4. How to be a financial advisor (if you want to pursue this field as a job)

# You are your own CFO

## A new economic landscape

### Major changes that increase individuals' responsibility for well-being:

- **Changes in the pension landscape**
  - More individual accounts
- **Changes in the labor market**
  - Workers change jobs more often
  - Skill-based wage differentials
- **Changes in the financial markets**
  - More complexity
  - More opportunities to borrow and in large amounts



# Managing money – a change from the past

## Being our own CFO

### ➤ Individuals make many financial decisions

- Investment in education
- Financial security after retirement
- Investing in financial markets & other markets (buying a home, car, etc.)

### ➤ Not enough to look at asset side; liability side is equally important

- Increase in debt & borrowing
- Debt normally incurs higher interest rates than what is earned on assets

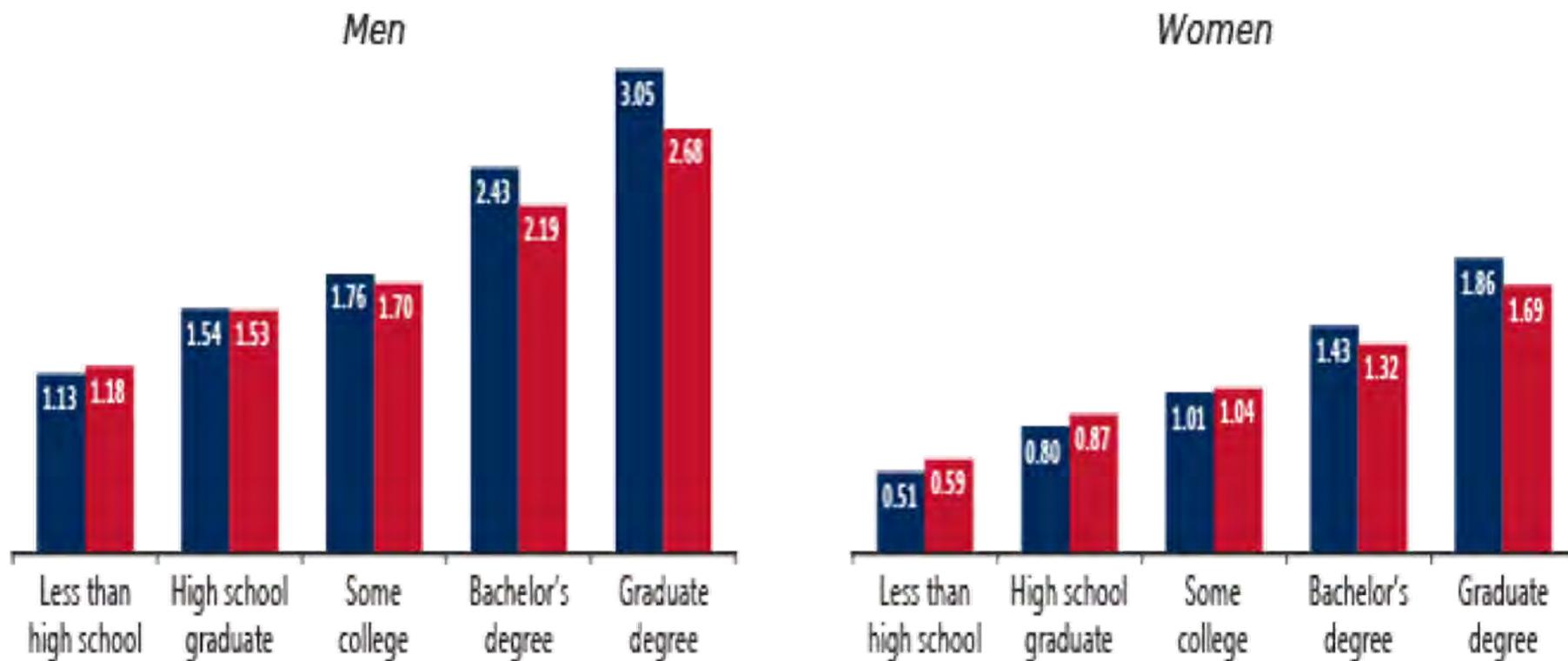
### ➤ Financial decisions are complex

- Many more financial products than in the past
- We have courses to manage money for firms (corporate finance)



# Earnings over a lifetime

■ Gross (without controls) ■ Net (with controls)



Source: Tamborini, Christopher R., Chang Hwan Kim, and Arthur Sakamoto. 2015. "Education and Lifetime Earnings in the United States." *Demography* 52: 1383–1407.

# Background: The US market

## Before the financial crisis



1. Americans were saving very little
2. Household debt had been growing steadily
3. Opportunities to borrow became widely available
4. Majority of individuals are not financially literate

**→ Importance of financial advisors**

# Background: Other markets

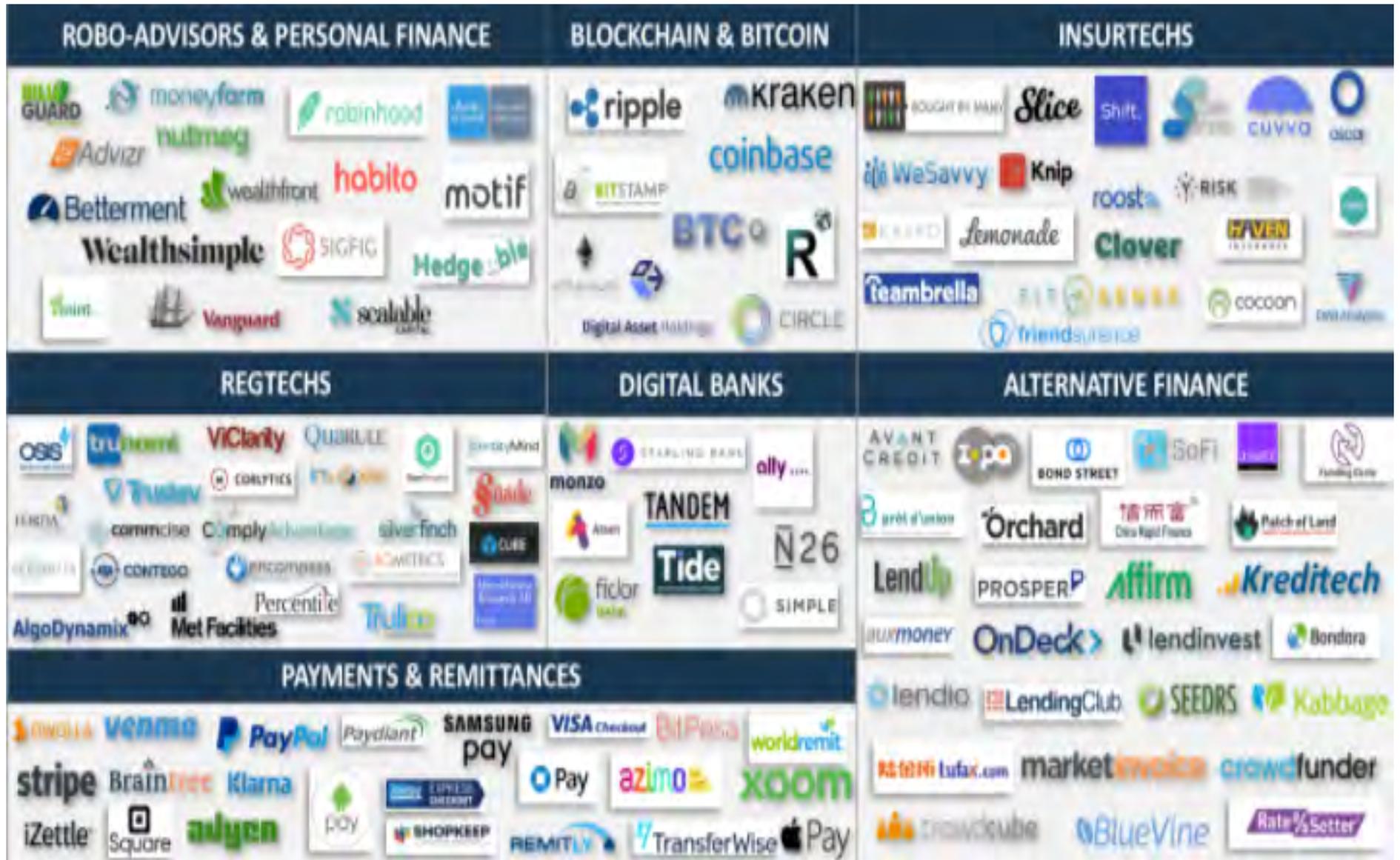
## Opportunities offered by new landscape in other markets as well

1. Increase in individual responsibility in other economies, particularly those which have privatized or are planning to privatize Social Security or pensions.
2. Emerging middle class in BRICS (Brazil, Russia, India, China, and South Africa) and other economies (Turkey, Indonesia, etc.). These individuals have to participate in “formal” markets and use financial products.

We will review this movie



# The rise of fintech



Source: *Business Insider*

# Course Preview

Consumer Applications to Come



# The value of a degree: investing in education

A graduate education costs tens of thousands of dollars for tuition and takes several years of study, but promises a higher salary in the future. Is it better to keep your tuition dollars, or get that degree?

**Tuition**



**Degree**



# Housing

Consumers are faced with many decisions when financing housing. Is better to have a fixed or adjustable rate mortgage? What are mortgage points and should I take them? When should I refinance?

**Fixed or adjustable rates?**

**Refinance?**

**Mortgage points?**



# Retirement. Retiring at 30?

Our life cycle is divided into stages, one when we accumulate savings and one when we use those savings. How much should I save for the long term? How do I protect myself against financial crises and changing interest rates?



**Inflation?**

**Social Security?**

**Financial crises?**

**Changing interest rates?**

# Managing debt

Our economic life often starts with debt (because of student loans) and we have to manage many types of debt. Debt is important because it normally charges high interest rates



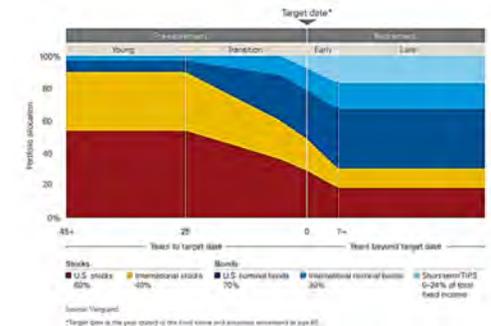
**Interest rate going up?**

**My FICO score?**

# And more

...and much more!

**Personal taxes**



**Investing**

**Risk diversification**

**Biases in consumer finance**



# Everybody needs financial education

At GWSB we designed a special program for athletes



- Our research together with a team at Caltech (AER, 2015) shows that professional football players go bankrupt as soon as they stop playing
- Designed a program for professional football players taught here at GWSB
- The program included a personal finance course targeted to these players

# What is unique about this course

- 1. Based on many years of research on financial literacy and personal finance**
  - Financial illiteracy is widespread in the US
  - Many poor financial decisions
- 2. This course is based on just on principles of finance but also economics, accountancy, and some psychology**
- 3. It recognizes differences across students**

# Interest Rates and Interest Compounding

## Lecture 1



# The price of money

Most financial transactions involve an exchange of money over time.

Essential elements:

1. Time
2. Price

Interest rate is the price of money.

Economists also define it as the opportunity cost of money.



# The growth rate of savings

The **interest rate** may also be defined as

## 1. The **growth rate of savings**

When an investor deposits a sum of money into a bank account or invests in the financial markets, that sum of money grows into a larger sum, and the higher the interest rate, the faster and larger that sum grows.



# The cost of borrowing

The **interest rate** may also be defined as

## 1. The **cost of borrowing**

Not only is the interest rate the rate at which savings grows, but it is also the **rate at which debt grows.**



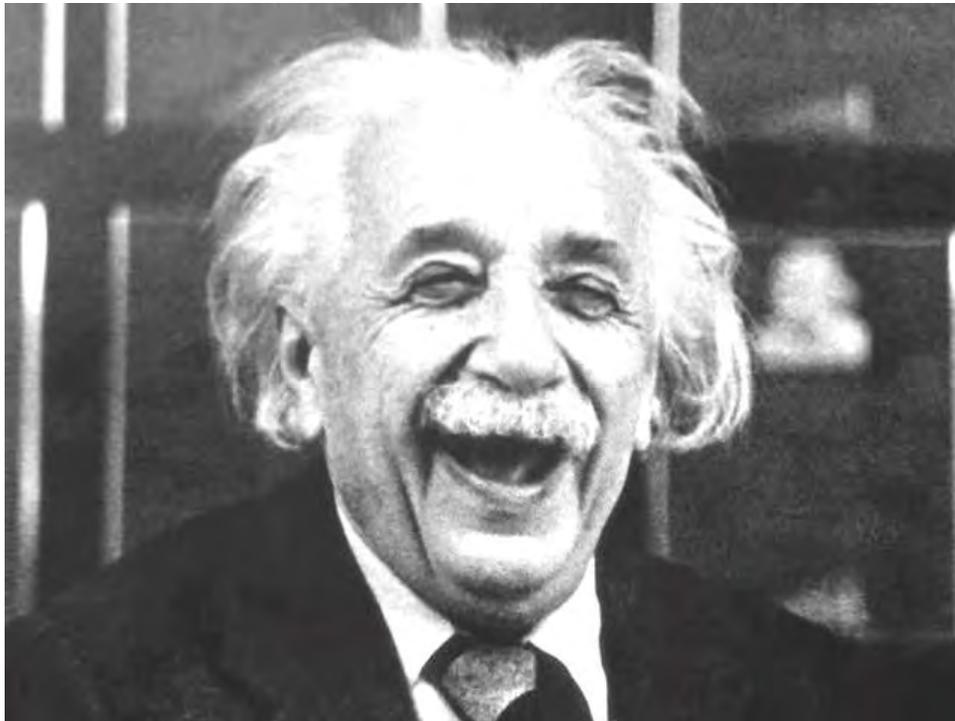
# The rental price of money

Borrowers **rent** money from lenders (savers/investors), and the **interest rate is the price** they pay to do so.

1. Money is a **scarce resource**.
2. There are individuals who would like to borrow money.
3. There are individuals who have a surplus of money.
4. Money is lent and borrowed through a price-based market, where the **rental price is the interest rate**.



# The most powerful force in the universe



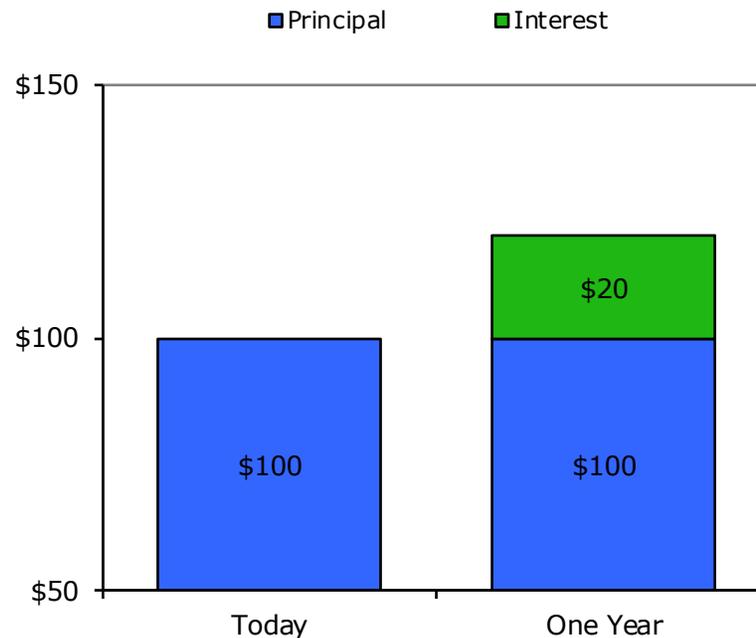
When asked to name the greatest invention in human history, **Einstein** simply replied “**compound interest.**”

Hartgill, David. "Power of Compounding." *The Advertiser*. 15 September 1997.

# Visualizing compound interest

If you borrow \$100 at 20% interest, you will owe \$20 after one year in interest.

**\$100 at 20% Interest**



# Interest compounding

**Over multiple years, interest accrues on interest. This is known as interest compounding.**

**Ex.** Assume \$100 is borrowed at 20% for *two* years. How much must the borrower pay back at the end of the second year?

**Ans.**

**After the first year, the debt grows to  $\$100 \times 1.20 = \$120$ .**

**The interest is then applied to this new \$120 balance in the second year and grows to  $\$120 \times 1.20 = \$144$ .**

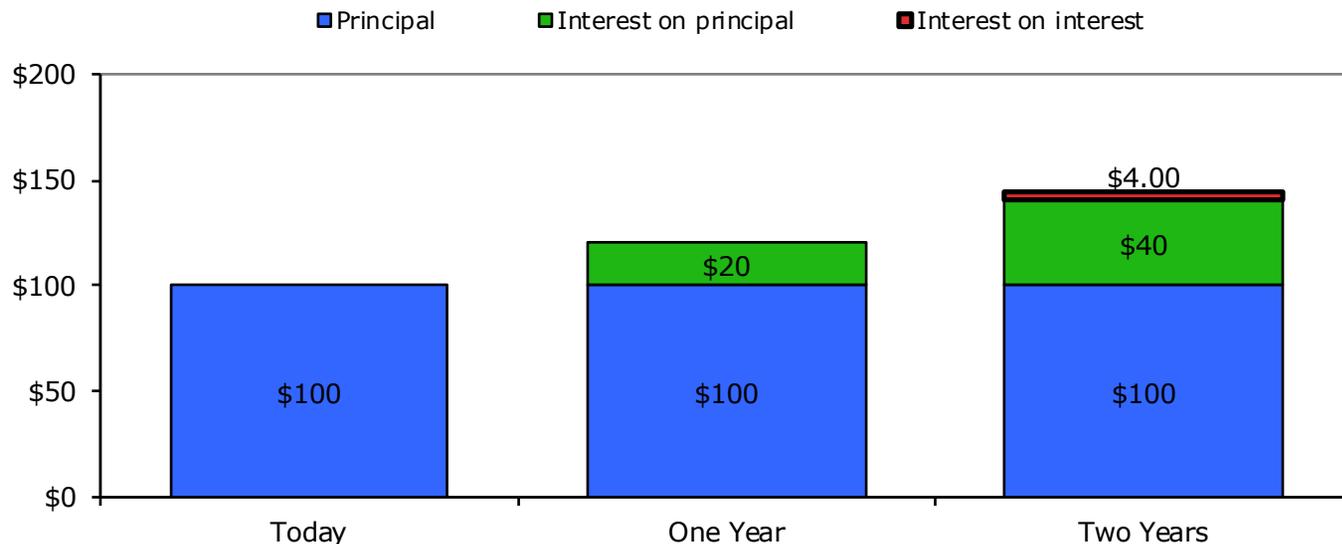
**Therefore, the interest is \$44 and *not*  $\$20 + \$20 = \$40$ .**

**This extra \$4 in the second year is the interest on the \$20 worth of interest in the first year. This is interest compounding.**

# Visualizing compound interest

The total interest accrues not only on the principal, but also on the interest.

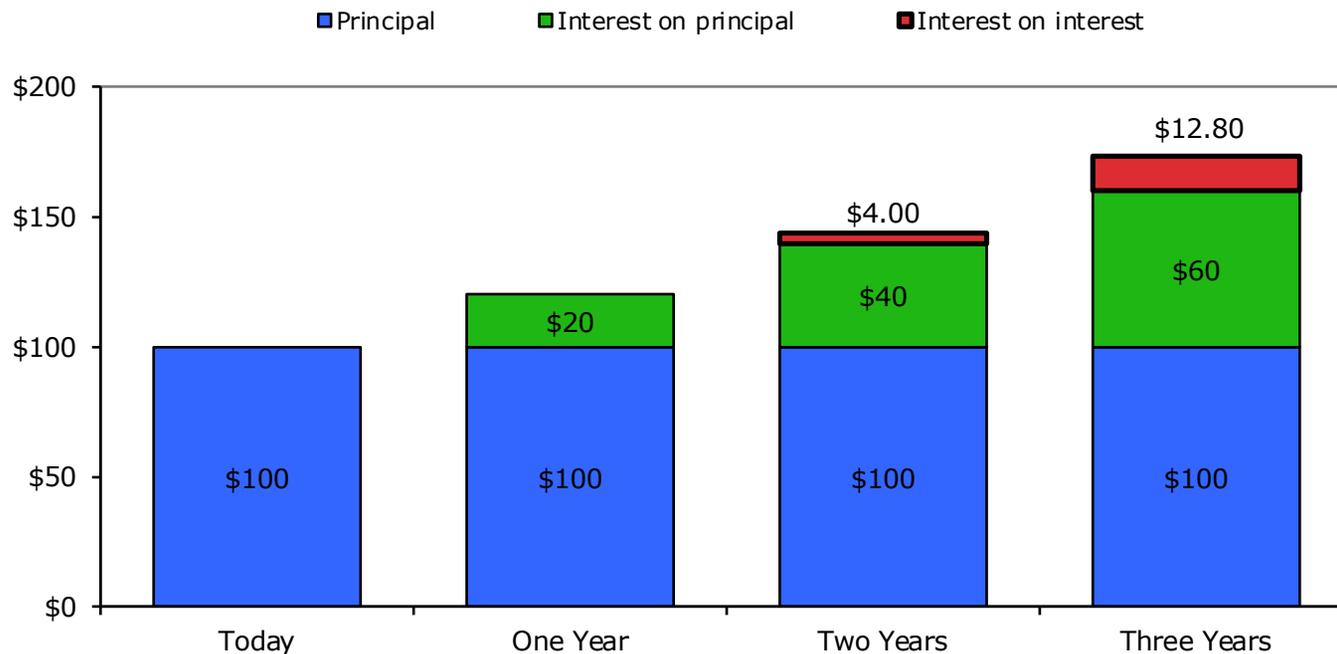
**Compounding Interest at 20% for Two Years**



# Visualizing compound interest

Interest on interest increases exponentially over time...

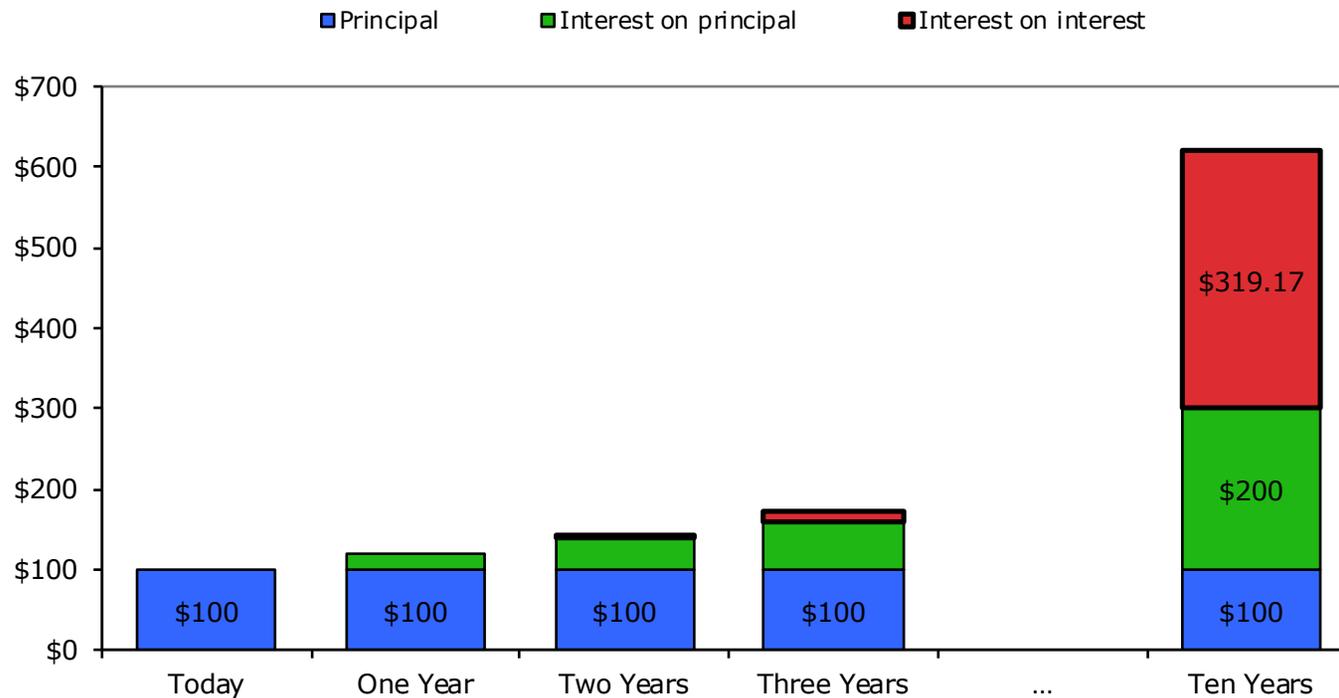
**Compounding Interest at 20% for Three Years**



# Visualizing compound interest

And eventually outweighs the interest on the principal!

**Compounding Interest at 20% for Ten Years**



# The interest compounding formula

**Interest compounding can be calculated using a simple formula.**

**Ex.** Assume \$100 is borrowed at an interest rate of  $r$  for several years. How much must the borrower pay back after  $T$  years?

**After one year, the \$100 will grow to  $\$100 * (1 + r)$ .**

**The next year, this amount is again multiplied by  $(1 + r)$  and grows to:**

$$\$100 * (1 + r) * (1 + r) = \$100 * (1 + r)^2$$

**This continues for  $T$  years until it grows to:**

$$\$100 * (1 + r) * (1 + r) * \dots * (1 + r) = \$100 * (1 + r)^T$$

# The interest compounding formula

In general, the **interest compounding formula** is:

$$F = P(1 + r)^T$$

Where:

P = starting amount (principal)

r = interest rate

T = time periods

F = final amount

# The interest compounding formula

In general, the **interest compounding formula** is:

$$F = P(1 + r)^T$$

This is an *exponential formula*.

As the amount of time,  $T$ , increases, the final value grows faster and faster.

# Investment Strategies



# Investing for the long-term

**So over the long-term, interest compounding can lead to great wealth.**

- If George Washington had set aside \$1 in a trust fund earning 8% (the average rate of return of stocks over the past 200 years) for his heirs on the first day of his presidency in 1789, his heirs in 2019 would have millions!

$$F = P(1 + r)^T = \$1 * (1.08)^{(2019-1789)} = \$48,692,689$$

**Think about that every time you see Washington's face on a \$1 bill!**



# Investing for the long-term

**So over the long-term, interest compounding can lead to great wealth.**

- **Of course, we don't all have 200+ year investment horizon. If you invest \$1,000 at 8% at age 55, when you reach age 65 you'll have:**

$$F = P(1 + r)^T = \$1,000 * (1.08)^{(65-55)} = \$2,158$$

- **But if you start at age 25 you'll have much more!**

$$F = P(1 + r)^T = \$1,000 * (1.08)^{(65-25)} = \$21,724$$

- **It pays to start saving early!**

# Investing at a high interest rate

And over the long-term, investing at a higher rate makes a big difference.

- If you put \$1,000 in a bank account earning 2% interest today, it will more than double in 40 years.

$$F = P(1 + r)^T = \$1,000 * (1.02)^{40} = \$2,208$$

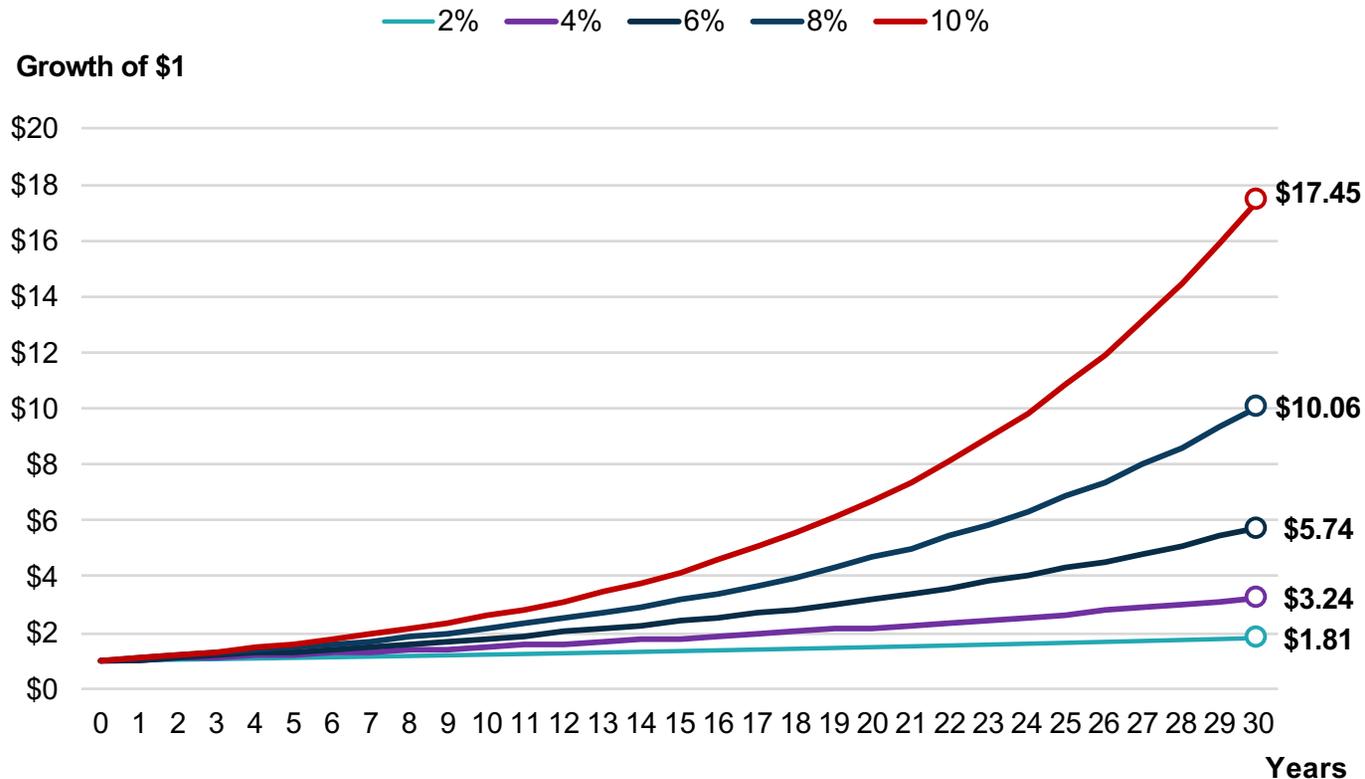
- But if you put that same \$1,000 in the stock market and earn 10% per year, in 40 years you would have many times that initial amount.

$$F = P(1 + r)^T = \$1,000 * (1.10)^{40} = \$45,259$$

# Investing at a high interest rate

The higher the interest rate, the larger the effect of interest compounding over time.

### Interest Compounding over 30 Years



# Investing early

**The interest compounding formula implies that it's best to start saving early.**

- **If you start saving for your child's \$200,000 private college education only three years before they begin school, you'll need to put \$172,768 in an investment account earning 5%.**

$$F = P(1 + r)^T = \$172,768 * (1.05)^3 = \$200,000$$

- **But if you start saving when they are born, your money will grow for 18 years, and you need only set aside \$83,104.**

$$F = P(1 + r)^T = \$83,104 * (1.05)^{18} = \$200,000$$

# Doubling debt

**But interest compounding is bad news when it concerns debt...**

- **A college student buys a \$1,500 laptop using a credit card that charges 15%. The student goes through four years of college and wait an additional year in his new job before paying of the debt. By this time, the cost of the laptop will double!**

$$F = P(1 + r)^T = \$1,500 * (1.15)^5 = \$3,017$$

# Who wants to be a millionaire?

## The magic of interest compounding

If a 25-year-old investor invests \$20,000 at 10%, how old will this investor be when the investment becomes \$1,000,000?

Formula:

$$F = P \cdot (1 + r)^t$$

What is your guess?



# Who wants to be a millionaire?

## The magic of interest compounding

**Ans.**

$$P = \$20,000;$$

$$F = \$1,000,000;$$

$$r = 10\%;$$

$$F = P(1+r)^t$$

$$T = \frac{\ln(F/P)}{\ln(1+r)}$$

**Solve for  $T$**

$$T = \frac{\ln(50)}{\ln(1.1)} =$$

$$= 41.05$$

The investor will be  $25 + 41.05 = 66$  years old.

# Waiting to be a millionaire

## The magic of interest compounding

**If the same investor instead waits until she is 46 before making the initial investment, how large must the initial investment be for it to grow to \$1,000,000 when she is 66 years old?**

What is your guess?



# Waiting to be a millionaire

## The magic of interest compounding

**Ans.**

$F = \$1,000,000;$

$r = 10%;$

$t = 66 - 46 = 20;$

*Solve for  $P$*

$$P = \frac{F}{(1+r)^t}$$

**= \$148,643.**

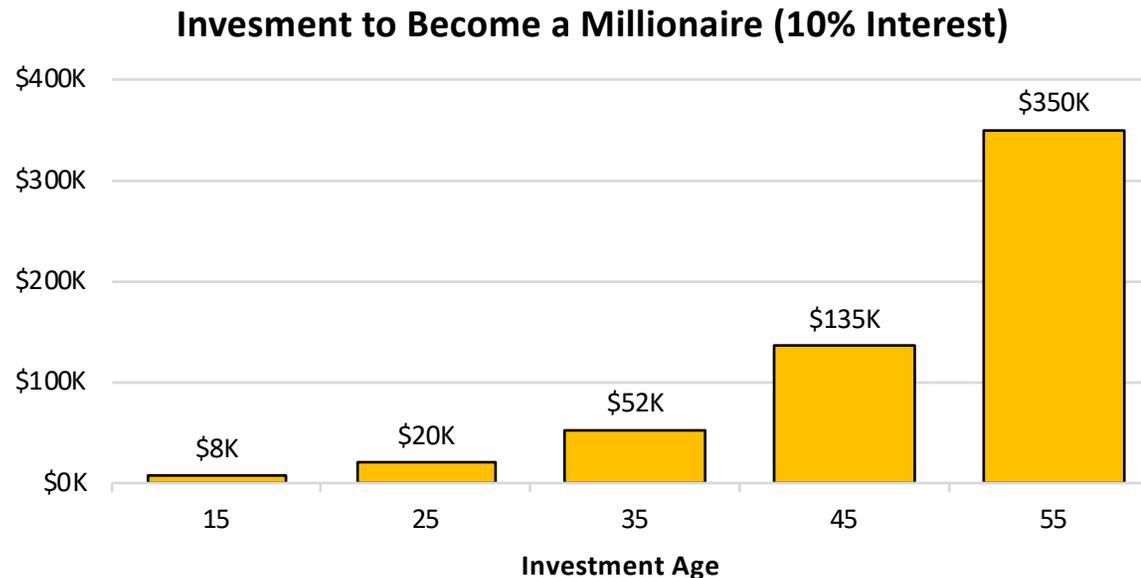


**So, the sum is large, it pays to save early!**

# Waiting to be a millionaire

## The magic of interest compounding

The chart below shows the initial investment needed to become a millionaire (at 66) for different ages.



The benefit of investing early comes from compounding interest...

# Getting rich via interest compounding

## The magic of interest compounding

**If the interest on the investment did not compound, how many years would the investment of \$20,000 take to become \$1,000,000 if  $r = 10\%$ ?**

What is your guess?



# Getting rich via interest compounding

## The magic of interest compounding

Ans.

The formula for simple interest compounding is:

$$F = P(1 + r \cdot T)$$

Therefore:

$$T = \frac{\left(\frac{F}{P} - 1\right)}{r} \quad T = \frac{(50 - 1)}{0.10} = \mathbf{490 \text{ years!}}$$

**This shows the power of compounding!**



# Different investment strategies

## Similar people with different investments

### Example:

**Take 2 people with the same income.  
Both have \$10,000 in savings at age 30.**

**One puts the money in a checking account at 1%  
The other in stock mutual funds at 7%.**

**At age 65, how much do they have?**

**\$14,166 versus \$106,766**



# **A Look at the Market**



# Data on financial capability

## National Financial Capability Study (NFCS)

### 2015 NFCS Data Release

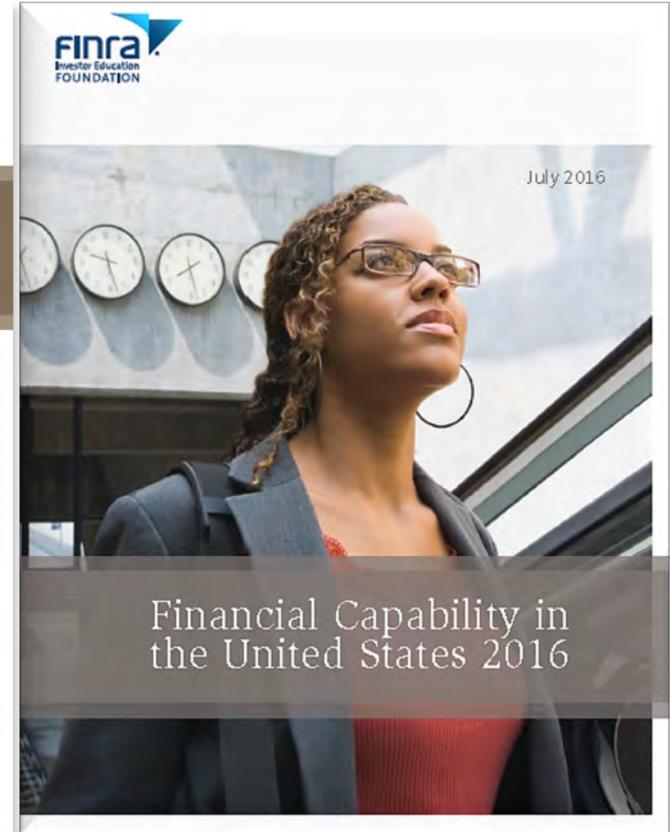
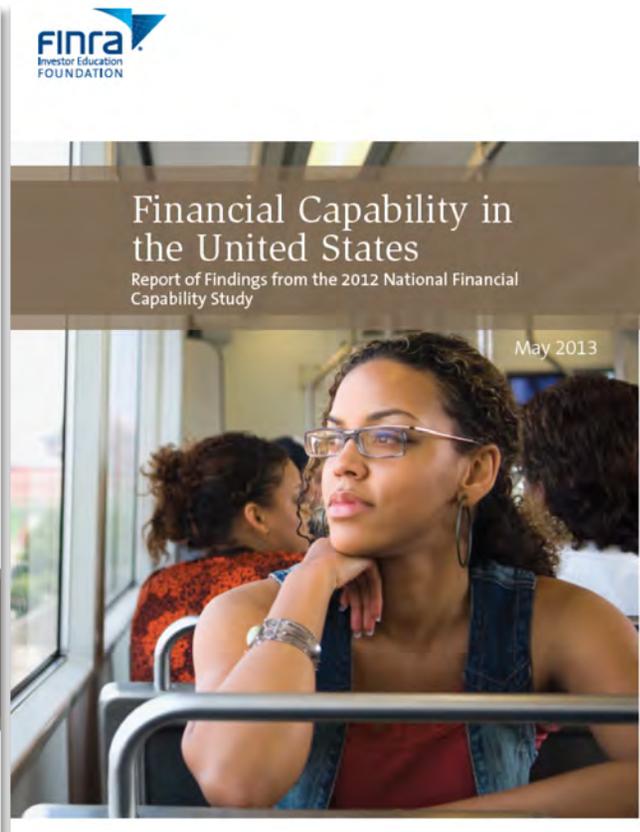
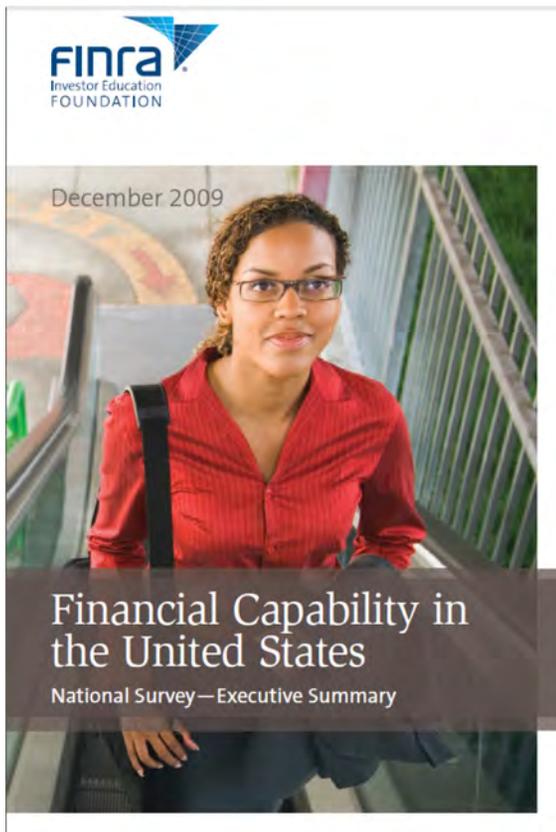
Now in its third iteration, the NFCS is one of the largest and most comprehensive financial capability studies in the country... the Study allows for state-by-state comparisons of financial literacy, making it invaluable to policy makers... The NFCS is one of many initiatives undertaken by the FINRA Investor Education Foundation to benchmark, better understand and build financial capability in America.

➤ Geraldine Walsh

President of the FINRA Investor Education Foundation

# Data on financial capability

## National Financial Capability Study (NFCS)



[2009](#), [2012](#), and [2015](#) Reports [by FINRA Investor Education Foundation](#)

# Measuring numeracy and interest compounding

## To test numeracy and understanding of interest rates, the survey asked:

“Suppose you had \$100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow?”

- a) More than \$102
- b) Exactly \$102
- c) Less than \$102
- d) Don't know
- e) Prefer not to say

Source: 2015 National Financial Capability Survey

# Measuring numeracy and interest compounding

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- a) **More than \$102**
- b) Exactly \$102
- c) Less than \$102
- d) Don't know
- e) Prefer not to say

**75%** responded correctly

(13% incorrect; 12% Don't know)

Source: 2015 National Financial Capability Survey

# Knowledge of interest compounding (US)

Suppose you owe \$1,000 on a loan and the interest rate you are charged is 20% per year compounded annually. If you didn't pay anything off, at this interest rate, how many years would it take for the amount you owe to double?

- a) Less than 2 years
- b) At least 2 years but less than 5 years
- c) At least 5 years but less than 10 years
- d) At least 10 years
- e) Don't know
- f) Prefer not to say

Source: 2015 National Financial Capability Survey

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- a) Less than 2 years
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- c) At least 5 years but less than 10 years
- d) At least 10 years
- e) Don't know
- f) Prefer not to say

**33%** answered correctly

(29% At least 5 years but less than 10 years, 25% Don't know)

Source: 2015 National Financial Capability Survey

# Measuring financial literacy (Sweden)

To test understanding of interest compounding, respondents were asked:

“Suppose you had SEK 200 in a savings account and the interest rate is 10% per year and is paid in the same account. How much will you have in the account after 2 years?”

- i) Your calculation (correct answer is SEK 242)
- ii) Don't know

**35%** of respondents answered correctly

Source: Almenberg, J. and Save-Soderbergh, J. “Financial literacy and retirement Planning in Sweden.” *Journal of Pension Economics and Finance*, 2011.

# Financial literacy: Smart about methods of payment

You purchase an appliance which costs \$1,000. To pay for this appliance, you are given the following two options: (a) Pay 12 monthly installments of \$100 each; (b) Borrow at a 20% annual interest rate and pay back \$1,200 a year from now. Which is the cheaper offer?

- a) Option (a)
- b) Option (b)
- c) They are the same
- d) Do not know
- e) Prefer not to answer

Appliance payment	Percent
Option a	40.6
<b>Option b (correct)</b>	<b>6.9</b>
They are the same	38.8
Do not know	9.2
No answer	4.5

Source: Lusardi, A. and Tufano, P. "Debt Literacy, Financial Experiences, and Overindebtedness ." *Harvard Business Review*, 2009.

# Returns to different investments

Example: Below is a table showing hypothetical average returns for different types of investments.

<u>Asset Class</u>	<u>Return</u>
Savings Account	1.5%
Treasury Bill	3.5%
Corporate Bond	6.0%
Stock	13.0%

Author's calculations

For each of these assets, if you invest \$100,000, how much will you have after 40 years?

# Returns to different investments

**Ans.**

For each asset class, the final value of the savings can be calculated with the formula:

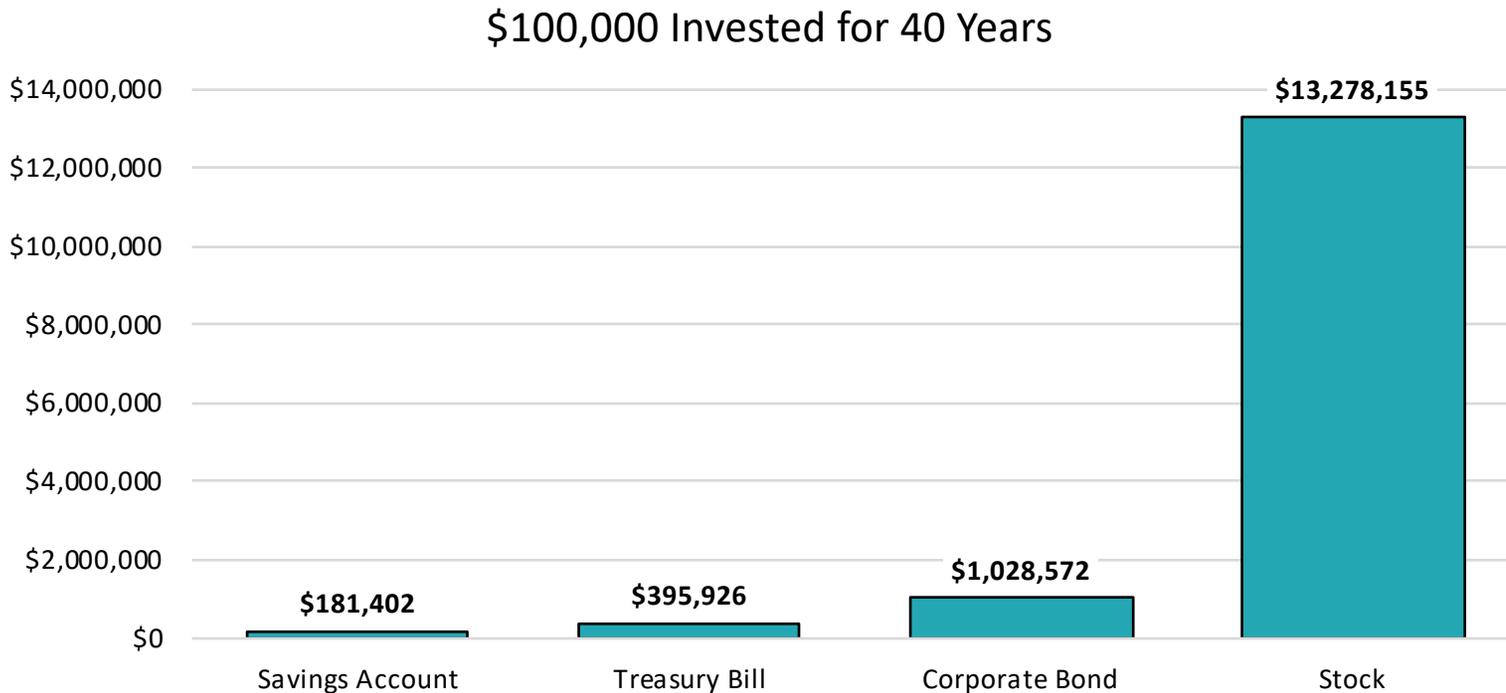
$$F = P(1 + r)^T = \$100,000 * (1 + r)^{40}$$

Where  $r$  is the listed return for the asset class. The following table shows the final value of \$100,000 invested in each asset class:

<u>Asset Class</u>	<u>Return</u>	<u>Final Value</u>
Savings Account	1.5%	\$181,402
Treasury Bill	3.5%	\$395,926
Corporate Bond	6.0%	\$1,028,571
Stock	13.0%	\$13,278,155

# Returns to different investments

The difference between investing in a savings account and the stock market is huge over the long term!



# Returns to different investments

For each of the above assets, how much would you need to set aside when your child is born to pay for their \$200,000 private college education in 18 years?

Here are the hypothetical average returns one more time:

<u>Asset Class</u>	<u>Return</u>
Savings Account	1.5%
Treasury Bill	3.5%
Corporate Bond	6.0%
Stock	13.0%

# Returns to different investments

**Ans.** To solve this problem, we first need to use some algebra to solve for the starting amount  $P$  in the interest compounding formula:

$$F = P(1 + r)^T$$

**Divide both sides by** to isolate  $P$ :

$$\frac{F}{(1 + r)^T} = P$$

We know have a formula for the starting amount  $P$ . **By plugging in the desired final amount of \$200,000 and the 18 year investment horizon, we get:**

$$P = \frac{\$200,000}{(1 + r)^{18}}$$

# Returns to different investments

**Ans. (continued)**

**By plugging in the appropriate return for each asset class, we get:**

<u>Asset Class</u>	<u>Return</u>	<u>Starting Amount</u>
Savings Account	1.5%	\$152,982
Treasury Bill	3.5%	\$107,672
Corporate Bond	6.0%	\$70,069
Stock	13.0%	\$22,162

Because stock returns compound at a higher rate, **much less needs to be set aside today to meet a future savings goal.**

# Interest compounding

**Video about the importance of interest compounding**

**“How Compound Interest Boosts Savings”**

<http://gflec.org/education/educational-videos/>

# The power of interest compounding

## Looking at interest compounding teaches us some important lessons:

- Savings barely grow in an account earning 1% interest.
- It pays to start saving early.
- Debt at a high interest rate will double quickly!

# Today we learned...

- ✓ Course topics
- ✓ Interest rates
- ✓ Interest compounding
- ✓ Investment strategies

## A quote

**“Knowledge is in every country the surest basis of public happiness.”**

*George Washington, First President of the United States*