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## Chapter 17 Investing in Mutual Funds

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New to the Seventh Edition

All chapters have been updated to present complete and current coverage at the time of publication. The key changes in the Seventh Edition of *Personal Finance* include the following:

- The Stephanie Spratt running examples throughout all chapters account for present economic conditions and the most recent tax law changes.
- The Sampsons case has been revised to ensure consistency throughout the text, and incorporates the most recent tax law changes.
- The Brad Brooks case has been revised to ensure consistency throughout the text, and incorporates the most recent tax law changes.
- The Building Your Own Financial Plan feature includes new applications and templates that enable students to easily create their own financial plan.
- Chapter 1, “Overview of a Financial Plan,” contains more information about how to select a college (or graduate school), a major, and an occupation. It also provides updated salary information about occupations and explains how to implement a financial plan to accomplish financial goals.
- Chapter 4, “Using Tax Concepts for Planning,” has been completely rewritten to account for the new tax law changes. This chapter is written in very simple terms, and offers clear guidance for students to estimate their own taxes if they take the standard deduction.
- Chapter 5, “Banking and Interest Rates,” contains more discussion on the online payment process for paying bills.
- Chapter 6, “Managing Your Money,” uses lower interest rates to reflect current conditions.
- Chapter 7, “Assessing and Selecting Your Credit,” contains more discussion of improving your credit score, and prevention of identity theft.
- Chapter 8, “Managing Your Credit,” contains more discussion of credit cards.
- Chapter 9, “Personal Loans,” contains more discussion of loan consolidations and student loans.
- Chapter 10, “Purchasing and Financing a Home,” illustrates how the recent tax law changes have reduced the potential tax benefits of owning a home.
- Chapter 17, “Investing in Mutual Funds,” includes much more information about exchange-traded funds (ETFs) because of their popularity.
- Chapter 19, “Retirement Planning,” contains updated information on all the different retirement plans that are available because many of the rules, such as the maximum allowable contribution per year, have changed.

Solving Teaching and Learning Challenges

Ask yourself these financial questions:

- Should you buy a new car or lease a car?
- How much can you borrow?
- Which bank offers the best services to satisfy your needs?
- How can you avoid identity theft?
- Under what conditions should you use a credit card or a debit card?
- Do you have enough insurance?
- Will you be able to retire while still young?

This textbook allows you to address these and other related financial dilemmas. It also guides you to create a financial plan for yourself. This textbook gives you the opportunity to develop the skills that can
improve your financial position over time. To do this, it incorporates Internet-based resources along with many examples, problems, and ongoing case studies, all of which focus on providing students with hands-on practice applying financial concepts.

The quantitative side of financial planning intimidates many students. This book simplifies the mathematics of personal finance by explaining the underlying logic. Formulas and calculations are explained in the text and then illustrated in examples. Examples that can be solved using a financial calculator are depicted with a calculator illustration. Students are referred to Web sites with online calculators whenever pertinent. The Financial Planning Problems provide students with ample opportunity to practice applying math-based concepts.

The key components of a financial plan are introduced in Chapter 1. The balance of the text is organized into the following seven parts, which are keyed to the financial plan components introduced in Chapter 1, concluding with the synthesis of those components into a comprehensive financial plan in Chapter 21:

2. Managing Your Liquidity covers banking, credit, and money management.
3. Personal Financing covers financing large purchases.
4. Protecting Your Wealth covers insurance planning.
5. Personal Investing covers a variety of investments and investing strategy.
6. Retirement and Estate Planning covers plans, strategies, and tax considerations related to retirement and estate planning.
7. Synthesis of Financial Planning covers the integration of the components into a comprehensive personal financial plan.

To improve student results, we recommend pairing the text content with MyLab Finance, which is the teaching and learning platform that empowers you to reach every student. By combining trusted author content with digital tools and a flexible platform, MyLab personalizes the learning experience and will help your students learn and retain key course concepts while developing skills that future employers are seeking in their candidates. From Dynamic Study Modules to Financial Planning Spreadsheets, MyLab Finance helps you teach your course, your way. Learn more at www.pearson.com/mylab/finance.

The main solutions that this textbook and MyLab offers are as follows.

**Building Your Own Financial Plan**

The seventh edition of *Personal Finance* integrates the Building Your Own Financial Plan feature along with the case studies in each chapter, to help students create their own personalized plans for financial success.

Students learn by doing. After each chapter, they are prompted to apply the key concepts in order to make their own financial planning decisions. At the end of the course, students will have completed a financial plan that they can use beyond the school term.
Decision Making

*Personal Finance*’s interactive approach incorporates Internet-based resources along with examples, problems, and ongoing case studies that help students make informed financial planning decisions.

### FREE APPS for Personal Finance

**Managing Your Budget in Real Time**

**Application:**
The Mint Money Manager, Budget, and Personal Finance app (by Mint.com) sends you reminders about future bills that are due and helps you schedule the payment of your future bills. This allows you to ensure that you manage your cash outflows more effectively.

**To Find It:**
Search for the “Mint” app on your mobile device.

Free Apps for Personal Finance highlights useful apps students can download to their smartphones for free that apply to some of the key concepts covered in the chapter.

### Financial Planning ONLINE

**Go to:**
www.irs.gov

**To get:**
Information about tax rates, tax forms, guidelines, and deadlines.

### FINANCIAL PLANNING PROBLEMS

*All Financial Planning Problems are available in MyLab Finance at www.pearson.com/mylab/finance. A financial calculator is recommended for Problems 4, 9, 11, 12, 13, 15 and 16. The financial tables can be used to answer Problems 1, 2, 3, 5, 6, 7, 9, 10, and 13.*

1. **Future Value.** Kyle has $1,000 in cash received for high school graduation gifts from various relatives. He wants to invest it in a certificate of deposit (CD) so that he will have a down payment on a car when he graduates from college in five years. His bank will pay 1.5% per year, compounded annually, for the five-year CD. How much account that averages a 5% annual return, what amount will be in the account in twenty years? How much will she have if the account earns 8% a year?

3. **Future Value.** Luis wants to know how much he will have available to spend on his trip to Belize in three years if he deposits $3,000 today at an annual interest rate of 2%.

Financial Planning Problems require students to demonstrate knowledge of mathematical concepts by performing computations to make well-informed personal finance decisions. All Financial Planning Problems are available in MyLab Finance.
Preface

**FINANCIAL PLANNING ONLINE EXERCISES**

1. Go to the Web site [www.consumer.gov](http://www.consumer.gov), and go to the section on credit, loans, and debt.
   a. What are some ways that you can build your credit history?
   b. What type of information is contained in your credit report?
   c. What are some advantages of having “good credit”?
2. Review the information at [www.ftc.gov](http://www.ftc.gov) about free credit reports.
   a. What is the only authorized source for free credit reports under federal law?
   b. How can you request a free credit report?
   c. Why should you review your credit report?

Financial Planning Online Exercises show students how to obtain, critically evaluate, and use Internet-based resources in making personal finance decisions.

**EXAMPLE**

Stephanie Spratt has $2,000 available to allocate to money market investments. She knows that she will need $400 to cover several small bills in the next week and may also need $600 in a month or so to pay for repairs on her car engine. She does not expect to need the other funds for at least one month. Her financial institution offers the following annualized yields on various money market instruments:

<table>
<thead>
<tr>
<th>Financial Instrument</th>
<th>Annualized Yield (%)</th>
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<tbody>
<tr>
<td>Checking account</td>
<td>0</td>
</tr>
<tr>
<td>Savings deposit</td>
<td>1.2</td>
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<tr>
<td>MMDA ($2,500 minimum balance)</td>
<td>2.0</td>
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A running example of a recent college graduate and new entrant into the workforce helps students apply concepts to real-life situations. Students are commonly faced with dilemmas similar to those Stephanie faces, such as how to control recreational spending or whether to buy or lease a car.

**THE SAMPSONS—A CONTINUING CASE: Chapter 3**

Dave and Sharon Sampson recently established a plan to save $300 per month (or $3,600 per year) for their children’s education. Their oldest child is six years old and will begin college in twelve years. They will invest the $300 in a savings account that they expect will earn interest of about 2% per year over the next twelve years. The Sampsons wonder how much additional money they would accumulate if they could earn 5% per year on the savings account instead of 2%. They also wonder how their savings would accumulate if they could save $400 per month (or $4,800 per year) instead of $300 per month.

Build a financial plan for a family! As the parents of two children, Dave and Sharon Sampson face common financial dilemmas, having made few plans regarding their financial future and being eager to start saving toward a new car, their children’s college education, and their retirement. Students apply chapter concepts to counsel the Sampsons on the accompanying online worksheets.
Learning Tools

Banking and Interest Rates

When Shawna arrived on campus for her first year of college, she relied on an automated teller machine (ATM) to obtain cash for the many little necessities of college life (food, movies, and more food). It was only on a weekend trip back home, where she reviewed her latest bank statement, that Shawna became aware of a problem. Her bank statement showed thirty-nine separate charges for ATM fees. She had been charged $1.00 for each trip to an “out-of-network” ATM not owned by her bank. There was another $1.50 fee charged by the bank that owned the ATM, so each ATM visit created two charges. In addition, Shawna discovered that she had made five balance inquiries on “out-of-network” ATMs, and her bank charged $0.50 for each of them. Altogether, for her seventeen visits to the ATM, Shawna had accrued $42.50 in ATM fees and $2.50 in inquiry fees for a total of $45.00. Shocked at this discovery, Shawna found a bank that offered a mobile app with an ATM locator that only on a weekend trip back home, she would enable her to easily find no-fee ATMS. The mobile app also allows her to check her account balance at any time, so she will always be aware if she is being charged fees. The opening of each chapter provides an interesting scenario that previews the chapter’s content.

Chapter Introductions

The objectives of this chapter are to:

- Provide a background on money management
- Describe the most popular money market investments
- Identify the risk associated with money market investments
- Explain how to manage the risk of your money market investments
- Explain how money management fits within your financial plan
While at the mall today, Lisa saw a pair of Italian shoes that she liked. The shoes were priced at $300 and were not on sale. Lisa did not have any cash with her, so she used her credit card to pay for the shoes. Lisa did not need the shoes but decided to buy them because she did not see anything else at the mall that she wanted. Before purchasing the shoes, Lisa used her smartphone and determined that she could purchase the same shoes online for $100 less, but she would have to wait several days for them to be delivered, and she wanted them now. Lisa was also aware that the shoe store periodically has 40% off sales, and she could likely buy the shoes at the sale price if she would be willing to wait. Lisa’s purchase decision was primarily influenced by her desire for immediate satisfaction. She knew that she could have waited until the shoes were on sale, but she went to the mall intending to purchase something today. Lisa’s purchase decision was especially easy because she used credit instead of cash. Thus, she was able to make the purchase and still has all her cash that she can use for other future purchases.

Marginal Glossary
Throughout the text, key terms and their definitions appear in the text margin where they are first introduced.

Explanation by Example
Practical examples applying concepts in realistic scenarios throughout chapters help cement student understanding.

Psychology of Personal Finance
Personal finance behavior is influenced by psychology. For example, some spending decisions are made on impulse due to the desire for immediate satisfaction.

Economic Impact
The Economic Impact logo identifies text that emphasizes how economic conditions can affect personal finance.

Summary
To aid in student study, the chapter summary presents the chapter’s key points in paragraph form.
Activities and Assessments

REVIEW QUESTIONS

All Review Questions are available in MyLab Finance at www.pearson.com/mylab/finance.

1. **Time Value of Money.** What is the time value of money? How is it related to opportunity costs?
2. **Importance of the Time Value of Money.** List one reason why the time value of money is an important concept.

Review Questions

Test knowledge of material by comparing and contrasting concepts, interpreting financial quotations, and understanding how financial data can be used to make personal finance decisions. All Review Questions are available in MyLab Finance.

Ethical Dilemmas

Real-life ethical situations are presented along with questions to encourage students’ critical thinking about ethics.

Ethical Dilemma. Jill just finished reconciling her account balance and discovered the bank made a $567 error in her favor. She double-checked her numbers and is certain the bank made an error, and the difference is not a miscalculation on her part. Jill knows the amount is miniscule to the bank’s overall value but it would help her make a payment that is due this month. Should she just let the bank find the error and use the money until that time? Or, should she report it now?

WEB SEARCH EXERCISE

You can develop your personal finance skills by conducting an Internet search for related articles. Find a recent online article about personal finance that reinforces one or more concepts covered in this chapter. If your class has an online component, your professor may ask you to post your summary of the article there and provide a link to the article so that other students can access it. If your class is live, your professor may ask you to summarize your application of the article in class. Your professor may assign specific students to complete this assignment or may allow any student to do the assignment on a volunteer basis.

Web Search Exercises

This exercise directs students to conduct an online search for real-world events related to the key content of each chapter.

VIDEO EXERCISE: Investing in Money Markets

Go to one of the Web sites that contain video clips (such as www.youtube.com), and view some video clips about investing in money market securities. You can use search phrases such as “investing in money markets.” Select one video clip on this topic that you would recommend for the other students in your class.

1. Provide the Web link for the video clip.
2. What do you think is the main point of this video clip?
3. How might you change your investment in money market securities after watching this video clip?

Video Exercises

This activity has students find a video on an important finance topic discussed in the chapter.
Psychology of Personal Finance Questions

At the end of every chapter is a section on the Psychology of Personal Finance that tests students’ understanding of how psychological forces such as desire for immediate satisfaction can influence personal finance decisions.

Financial Literacy Tests

A Financial Literacy Pre-Test is included just before Chapter 1. Answers are provided so that students can grade their performance. This test allows students to discover how much they do not know about personal finance and motivates them to develop their skills. A Financial Literacy Post-Test is provided immediately following Chapter 21. This test lets students discover how much they have learned after finishing the course. Answers are supplied so that students can easily assess their performance.

Psychology of Personal Finance: Using Your Credit Cards

For many people, less pain is associated with using a credit card to make purchases than with using cash, even if the payments are the same. The use of the credit card almost feels like there is no payment, but the use of cash means that there is less cash available for other purchases. Therefore, spending decisions are made more carefully when using cash.

1. Describe your opinion on this topic. Do you feel less pain when using a credit card? Are your spending decisions more carefully when you use cash as opposed to credit cards?

2. Read one practical article about how psychology affects the use of credit cards. You can easily retrieve possible articles by doing an online search using the terms “psychology” and “using credit cards.” Summarize the main points of the article.

Projects

Several projects are available in Appendix B.

• Assessing Your Credit prompts students to evaluate their credit card balance and credit limit. It also guides students to obtain their credit score and to consider whether they should implement a strategy to pay down their existing credit balance.

• Career Planning Project allows students to research a particular career that they plan to pursue and report on their research.

• Leasing an Apartment allows students to assess the cost and potential benefits of leasing a particular apartment that they have identified.

• Stock Market Project allows students to simulate the investing process, monitor a particular stock, and analyze how stock values respond to economic conditions.
Financial Planning Workbook

The financial planning workbook, which requires students to take decisions based on their learning, is fully integrated into the text. At the end of each chapter, the student is prompted to complete the Building Your Own Financial Plan exercises and the Sampson family continuing case. At the end of each part, the student is prompted to complete the Brad Brooks continuing case. Students should use the worksheets in MyLab Finance where Excel software can be applied to facilitate the process.

Additional software features include the following:

- Calculation-based templates allow students to easily forecast their future salary, forecast their future savings, determine their income tax liability, and estimate their monthly payments on a mortgage.
- Enhanced graphics, such as pie charts and bar graphs that are generated based on user input, aid students in visualizing their cash outflows and asset allocation.

Developing Employability Skills

This textbook enhances the employability skills of students in the following ways:

- It provides a background on all the major personal finance functions, which is essential for employment in financial services fields such as banking or insurance, where personal customer service is crucial.
- It enables students to develop their own personal financial plan, which is a necessary skill in order to pursue employment as a financial advisor.
- The financial planning exercises and cases give students experience in critical thinking, and solving dilemmas, which is necessary for many occupations.
- The personal budgeting and financial planning skills that students attain can be applied to many occupations in the business world, because businesses must manage liquidity and financing in order to accommodate their spending plans.

This table identifies which features and end-of-chapter materials will help students to develop their employability skills:

<table>
<thead>
<tr>
<th></th>
<th>Communication</th>
<th>Critical Thinking</th>
<th>Collaboration</th>
<th>Knowledge Application and Analysis</th>
<th>Business Ethics and Social Responsibility</th>
<th>Information Technology and Computing Skills</th>
<th>Data Literacy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building Your Own Financial Plan</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Financial Planning Problems</td>
<td>✓</td>
<td>✓</td>
<td></td>
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</tr>
<tr>
<td>Financial Planning Online Exercises</td>
<td>✓</td>
<td>✓</td>
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<tr>
<td>Example: Stephanie Spratt</td>
<td>✓</td>
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Instructor Teaching Resources

The following array of supplementary materials is available to help busy instructors teach more effectively and to allow busy students to learn more efficiently.

<table>
<thead>
<tr>
<th>Supplements available to instructors at <a href="http://www.pearsonhighered.com/madura">www.pearsonhighered.com/madura</a></th>
<th>Features of the Supplement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instructor’s Manual authored by Mike Casey</td>
<td>• Chapter-by-chapter summaries</td>
</tr>
<tr>
<td></td>
<td>• Examples and activities not in the main book</td>
</tr>
<tr>
<td></td>
<td>• Teaching tips</td>
</tr>
<tr>
<td></td>
<td>• Solutions to all questions and problems in the book</td>
</tr>
<tr>
<td>Test Bank authored by Alan Wolk</td>
<td>Over 2,000 multiple-choice, true/false, and short-answer questions with these annotations:</td>
</tr>
<tr>
<td></td>
<td>• Difficulty level (1 for straight recall, 2 for some analysis, 3 for complex analysis)</td>
</tr>
<tr>
<td></td>
<td>• Topic (the term or concept the question supports)</td>
</tr>
<tr>
<td></td>
<td>• AACSB learning standard (Written and Oral Communication; Ethical Understanding and Reasoning; Analytical Thinking; Information Technology; Interpersonal Relations and Teamwork; Diverse and Multicultural Work; Reflective Thinking; Application of Knowledge)</td>
</tr>
<tr>
<td>Computerized TestGen</td>
<td>TestGen allows instructors to:</td>
</tr>
<tr>
<td></td>
<td>• Customize, save, and generate classroom tests</td>
</tr>
<tr>
<td></td>
<td>• Edit, add, or delete questions from the Test Item Files</td>
</tr>
<tr>
<td></td>
<td>• Analyze test results</td>
</tr>
<tr>
<td></td>
<td>• Organize a database of tests and student results</td>
</tr>
<tr>
<td>PowerPoints authored by Mike Casey</td>
<td>Slides includes graphs, tables, and equations in the textbook.</td>
</tr>
<tr>
<td></td>
<td>PowerPoints meet accessibility standards for students with disabilities. Features include, but not limited to:</td>
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Dr. Jeff Madura is presently Emeritus Professor of Finance at Florida Atlantic University. He has written several successful finance texts, including International Financial Management (in its 13th edition), and Financial Markets and Institutions (in its 12th edition). He has more than 200 articles on financial topics published in academic journals, including Journal of Financial and Quantitative Analysis; Journal of Banking and Finance; Journal of Money, Credit and Banking; Financial Management; Journal of Financial Research; Journal of Financial Services Research; and Financial Review. Dr. Madura has received multiple awards for excellence in teaching and research. He has also served as a consultant for financial services firms. He has served as a director for the Southern Finance Association and Eastern Finance Association, and he is also former president of the Southern Finance Association.
Financial Literacy
PRE-TEST

The following test will help you determine how much you already know about personal finance. It contains basic questions that can determine your ability to make proper financial planning decisions. This text explains the concepts identified in the test that are essential to make financial planning decisions. It also covers more analytical concepts that can allow you to develop an effective financial plan.

After taking the test, grade your performance based on the answers provided at the end of the test.

1. If you give something up as a result of making a decision, you are incurring a(n) ________.
   a. liquidity problem
   b. net cost
   c. opportunity cost
   d. none of the above

2. ________ sell shares to individuals and invest the proceeds in investment instruments such as bonds or stocks.
   a. Financial plans
   b. Budget plans
   c. Mutual funds
   d. none of the above

3. When finding the present value of a future value or the present value of an annuity, the ________ the interest rate, the ________ the present value.
   a. higher; higher
   b. lower; lower
   c. higher; lower
   d. none of the above

4. ________ reduce taxable income if the taxpayer does not itemize.
   a. The standard deduction
   b. Dividends
   c. Capital gains
   d. none of the above

5. When the Federal Reserve wishes to ________ interest rates, it ________ the amount of funds at commercial banks.
   a. reduce; reduces
   b. increase; increases
   c. reduce; increases
   d. Answers (a) and (b) are correct.

6. A ________ offered by a depository institution specifies a minimum amount that must be invested, a maturity date on which the deposit matures, and an annualized interest rate.
   a. NOW account
   b. money market deposit account
   c. certificate of deposit
   d. savings account

7. In all cases of identity theft, you should notify the ________.
   a. FTC
   b. U.S. Postal Service
   c. FBI
   d. Secret Service

8. The ________ quoted on credit represents the simple interest rate charged after including any fees imposed by the creditor.
   a. annual percentage rate (APR)
   b. money market rate (MMR)
   c. effective annual rate (EAR)
   d. debit card rate (DCR)
9. Which of the following is not a disadvantage of leasing?
   a. You may have to purchase more car insurance than you already have.
   b. You must worry about finding a buyer for the car at the end of the lease period.
   c. You have no equity investment in the car.
   d. You may be charged if you drive more than a maximum number of miles specified in the original lease agreement.

10. When purchasing a home, which of the following costs will you not incur?
   a. Closing costs
   b. Loan application fee
   c. Real estate broker’s commission
   d. Down payment

11. A deductible of $500 requires 
   a. you to pay the first $500 in damages
   b. the party at fault to pay the first $500 in damages
   c. the insurance company to pay the first $500 in damages
   d. none of the above

12. 
   a. Insurance from Social Security
   b. Employer disability insurance
   c. Insurance from worker’s compensation
   d. All of the above are sources of disability income insurance.

13. For a given life insurance policy with specific benefits, the insurance premium is related to one’s age.
   a. rarely
   b. never
   c. positively
   d. inversely

14. 
   a. Making decisions based on unrealistic goals
   b. Borrowing to invest
   c. Taking risks to recover losses from previous investments
   d. All of the above are common investment mistakes made by individuals.

15. When investors purchase stock on margin, they
   a. are buying stock in the over-the-counter market.
   b. are using a buy-stop order.
   c. are borrowing money from the brokerage firm to fund part of the purchase.
   d. are lending money to the brokerage firm.

16. The ______ a bond provides credit.
   a. shareholder of
   b. investor in
   c. issuer of
   d. none of the above

17. Which of the following is not a motive for investing in mutual funds?
   a. The expertise of the portfolio managers who decide how to invest the money you provide
   b. Mutual funds are designed to meet specific investment goals
   c. Investing in a broadly diversified portfolio with a small initial investment
   d. All of the above are motives for investing in mutual funds.

18. The price at which an option can be exercised is the ______.
   a. premium
   b. put add-on
   c. call price
   d. exercise price

19. Individuals subject to a ______ income tax rate enjoy the greatest tax benefits as a result of using a retirement plan.
   a. middle
   b. high
   c. zero
   d. low

20. The executor of a will is also referred to as the ______.
   a. grantor
   b. guardian
   c. personal representative
   d. trustee

Answers
   1. C
   2. C
   3. C
   4. A
   5. C
   6. C
   7. A
   8. A
   9. B
   10. C
   11. A
   12. D
   13. C
   14. D
   15. C
   16. B
   17. D
   18. D
   19. B
   20. C