

# Most Americans Fail at Financial Literacy. Here Are 3 Concepts You Absolutely Need to Know

**My Comments:** A dilemma for many people is they find the language used by those of us in the world of finance and economics very hard to understand. It goes in one ear and comes out the other.

I'm about to launch an internet course that will help solve this problem. I call it Successful Retirement Secrets. Look for a blog post in the coming days and an opportunity for everyone to see a free preview.

In the meantime, here are three concepts to get you started.

**Maurie Backman \ 21 MAR 2018 \ <https://tinyurl.com/vksr8ze5>**

Need a crash course on finances? We've got you covered.

While Americans might have no problem spending money, managing it is a different story. In fact, nearly two-thirds of U.S. adults can't pass a basic financial literacy test, according to the FINRA Foundation. Specifically, Americans have a hard time calculating interest payments, answering questions about financial risk, and understanding the relationship between bond prices and interest rates (the former falls when the latter rises, and vice versa). With that in mind, here are a few basic financial concepts everyone should know.

## **Compounding**

If you're not familiar with compounding, you're not alone -- but you'll also need a quick lesson, because this is a concept that can work both for you and against you. First, the positive. Compounding is the concept of earning interest on interest. Imagine you put \$2,000 in a savings account paying 1% interest per year. Let's also assume that interest compounds once a year. At the end of the first year, your account balance will be \$2,020. But if you leave that money where it is and your interest rate stays the same, then during the second year, you'll be earning 1% interest on \$2,020, as opposed to just the \$2,000 you initially put in.

Now here's where compounding really gets interesting. Imagine you're saving for retirement by socking away \$300 a month in an IRA or 401(k). Over a 40-year period, that's \$144,000 in out-of-pocket contributions. But if your investments deliver a 7% average yearly return, then you'll actually wind up with roughly \$719,000 after 40 years, because your earnings will have compounded over time.

Sounds pretty great, right? Don't get too excited, though, because compounding can also work against you. Any time you fail to pay off your credit card, for example, the balance you owe will accrue interest. But over time, you'll be charged interest on top of that interest, and you'll end up paying well more than the initial outstanding amount.

Imagine you rack up \$2,000 of debt on a credit card charging 20% interest. If it takes you three years to pay off that sum, it'll cost you a total of \$2,675. But if you manage to pay it off in just six months, you'll only spend \$2,118. Why? Because you'll be giving that interest less time to compound against you.

## **Inflation**

In 1940, a loaf of bread cost just \$0.10 on average. In 2013, it averaged \$1.98. Why is this significant? Because it illustrates the point that a dollar today will have less buying power in the future. It's a concept known as inflation, and it basically refers to the tendency of expenses to rise over time. This affects everything from housing to consumer goods to healthcare.

Why do you need to worry about inflation? It's simple: If you're eager to live comfortably in retirement (which you probably are), you'll need to start setting money aside today. But the money you contribute to your IRA or 401(k) today won't have the same buying power in 40 years as it does now. That's why it's crucial to grow your savings through smart investments -- to take advantage of compounding and keep up with or outpace inflation.

In the above example, we saw that investing \$3,600 a year at an average annual 7% return would result in \$719,000. If you were to take those same \$300 monthly contributions and house them in a savings account paying just 1% interest, then in 40 years, you'd have \$176,000 -- more than the \$144,000 you originally put away, but still hardly any growth to keep up with inflation.

As a result, that ending balance likely wouldn't be enough to pay for your living expenses when you're older, whereas \$719,000 will more likely enable you to retain the buying power you had when you first set that money aside.

## **Diversification**

We just saw how a 7% average annual return could turn a series of smaller contributions into a much larger sum. But why 7% and not another number?

The truth is, it's hard to say exactly what average return your investments might generate, but that 7% is a reasonable assumption for a stock-heavy portfolio based on the market's historical performance. In fact, it's for this reason that younger investors are typically advised to load up on stocks.

That said, you don't want to put all of your money in stocks. Rather, it's wise to spread your assets out over a variety of options, from stocks to bonds to cash to real estate. This way, if the stock market has a major downturn, you'll have other assets to tap that won't necessarily lose value the same way. It's a concept known as diversification, and it basically means putting your eggs in different baskets to protect yourself from severe market conditions.

There's even the potential to diversify within an asset type. For example, among your stock investments, you shouldn't have 90% in, say, biotech. Rather, you should invest in different industries so that if a particular sector goes down, you're not totally out of luck. Index funds are another great way to get some instant diversification in your stock portfolio, especially if you're new to investing and don't quite know how to choose individual stocks.

While you don't need to be a financial wizard to successfully manage your money, it's critical that you grasp these basic concepts and learn how to work them into your investment strategy. A little extra reading today could set the stage for a wealthier future.