Save or Invest: What's the Difference?

Learn when and how to implement these critical financial actions.

BY ANDE FRAZIER

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How much do I need to have saved for emergencies? What about paying for college or purchasing a second home? What about retirement? How do I decide when to save and when to invest? What's the difference between the two? There certainly is a lot to figure out, so let's break it down.

A Look at Savings

There's a difference between saving and investing. When you think of savings, think of having this money liquid to cover emergencies, take advantage of opportunities, and meet short-term goals. Accessibility is typically more important than the rate of return. Since you may need this money soon, you don't want it exposed to unnecessary risk.

Some people oppose taking any risk and would rather keep their money "safe." However, in exchange for this "safety," you might be losing money. With inflation running higher than it has been for decades, you should consider if you're earning enough in savings vehicles to outpace inflation. If the answer is no, then you might consider investing. Regardless, always work with a financial professional who listens to you and takes the time to understand your risk tolerance. This will help you to feel comfortable and that you're making the right decision with your money.

How much should you save? Ideally, 15% of your income. For the amount of money you should have on hand, aim for 6 months' worth of income. Why 6 months? Because this will give you enough time to find a new job, make a career change, or handle a relationship transition. Anything less can put too much pressure on you, which can lead to poorly thought-out decisions.

Given the variety of savings vehicles, here's an overview of the options so that you can make an informed decision.

High-Yield Savings Account

Typically, these accounts are found through online banks and credit unions and are insured by the Federal Deposit Insurance Corporation (FDIC) for up to $250,000. The advantage is that they can offer a higher interest rate than traditional savings accounts. Shop around to find out the minimums required to open these accounts, as they vary a bit. Also, ask about fees charged and withdrawal limits.

Interest-Bearing Checking Accounts

These accounts are like typical checking accounts but may pay a small amount of interest. They typically require a minimum balance to be maintained in the account to earn interest and may have higher maintenance fees or other requirements.

Money Market Accounts

Think of a savings account with checking account features. Monies are easily accessible, but there may be large minimum deposit requirements, withdrawal restrictions, and monthly maintenance fees. You can find these accounts at credit unions, online lenders, and banks with FDIC insurance up to $250,000.

Certificates of Deposit (CDs)

While you might be able to earn a little more from a CD, it'll come at a cost. Most CDs require you to lock up funds for 3 to 5 years, with penalties for early withdrawal. These are also FDIC insured up to $250,000.

U.S. Treasury Bonds

Backed by the federal government, U.S. Treasury bonds can provide a low-risk

option with higher interest than typical savings accounts. If you need the money before the 30 years are up, you can cash them in and get your money back with any interest earned up to that point. Although you'll have to pay federal tax on any interest, there are no state or local taxes due.

Cash Value of Life Insurance

Many people don't think about life insurance as a place to save money. However, it can be a very tax-efficient way to accumulate savings. Most policies will have guaranteed increases in cash value with additional nonguaranteed increases possible. Cash value doesn't show up on the Free Application for Student Aid (FAFSA®) form, so if you're thinking of college planning, this can be a great way to save. The bonus is you also have a death benefit, which helps replace income lost due to death.

Diving into Investing

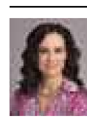
Now that we've discussed some of the places we can save, how do we know when to invest? When you have more time, aren't looking to use this money in the short term, and are willing to take a bit of risk, you can consider investing. Longer-term goals have the advantage of time, which can mean an opportunity to earn a little more on your money, leading to opportunities for investing—think retirement, college, and legacy planning.

When it comes to retirement, many have been told to save enough money to replace 80% of their income. However, with rising health care costs, spotty inflation, and planned obsolescence, it's more likely that you should consider investing enough to replace 100% of the income you made while working. This isn't easy to do since studies have shown that to make a portfolio of investments last 20 or 30 years, you should take no more than 4% off that portfolio a year. To give you an example, if you had a million dollars saved and took off 4%, then that would be $40,000 a year before taxes. Coupled with Social Security, that may not be enough to replace your income, and who knows what purchasing power will be like in the future. This is why saving early and habitually is key.

For college planning, many people look to 529 plans since you can grow your money tax-deferred and, if the monies are spent on qualified educational expenses, those monies can be withdrawn tax-free. Yet, if the child you're purchasing the 529 plan for gets a scholarship or decides not to go to college, your options are to transfer the 529 plan to another child or take the money out and pay ordinary income tax on the growth of that account. There are other alternatives to 529 plans, including regular investing in mutual funds, stocks, bonds, and cash-value life insurance. With college costs rising, many families can't simultaneously save for college and retirement. When you must make a choice, remember you can finance college, but you can't finance retirement.

As far as where to invest, that depends on your risk tolerance. The question is not how much risk should you take, but rather, how much are you willing to lose. There are a variety of places to invest; mutual funds, stocks, bonds, real estate investment trusts (REITs), and investment real estate, just to name a few. Deciding where to invest isn't really the most important part. The most important part is asking yourself, what's the true purpose of this money? How does it fit inside my overall financial plan?

Organizing your financial decisions into a coordinated plan allows you to think about what you want your money to do for you. When you have a plan, it's easier to decide when to save, when to invest, and where you should do both.



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