Building Wealth

A BEGINNER'S GUIDE TO SECURING YOUR FINANCIAL FUTURE

FEDERAL RESERVE BANK OF DALLAS

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Financial education supports not only individual well-being, but also the economic health of our nation.

Ben S. Bernanke, Chairman,
Federal Reserve System

Building Wealth: A Beginner's Guide to Securing Your Financial Future offers introductory guidance to individuals and families seeking help to develop a plan for building personal wealth. While a comprehensive discussion of accounting, finance and investment options is beyond the scope of this workbook, it presents an overview of personal wealth-building strategies. For more information and assistance, consult the resource guide at the back. For additional copies of this workbook (also available in Spanish), call (800) 333-4460, ext. 5254, or order online, dallasfedbuildingwealth.org. *Building Wealth* is also available as an animated online interactive version and a mobile app; both versions may be accessed directly from our website. The mobile app is also available as a free download in the app stores for Android, Apple and BlackBerry mobile devices. All *Building Wealth* materials are available at dallasfedbuildingwealth.org.

Building Wealth

You can create personal wealth. It's possible to meet your financial goals. By choosing to budget, save and invest, you can pay off debt, send your child to college, buy a comfortable home, start a business, save for retirement and put money away for a rainy day. Through budgeting, saving and investing, building credit and controlling debt, all these goals are within your reach.

DEFINING WEALTH

Some people consider themselves wealthy because they live in a very expensive house and travel around the globe. Others believe they are wealthy simply because they're able to pay their bills on time. What we are talking about here is financial wealth and what it means to you. In the following space, write your definition.

Wealth is…

1. ______________________________

2. ______________________________

3. ______________________________

Examples: Wealth is…

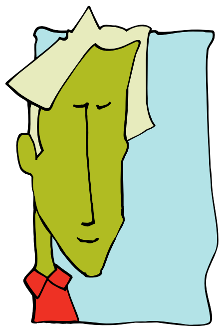
1. *being able to put my kids through college.*

2. *having enough money to buy a house.*

Now that you have defined what wealth means to you, how do you acquire it?

Building wealth requires having the right information, planning and making good choices. This workbook provides basic information and a systematic approach to building wealth. It is based on time-honored principles you probably have heard many times before—budget to save; save and invest; build credit; control debt; and protect the wealth you accumulate.

① Wealth Creation:
Learn the Language



Bob

If you make a good income each year and spend it all, you are not getting wealthier. You are just living high.
Thomas J. Stanley and William D. Danko, *The Millionaire Next Door*

You want to create personal wealth, right? So does Bob.

Bob is 35 and works for a manufacturing company. He looked at his finances and realized that at the rate he was going, there wouldn't be enough money to meet his family's financial goals. So he chose to embark on a personal wealth-creation strategy. His first major step was to pick up a copy of this workbook for guidance. Bob began by learning the language of wealth creation. The first lesson was to understand the meaning of **assets**, **liabilities** and **net worth**. They make up this very important formula:

ASSETS – LIABILITIES = NET WORTH

A wealth-creating ***asset*** is a possession that generally increases in value or provides a return, such as:

- A savings account.
- A retirement plan.
- Stocks and bonds.
- A house.

Some possessions (like your car, big-screen TV, boat and clothes) are assets, but they aren't wealth-creating assets because they don't earn money or rise in value. A new car drops in value the second it's driven off the lot. Your car is a tool that takes you to work, but it's not a wealth-creating asset.

The market value of a home is an asset; the mortgage, a liability. Let's say your house is worth $120,000, but your mortgage is $80,000. That means your equity in the home is $40,000. Equity contributes to your net worth.

A ***liability***, also called debt, is money you owe, such as:

- A home mortgage.
- Credit card balances.
- A car loan.
- Hospital and other medical bills.
- Student loans.

Net worth is the difference between your assets (what you own) and your liabilities (what you owe). Your net worth is your wealth.

To calculate how much he is worth, Bob used the following formula: **Assets – Liabilities = Net Worth**. He made a balance sheet listing all his assets and all his liabilities. He listed his wealth-building assets first.

Bob discovered his net worth is $24,000. Using Bob's balance sheet as an example, figure your own net worth. Be sure to add any assets and liabilities you have that are not listed here. Remember that net worth is your wealth. Are you worth as much as you want to be?

Bob's Balance Sheet

Wealth-building assets	Amount
Cash	$ 1,500
Savings account	1,000
Stocks, bonds and other investments	5,000
401 (k) retirement plan /IRA	25,000
Market value of home	0
Other assets	
Market value of car	14,000
Total assets	$ 46,500

Liabilities	Amount
Home mortgage	$ 0
Home equity loan	0
Car loan balance	13,000
Credit card balances	3,000
Student loan	5,000
Miscellaneous liabilities	1,500
Total liabilities	$ 22,500
Net worth	$ 24,000

My Balance Sheet

Wealth-building assets	Amount
Cash	
Savings account	
Stocks, bonds and other investments	
401 (k) retirement plan /IRA	
Market value of home	
Other assets	
Market value of car	
Total assets	

Liabilities	Amount
Home mortgage	
Home equity loan	
Car loan balance	
Credit card balances	
Student loan	
Miscellaneous liabilities	
Total liabilities	
Net worth	

② Budget to Save

What would you like your net worth to be

5 years from now? $ ______________________

10 years from now? $ ______________________

SET FINANCIAL GOALS

It takes as much energy to wish as it does to plan.
Eleanor Roosevelt

Most people who have built wealth didn't do so overnight. They got wealthy by setting goals and pushing themselves to reach them. Bob set two short-term goals: (1) to save $3,000 a year for three years to have $9,000 for a down payment on a house, and (2) to pay off his $3,000 credit card debt within two years. Bob also set two long-term goals: (1) to save and invest enough to have $25,000 in 15 years for his children's college education, and (2) to have $5,000 a month to live on when he retires in 30 years.

A personal wealth-creation strategy is based on specific goals. In preparing your goals:

- Be realistic.
- Establish time frames.
- Devise a plan.
- Be flexible; goals can change.

In the space provided, list your top goals.

Example: Short-term

1. *In one year, add $500 to my emergency fund.*
2. *In two years, pay off $3,000 in credit card debt.*

Example: Long-term

1. *In 15 years, save $25,000 to help my child with college.*
2. *In 30 years, have $5,000 a month to live on.*

My short-term goals are:

1. ______________________
2. ______________________
3. ______________________

My long-term goals are:

1. ______________________
2. ______________________
3. ______________________

Now you, like Bob, can choose how to meet those goals. This is where budgeting to save comes into play.

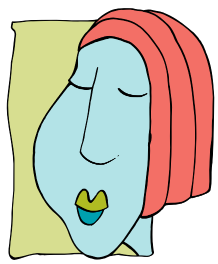
DEVELOP A BUDGET AND LIVE BY IT

When it comes to reaching your financial goals, are you doing or wishing? The difference is doers put action to their goals. And doers are much more likely to reach their goals and achieve their dreams.

If you are a doer, you are more likely to:

- Track spending.
- Live within your means.
- Stick to a budget.
- Pay off credit cards in a timely way.
- Deposit money into savings each month.
- Make regular contributions to retirement savings.

To maximize your wealth-creating ability, you want to be a doer, like Betty.


Betty

Betty is a single parent with one child. “I have to budget in order to live on my modest income. I have a little notebook I use to track where every dime goes. Saving is very important to me. When my son was born, I started investing every month in a mutual fund for his college education. I am proud to say that I control my future. I have bought my own home and provided for my son, and I’ve never bounced a check. You must have common sense regarding money!”


Lynne

Lynne, by contrast, doesn’t put action to her dreams. Lynne has a good job, makes good money and lives a pretty comfortable life, but her bank statement tells a different story. She has no savings or investments, owns no property and has no plans for retirement. Plus, she’s got a lot of credit card debt, lives from paycheck to paycheck and doesn’t budget.

You can choose to be like Lynne, or you can follow Betty’s road to wealth creation by learning to budget and save.

A budget allows you to:

- Understand where your money goes.
- Avoid overspending.
- Find money for saving and investing to build your wealth.

To develop a budget, you need to:

- Calculate your monthly income.
- Track your daily expenses.
- Determine how much you spend on monthly bills.

Track Day-to-Day Spending

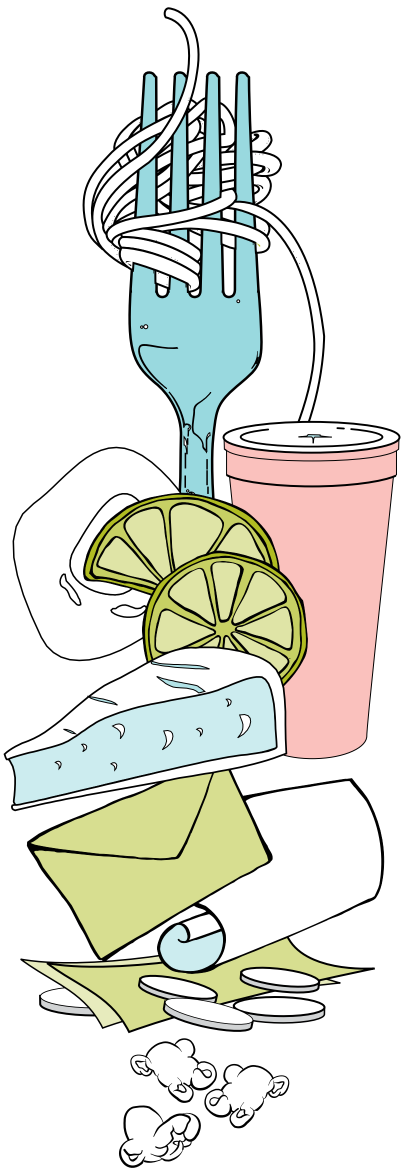
One day, Lynne, the dreamer, realized that to create wealth she had to become more of a doer, like Betty, and plan her financial future. To start, Lynne looked at her finances to see how much money she made and how she was spending it. She set a goal to save $125 a month to put toward her wealth-creation goals. First, she calculated her income. Then she added up her monthly bills.

She also carried a little notebook in her purse for jotting down her daily spending, whether by cash or debit card, check or credit card. Here is a page from her notebook.

Lynne's Day-to-Day Spending

Date	Expense	Cash/debit/check	Charge
1/2	Breakfast, Get-N-Go	$ 3.56	
1/2	Coffee	1.90	
1/2	Lunch		$ 6.75
1/2	Soft drink	1.25	
1/2	Gas for car		46.00
1/2	Drinks with friends	10.00	
1/2	Groceries		50.00
1/2	Dinner	15.00	
1/2	Newspaper	.50	
1/3	Bacon and eggs, Moonlight Diner	4.95	
1/3	Newspaper	.50	
1/3	Coffee	1.90	
1/3	Lunch with coworkers		5.72
1/3	Dinner		15.00
1/3	Dress		45.00
1/3	Soft drink	1.25	
1/3	Trip to the movies	15.00	
1/4	Breakfast	3.50	
1/4	Coffee	1.90	
1/4	Lunch	5.75	
1/4	Cookies	1.25	
1/4	Newspaper	.50	
1/4	Birthday present	15.00	
1/4	Dinner		6.77
1/5	Breakfast	3.25	
1/5	Coffee	1.90	
1/5	Soft drink	1.25	
1/5	Newspaper	.90	
1/5	Magazine	3.95	
1/6	Breakfast	3.25	
1/6	Coffee	1.90	
1/6	Newspaper	.50	
1/6	Lunch	4.50	
1/6	Cookies	1.25	
1/6	Jacket		50.00
1/6	Movie rental	3.95	

You can study your own spending habits by using this sheet to track daily expenses. Be sure to include items purchased with credit cards, as well as those purchased with cash, debit card or check. Seeing where your money is going now will help you see where you need to make changes to start building wealth.



My Day-to-Day Spending

Date	Expense	Cash/debit/check	Charge

Get a Handle on Income and Expenses

Lynne used the information from tracking her day-to-day expenses to develop a monthly budget. When Lynne reviewed her budget, she realized she was spending more than she earned. This means she was building debt, not wealth. Lynne knew if she were ever going to save $125 a month, she had to cut her expenses, earn more money, or both. She worked overtime at her company, which increased her take-home pay. She bought fewer clothes, discontinued premium cable TV channels, carpooled to work to cut gas consumption and reduced her spending on eating out and entertainment. Tracking her expenses paid off. Lynne successfully developed a budget that enables her to save $125 each month.

Here is her budget. If Lynne sticks to it, she will have $125 a month that she can:

- Put in a savings account.
- Invest in a 401(k) retirement plan at work.
- Invest in an individual retirement account (IRA).
- Invest in stocks, bonds or mutual funds.
- Use to pay off debt.

These are just some of the wealth-building choices available when you budget to save.

Lynne's Monthly Budget

	Current income	Income changes	New budget
Take-home pay	$ 2,235		$ 2,235
Overtime pay		$ 40	$ 40
Pension, Social Security benefits			
Alimony/child support			
Other income			
Total income	$ 2,235	$ 40	$ 2,275

	Current expenses	Spending changes	New budget
Rent	$ 680		$ 680
Renter's insurance	20		20
Electricity	60		60
Gas	30		30
Water	25		25
Telephone	50		50
Cable TV/Internet service	55	–20	35
Insurance (life, disability)	0		0
Charitable donations	0		0
Credit card payment	25		25
Groceries	200		200
Clothing	130	–30	100
Day care/tuition	0		0
Car loan	300		300
Car insurance	75		75
Gas for car	145	–20	125
Meals out & entertainment	425	–50	375
Miscellaneous daily expenses	100	–50	50
Total expenses	$ 2,320	$ –170	$ 2,150
Monthly net (income – expenses)	$ –85		$ 125

Available to save or invest	$ 0		$ 125

Using Lynne's budget as an example, track your income and expenses. Identify changes you can make to increase your income or decrease your expenses, and develop a new budget that includes more savings. Be sure to make reasonable budget changes that you can live with month to month.

To help you maintain the discipline to save:

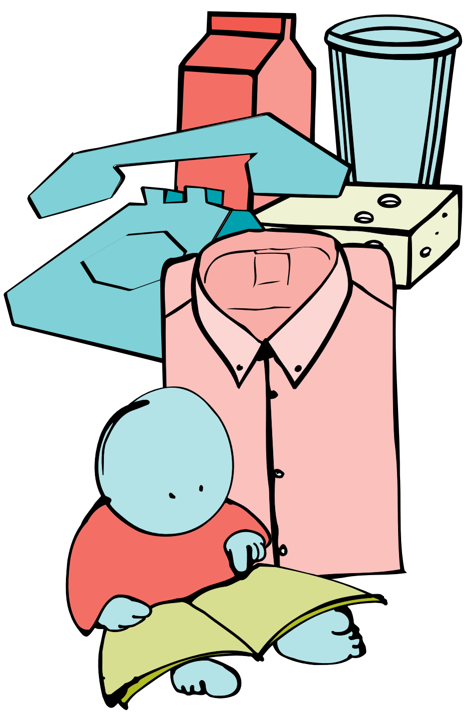
- Save every month.
- Have savings automatically deducted from your paycheck or checking account.
- Base your budget on what's left.

In other words, get on automatic pilot and stay there.

How much do you currently save each month? $ ____________

How much are you ***going*** to save each month? $ ____________

You have now successfully budgeted to save. The next step is saving and investing.



My Monthly Budget

	Current income	Income changes	New budget
Take-home pay			
Overtime pay			
Pension, Social Security benefits			
Alimony/child support			
Other income			
Total income			

	Current expenses	Spending changes	New budget
Rent/House Payment			
Property insurance			
Electricity			
Gas			
Water			
Telephone			
Cable TV/Internet service			
Insurance (life, disability)			
Charitable donations			
Credit card payment			
Groceries			
Clothing			
Day care/tuition			
Car loan			
Car insurance			
Gas for car			
Meals out & entertainment			
Miscellaneous daily expenses			
Total expenses			
Monthly net (income – expenses)			

Available to save or invest			

3 Save and Invest

Take the power of compound interest seriously—and then save.
Dwight R. Lee and Richard B. McKenzie, *Getting Rich in America*

You have budgeted and identified an amount to save monthly. Where are you going to put your savings? By investing, you put the money you save to work making more money and increasing your wealth. An ***investment*** is anything you acquire for future income or benefit. Investments increase by generating income (interest or dividends) or by growing (appreciating) in value. Income earned from your investments and any appreciation in the value of your investments *increase* your wealth.

GET GUIDANCE

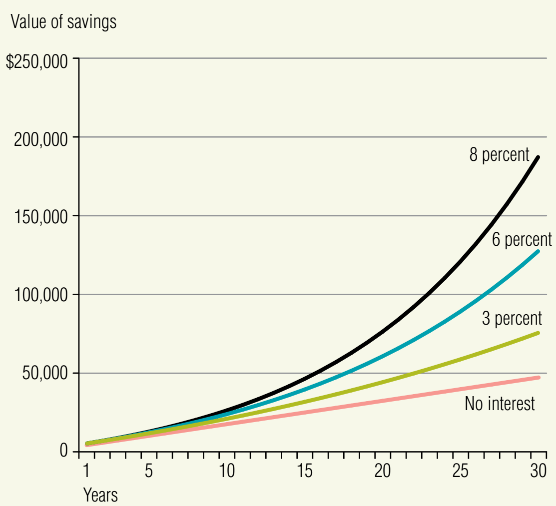
There is an art to choosing ways to invest your savings. Good investments will make money; bad investments will cost money. Do your homework. Gather as much information as you can. Seek advice from licensed or registered advisers. States require licensing or registration for brokers, investment advisers and insurance salespeople, so check with your state securities regulator before trusting any investment adviser. Also, check out the Wealth-Building Resource Guide on page 33 for helpful sites.

TAKE ADVANTAGE OF COMPOUND INTEREST

Compound interest helps you build wealth faster. Interest is paid on previously earned interest as well as on the original deposit or investment. For example, $5,000 deposited in a bank at 6 percent interest for a year earns $308 if the interest is compounded monthly. In just 5 years, the $5,000 will grow to $6,744.

Let's see how interest compounds on Lynne's savings. Assume that Lynne saves $125 a month for 30 years and the interest on her savings is compounded monthly.

The Compound Interest Advantage



Examples assume $125 monthly deposits;
the compound interest examples assume monthly compounding.

The chart to the left shows how compound interest at various rates would increase Lynne's savings compared with simply putting the money in a shoebox. This is compound interest that you earn. And as you can see from Lynne's investment, compounding has a greater effect after the investment and interest have increased over a longer period.

There is a flip side to compound interest. That is compound interest you are charged. This compound interest is charged for purchases on your credit card. Chapter 4, "Build Credit; Control Debt," discusses this type of interest.

UNDERSTAND THE RISK–EXPECTED RETURN RELATIONSHIP

An investment in knowledge always pays the best interest.
Benjamin Franklin

When you are saving and investing, the amount of expected return is based on the amount of risk you take with your money. Generally, the higher the expected return, the higher the risk of losing money. For less risk, an investor will expect a smaller return.

For example, a savings account at a financial institution is fully insured by the Federal Deposit Insurance Corp. up to $250,000. The return—or interest paid on your savings—will generally be less than the expected return on other types of investments.

On the other hand, an investment in a stock or bond is not insured. The money you invest may be lost or the value reduced if the investment doesn't perform as expected.

After deciding how much risk you are able to take, you can use the investment pyramid to help balance your savings and investments. You should move up the pyramid only after you have built a strong foundation.

HOW MUCH RISK DO YOU WANT TO TAKE?

Here are some things to think about when determining the amount of risk that best suits you.

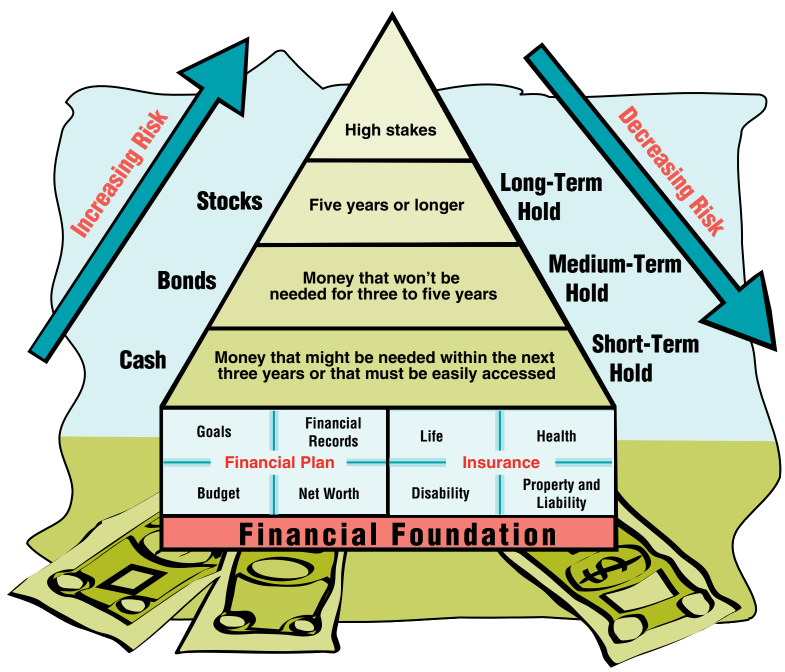
Financial goals. How much money do you want to accumulate over a certain period of time? Your investment decisions should reflect your wealth-creation goals.

Time horizon. How long can you leave your money invested? If you will need your money in one year, you may want to take less risk than you would if you won't need your money for 20 years.

Financial risk tolerance. Are you in a financial position to invest in riskier alternatives? You should take less risk if you cannot afford to lose your investment or have its value fall.

Inflation risk. This reflects savings' and investments' sensitivity to the inflation rate. For example, while some investments such as a savings account have no risk of default, there is the risk that inflation will rise above the interest rate on the account. If the account earns 5 percent interest, inflation must remain lower than 5 percent a year for you to realize a profit.

Investment Pyramid



NOTE: Information not intended as specific individual investment advice.

SOURCES: National Institute for Consumer Education, Eastern Michigan University; AIG VALIC.

TOOLS FOR SAVING

A good first step toward saving is to open a savings account at a bank or credit union. With a savings account, you can:

- Take advantage of compound interest, with no risk.
- Keep your money safer than in your pocket or at home.
- Take advantage of direct deposit of your paycheck.
- Monitor your balance online.

Financial institutions offer a variety of savings accounts, each of which pays a different interest rate. The box below describes the different accounts. Find the best one for your situation and compare interest rates and fees. You can choose to use these typical accounts to save for the near future or for years down the road.

Individual Development Accounts

In some communities, people whose income is below a certain level can open an individual development account (IDA) as part of a money-management program organized by a local nonprofit organization. IDAs are generally opened at a local bank. Deposits made by the IDA account holder are often matched by deposits from a foundation, government agency or other organization. IDAs can be used for buying a first home, paying for education or job training, or starting a small business.

Training programs on budgeting, saving and managing credit are frequently part of IDA programs.

Find an IDA program near you: cfed.org/programs/idas.

Types of Savings Accounts

Savings account (in general)

- Access your money at any time.
- Earn interest.
- Move money easily from one account to another.
- Savings insured by the FDIC (NCUA for credit unions) up to $250,000.

Money market account

- Earn interest.
- Pay no fees if you maintain a minimum balance.
- May offer check-writing services.
- Savings insured by the FDIC/NCUA up to $250,000.

Certificate of deposit (CD)

- Earn interest during the term (three months, six months, etc.).
- Must leave the deposit in the account for the entire term to avoid an early-withdrawal penalty.
- Receive the principal and interest at the end of the term.
- Savings insured by the FDIC/NCUA up to $250,000.

TOOLS FOR INVESTING

Once you have a good savings foundation, you may want to diversify your assets among different types of investments. ***Diversification*** can help smooth out potential ups and downs of your investment returns. Investing is not a get-rich-quick scheme. Smart investors take a long-term view, putting money into investments regularly and keeping it invested for five, 10, 15, 20 or more years.

Bonds—Lending Your Money

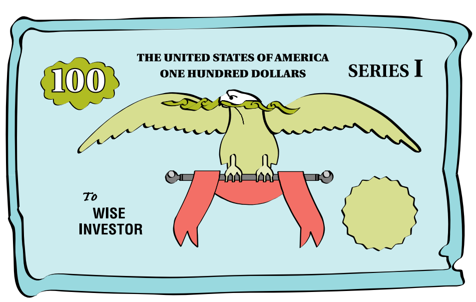
Bonds. When you buy bonds, you are lending money to a federal or state agency, municipality or other issuer, such as a corporation. A bond is like an IOU. The issuer promises to pay a stated rate of interest during the life of the bond and repay the entire face value when the bond comes due or reaches maturity. The interest a bond pays is based primarily on the

A Good Rule of Thumb

The Rule of 72 can help you estimate how your investment will grow over time. Simply divide the number 72 by your investment's expected rate of return to find out approximately how many years it will take for your investment to double in value.

Example: Invest $5,000 today at 8 percent interest. Divide 72 by 8 and you get 9. Your investment will double every nine years. In nine years, your $5,000 investment will be worth about $10,000, in 18 years about $20,000 and in 27 years, $40,000.

The Rule of 72 also works if you want to find out the rate of return you need to make your money double. For example, if you have some money to invest and you want it to double in 10 years, what rate of return would you need? Divide 72 by 10 and you get 7.2. Your money will double in 10 years if your average rate of return is 7.2 percent.



credit quality of the issuer and current interest rates. Firms like Moody's Investor Service and Standard & Poor's rate bonds. With corporate bonds, the company's bond rating is based on its financial picture. The rating for municipal bonds is based on the creditworthiness of the governmental or other public entity that issues it. Issuers with the greatest likelihood of paying back the money have the highest ratings, and their bonds will pay an investor a lower interest rate. Remember, the lower the risk, the lower the expected return.

A bond may be sold at face value (called ***par***) or at a premium or discount. For example, when prevailing interest rates are lower than the bond's stated rate, the selling price of the bond rises above its face value. It is sold at a premium. Conversely, when prevailing interest rates are higher than the bond's stated rate, the selling price of the bond is discounted below face value. When bonds are purchased, they may be held to maturity or traded.

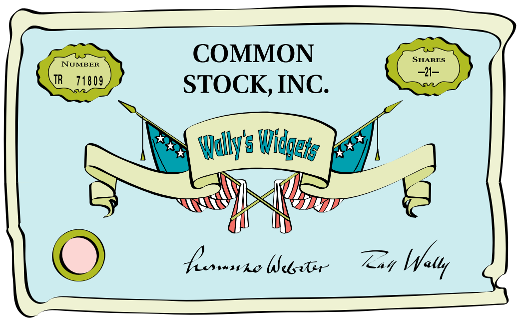
Savings bonds. ***U.S. savings bonds*** are government-issued and government-backed. Unlike other investments, you can't get back less than you put in. There are different types of savings bonds, each with slightly different features and advantages. ***Series I*** bonds are indexed for inflation. The earnings rate on this type of bond combines a fixed rate of return with the annualized rate of inflation. Savings bonds can be purchased in denominations ranging from $50 to $10,000.

NOTE: If you have paper U.S. savings bonds, you can register them online at TreasuryDirect, www.treasurydirect.gov. Then, you won't have to worry about losing the paper copy.

Treasury bonds, bills and notes. The bonds the U.S. Treasury issues are sold to pay for an array of government activities and are backed by the full faith and credit of the federal government. ***Treasury bonds*** are securities with terms of more than 10 years. Interest is paid semiannually. The U.S. government also issues securities known as Treasury bills and notes. ***Treasury bills*** are short-term securities with maturities of three months, six months or one year. They are sold at a discount from their face value, and the difference between the cost and what you are paid at maturity is the interest you earn. ***Treasury notes*** are interest-bearing securities with maturities ranging from two to 10 years. Interest payments are made every six months. ***Treasury Inflation-Protected Securities (TIPS)*** offer investors a chance to buy a security that keeps pace with inflation. Interest is paid on the inflation-adjusted principal.

Bonds, bills and notes are sold in increments of $1,000. These securities, along with U.S. savings bonds, can be purchased directly from the Treasury through TreasuryDirect at www.treasurydirect.gov.

Some government-issued bonds offer special tax advantages. There is no state or local income tax on the interest earned from Treasury and savings bonds. And in most cases, interest earned from municipal bonds is exempt from federal and state income tax. Typically, higher income investors buy these bonds for their tax benefits.



Stocks—Owning Part of a Company

When you buy ***stock***, you become a part owner of the company and are known as a ***stockholder***, or ***shareholder***. Stockholders can make money in two ways—receiving dividend payments and selling stock that has appreciated. A ***dividend*** is an income distribution by a corporation to its shareholders, usually made quarterly. ***Stock appreciation*** is an increase in the value of stock in the company, generally based on its ability to make money and pay a dividend. However, if the company doesn't perform as expected, the stock's value may go down.

There is no guarantee you will make money as a stockholder. In purchasing shares of stock, you take a risk on the company making a profit and paying a dividend or seeing the value of its stock go up. Before investing in a company, learn about its past financial performance, management, products and how the stock has been valued in the past. Learn what the experts say about the company and the relationship of its financial performance and stock price. Successful investors are well informed.

Mutual Funds—Investing in Many Companies

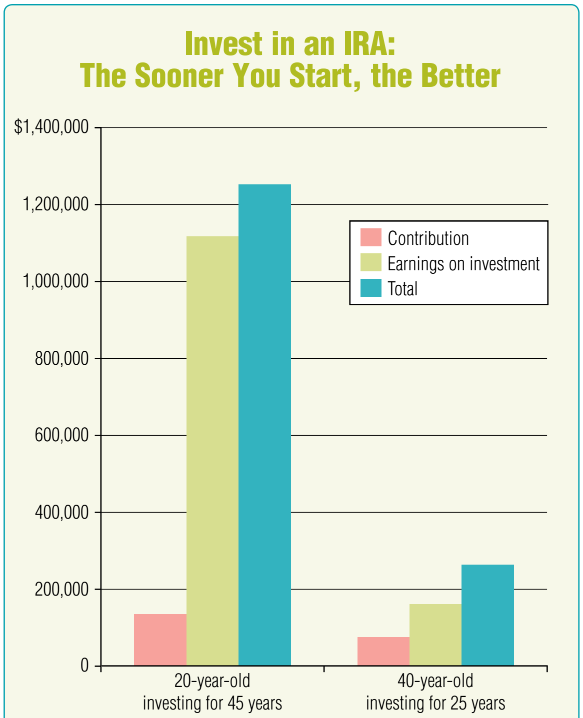
Mutual funds are established to invest many people's money in many firms. When you buy mutual fund shares, you become a shareholder of a fund that has invested in many other companies. By diversifying, a mutual fund spreads risk across numerous companies rather than relying on just one to perform well. Mutual funds have varying degrees of risk. They also have costs associated with owning them, such as management fees, that will vary depending on the type of investments the fund makes.

Before investing in a mutual fund, learn about its past performance, the companies it invests in, how it is managed and the fees investors are charged. Learn what the experts say about the fund and its competitors.

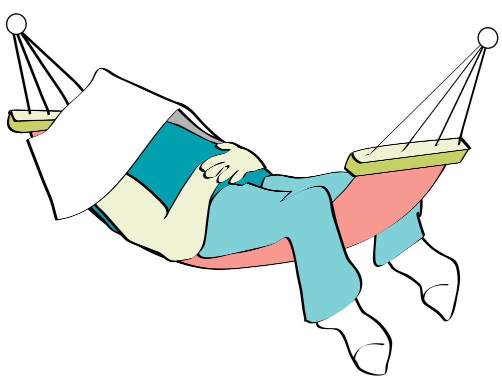
Stocks, bonds and mutual funds can be purchased through a full-service broker if you need investment advice, from a discount broker, or even directly from some companies and mutual funds. Remember, when investing in these products:

- Find good information to help you make informed decisions.
- Make sure you know and understand all the costs associated with buying, selling and managing your investments.
- Beware of investments that seem too good to be true; they probably are.

INVEST FOR RETIREMENT



Assumes an annual investment of $3,000 and an 8 percent rate of return.



Have you ever thought about how much money you will need when you retire? Will you save enough today to meet your future needs at prices higher than today's due to ***inflation***? Many people don't save enough for retirement.

The chart to the left illustrates why it's better to start saving and investing for retirement early in your career. A 20-year-old who begins investing $3,000 each year toward retirement will have a nest egg over $1.2 million at age 65 if that investment earns an average annual rate of return of 8 percent. If you wait until you are 40 to start investing, the results are much lower.

Individual Retirement Accounts

An individual retirement account (IRA) lets you build wealth and retirement security. The money you invest in an IRA grows tax-free until you retire and are ready to withdraw it. You can open an IRA at a bank, brokerage firm, mutual fund or insurance company. IRAs are subject to certain income limitations and other requirements you will need to learn more about, but here is an overview of what they offer, with the maximum tax-free annual contributions as of 2013.

You can contribute up to $5,500 a year to a ***traditional IRA***, as long as you earn $5,500 a year or more. A married couple with only one person working outside the home may contribute a combined total of $11,000 to an IRA and a ***spousal IRA***. Individuals 50 years of age or older may make an additional "catch-up" contribution of $1,000 a year, for a total annual contribution of $6,500. Money invested in an IRA is deductible from current-year taxes if you are not covered by a retirement plan where you work and your income is below a certain limit.

A traditional IRA is tax-deferred, meaning you don't pay taxes on the money until it is withdrawn. All withdrawals are taxable, and there generally are penalties on money withdrawn before age 59½. However, you can make certain withdrawals without penalty, such as to pay for higher education, to purchase your first home, to cover certain unreimbursed medical expenses or to pay medical insurance premiums if you are out of work.

A ***Roth IRA*** is funded by after-tax earnings; you do not deduct the money you pay in from your current income. However, after age 59½ you can withdraw the principal and any interest or appreciated value tax-free.