Money 101

1. Setting Priorities

Top things to know

1. Narrow your objectives.
You probably won't be able to achieve every financial goal you've ever dreamed of. So identify your goals clearly and decide which are most important -- by concentrating your efforts, you have a better chance of achieving what matters most.

2. Focus first on the goals that matter.
To accomplish primary goals, you will often need to put equally desirable but less important ones on a back burner.

3. Be prepared for conflicts.
Even worthy goals often conflict with one another. When faced with such a conflict, you can sometimes choose by applying criteria like: Will one of the conflicting goals benefit more people than the other? Which goal will cause the greater harm if it is deferred?

4. Put time on your side.
The most important ally you have in reaching your goals is time. Money stashed in savings accounts or invested in stocks and bonds grows and compounds. The more time you have, the more chance you have of success.

5. Choose carefully.
In drawing up your list of goals, you should look for things that will help you feel financially secure, happy or fulfilled. Some of the items that wind up on such lists include building an emergency fund, getting out of debt, and paying the kids' tuition. Once you have your list together, you need to rank the items in order of importance (if you have trouble doing so, use the CNN/Money Prioritizer for help).

6. Include family members.
If you have a spouse or significant other, make sure he or she is part of the goal-setting process. Children, too, should have some say in goals that affect them.

7. Start now.
The longer you wait to identify and begin working toward your goals, the more difficulty you'll have reaching them.

8. Sweat the big stuff.
Once you have prioritized your list of goals, keep your spending on course. Whenever you make a large payment for anything ask yourself: "Is this taking me nearer to my primary goals -- or leading me farther away from them?" If a big expense doesn't get you closer to your goals, try to defer or reduce it.

9. Don't sweat the small stuff.
Although this lesson encourages you to focus on big-ticket, long-range plans, most of life

is lived in the here-and-now and most of what you spend will continue to be for daily expenses -- including many that are simply for fun. That's okay -- so long as your long-range needs are also provided for.

10. Be prepared for change.
Your needs and desires invariably change as you age, so you should probably reexamine your priorities at least every five years.

Identifying goals

Unless you win the lottery, you probably won't achieve every financial goal. But you can go farther than you think if you focus on what matters most.

What are your top three financial objectives?

Most people, when asked that question, answer with general goals, such as achieving financial security.

The fact is, many of us have never thought much about which financial objectives really matter most. Instead, we muddle through our financial lives, spending to meet the day-to-day expenses that always clamor for attention. There's nothing terribly wrong with that approach -- except that it risks leaving the most important objectives unfulfilled.

That's what this lesson is all about: helping you to choose which financial goals matter most so that you can make sure they happen.

That's not as easy as it sounds, since financial goals continually collide with one another. Paying for a child's braces may rob money that would otherwise go into his college fund, for example. And saving effectively for your kids' college can wipe out any hope of putting aside adequate money for your own retirement.

That's why to get what you want most you must 1) decide which goals will take priority and 2) work toward the lesser goals only after the really important ones are well provided for.

Fortunately, you have at least one ally in meeting your long-range goals: time. That's an advantage because of the power of compounding -- the fact that even a small amount of money can earn interest, and that each year that interest gets applied to a growing sum of money.

Suppose, for example, you put aside only the cost of a single candy bar -- about 65 cents -- each day. Invested in a tax-deferred account paying 5 percent a year, that string of savings would grow to $3,079 in just 10 years and to $16,521 in 30 years. For other examples of the way that money can grow over time, try CNN/Money's **savings calculator**.

To put the power of compounding on your side, you have to start early. Suppose there are two siblings who both invest in Individual Retirement Accounts earning 8 percent a year. The sister starts at age 20, and for the next 10 years she stuffs $2,000 a year into her IRA. At age 30, though, she stops and never adds another penny.

Her brother waits until age 30 to get started, but then dutifully salts away $2,000 a year for the rest of his life. Which sibling do you think will be better off? In this case, the early bird will always be ahead. The sister reaches age 65 with over $428,000, while her brother will have a little under $345,000 -- about 20 percent less.

Of course, it's far better, to start early AND keep it up. If both siblings started saving

$2,000 a year in an IRA at 20, and keep it up until retirement, and you'd end up with nearly three-quarters of a million dollars.

The point is that to put time on your side, you need to decide early which of the many possible financial goals are really worth pursuing -- and start working toward them.

To get started, make a list of all the things that you'd need to feel secure, happy or fulfilled. These can range from the weighty (getting out of debt) to the luxurious (a Lamborghini). You don't need to prioritize them yet. But you should try to get down all of the money-related things that will really get your motor started. And if you have a spouse or significant other, it's a good idea to do this exercise together -- assuming you think your relationship can survive it! Here are some of the less frivolous items that you may want to include among the possibilities:

- Accumulating enough savings to handle an emergency
- Buying a house large enough to accommodate you comfortably
- Getting out of debt -- and staying out
- Ensuring that your parents are comfortable and well taken care of in their old age
- Paying for your children's college education
- Amassing enough wealth to retire comfortably

Once you have your list in hand, push on to the next section where you'll determine which of these goals are most important to you.

Resolving conflicts

Understanding your priorities can help you resolve conflicts among your goals.

After you've clarified your priorities, what do you do with your new insight? Each time you spend more than pocket change on a purchase that doesn't help you attain one of your chief goals, ask yourself whether the outlay is really necessary.

For example, let's say your highest priority is achieving financial independence. And let's say you've saved $4,000 to take the family on a vacation. If you take the trip, you'll be $4,000 farther from kissing the time clock good-bye. (Farther, actually, since $4,000 in savings would grow to nearly $20,000 invested for 20 years at a tax-deferred 8 percent -- as CNN/Money's Savings Calculator would show.) Of course, if your family has been expecting the trip for months, you'd be unfair to tell them that it's off. Instead, from the beginning you should have earmarked the cash for your investment portfolio and either planned a low-ticket vacation or worked a deal with family members to take the trip later.

Okay, you say, but that choice isn't terribly difficult. You're more concerned about tougher decisions -- choosing, for instance, among such priorities as health care, education and savings. Suppose, for example, that your father needs help paying for bypass surgery at the same time that you're getting socked with tuition bills and trying to save for retirement. All three expenses are at or near the top of your priority list. How do you resolve conflicts among them? No single approach will work for everyone -- but here are some guidelines that may help.

- **Is someone's health involved?** If you believe that the ultimate purpose of money is to make life better, then you might decide that saving cash at the cost of your well being -- or of a relative's -- is a poor choice. For most people, someone's illness is the rainy day for which they've been saving.

- **How many people will be affected by my choice?** Will one of your goals make your own life better while another will give equivalent help to two of your children? You could decide that when more people derive roughly equal benefit from a goal, its priority rises.
- **If two goals offer similar rewards, which causes the least harm?** This method of selection is typically a last resort, but it can be useful when no other analysis helps you decide among options.

Let's take the above supposition that your father needs expensive surgery, you have a child entering college and your retirement isn't adequately funded. Obviously there are a number of ways this decision could be analyzed. It would be selfish, for example, but not totally unreasonable to conclude that saving for your own retirement should be paramount. You know that you won't be able to live adequately on the money you expect from your pension and Social Security, and you don't want to depend on your kids for support.

As for the child in college, he can take out a tuition loan. And perhaps your dad can have the operation at a community hospital where it will cost less. That logic falls apart, however, when analyzed by the principles above. Both the "health" and the "least harm" principles suggest that helping your dad should be priority No. 1.

You can't put every nickel toward top priorities, of course -- nor should you. Instead, you need to set aside part of your income for current pleasures, so long as you have enough cash left over to put toward your long-range goals.

Also, remember that as the years go by, your priorities will change. You'll need to reexamine and rank your needs regularly throughout life in order to use your money most effectively.

When you can save a dollar, though, you need to decide why you're putting it away. In addition, if you acquire the habit of quickly rating the urgency of every big purchase against the primary financial goals you've set for yourself, you'll eventually find that your spending is under control.

Making plans

Now that you've identified the right goals, here are examples of some game plans that will achieve them.

Here are examples of plans you might draw up to meet three of the most common objectives: getting out of debt, paying for college, or financing a retirement:

Getting out of debt
If you struggle to meet credit-card payments every month, then face it: You probably need to shed or consolidate some of that debt. For example, suppose you owe $3,000 in outstanding credit-card debt at a 16 percent interest rate and a $10,000 car loan at 9 percent. To pay off both these obligations in a year, you'd need to pony up $1,150 a month.

But if you are a home owner with equity in your property, you could borrow $13,000 on a home-equity loan at the same 9 percent and retire those other bills. Then your cost to pay off the home-equity loan in a year would be lower -- $1,140 a month -- because you're no longer paying high credit-card rates of interest. Moreover, because you can deduct the interest on most home-equity loans, you'd reduce your taxable income by $680 that year -- a $210 saving for someone in the 31 percent federal tax bracket. In effect, the government would help you pay off your nagging expenses.

Of course, this kind of strategy works only if you stop putting new charges on your credit cards at the same time.

Paying for college
Tuition, room and board at a private college can cost upward of $30,000 a year, and that bill is projected to reach $78,000 (based on projections by T. Rowe Price) by the time this year's crop of newborns are entering college.

Your children may qualify for financial aid either in the form of a scholarship or a loan, and many students work their way through college. But if you want to spare your kids the burden of graduating in debt, there are a couple of good savings vehicles available to you. Most states now offer so-called 529 Plans -- contributions go into in pre-selected mutual funds, grow tax-free each year, and withdrawals to pay tuition are also tax free. For more on 529 Plans, click here.)

You could also open a Coverdell Education Savings Account (previously called an Education IRA) that lets you put $2,000 a year, after taxes, into a bank account or other investments; earnings on that type of account are totally tax-free, provided the money is used for tuition when it's withdrawn.

It's amazing how far these plans will get you. For example, if you started putting $2,000 a year today into a Coverdell account earning 8 percent, after 18 years you'd have more than $80,000. If you keep in mind that being able to pay your newborn's college costs is more important to you than, say, driving a luxury car, then stick with a family car instead. Let your priorities direct your discretionary spending.

Financing a retirement
A popular rule of thumb says that retirees need only 70 percent of their pre-retirement income to maintain their lifestyle, since they no longer have to pay for such costs as commuting or for work clothes.

However, other costs go up in retirement, such as utility bills (if you're home all day), the price of hobbies and travel -- and, of course, the cost of health care. In fact, some retirees find they need as much income in retirement as they spent while working.

Unfortunately, traditional pensions pay only a fraction of your salary, and Social Security won't make up the difference. In addition, the younger you are, the less certain you can be about how much money you'll receive at age 65 from any of the retirement plans you have today. Why? Because Social Security benefits may be revised, and employers are free at any time to change their pension-plan formulas. (They can't do so retroactively -- every retirement dollar that you've already qualified for is yours to keep.) And of course, Congress can change the laws governing retirement savings plans at any time.

So to make your retirement finances secure, you need to contribute to as many different plans as possible. If you have a 401(k), 403(b) or 457 program at work, put in as much money as you can. Most employers will match your contributions, giving you money for retirement that you won't get any other way. If you have no retirement plan at work, contribute to an IRA. Note that contributions to all of these plans are tax deferred, so that you, Uncle Sam and your boss together could be adding to your retirement stash.

Then to insure against possible new retirement-plan rules mandated by Congress, you need to have your own taxable savings plan as well -- ideally invested in stocks, bonds, or mutual funds which generally return more than bank accounts. Best of all, as your investing account grows, it can help you finance other goals as well.

2. Making a Budget

Top things to know

1. Budgets are a necessary evil.
They're the only practical way to get a grip on your spending so you can make sure your money is used the way you want it.

2. Creating a budget generally requires three steps.
They are: 1) identify how you spend money now, 2) evaluate that spending and set goals that take into account your financial objectives, and 3) track your spending to make sure it stays within those guidelines.

3. Use software to save grief.
If you use a personal-finance program such as Quicken or Microsoft Money, the built-in budget-making tools can create your budget for you.

4. Don't drive yourself nuts.
One drawback of monitoring your spending by computer is that it encourages overzealous attention to detail. Once you determine which categories of spending can and should be cut (or expanded), concentrate on those categories and worry less about other aspects of your spending.

5. Watch out for cash leakage.
If withdrawals from the ATM machine evaporate from your pocket without apparent explanation, it's time to keep better records. In general, any time cash expenses exceed 5 percent of your total spending, they need to be checked.

6. Spending beyond your limits is dangerous.
If so, you've got plenty of company. Government figures show that many households with total income of $50,000 or less are spending more than they bring in. This doesn't make you an automatic candidate for bankruptcy -- but it's definitely a sign you need to make some serious spending cuts.

7. Beware of luxuries dressed as necessities.
If your income doesn't cover your costs, then some of your spending is probably for luxuries -- even if you've been considering them to be filling a real need.

8. Tithe yourself.
Aim to spend no more than 90 percent of your income. That way, you'll have the other 10 percent left to save for your big-picture items.

9. Don't count on windfalls.
When projecting the amount of money you can live on, don't include dollars that you can't be sure you'll receive, such as year-end bonuses, tax refunds or investment gains.

10. Beware of spending creep.
As your annual income climbs from raises, promotions and smart investing, don't start spending for luxuries until you're sure that you're staying ahead of inflation.

The dubious joy of budgets

Most people would rather stick pins in their eyes than draw up a budget. They may have a point.

If you're the type of person who always has plenty of cash, knows exactly where every penny goes and never has trouble paying bills, skip this chapter. You're either too rich or too smart to need it.

For the rest of us, unfortunately, making -- and sticking to -- a budget is the essential tool for ensuring that our money gets used the way we need it to. And even if you're in the happy situation of having plenty of income, the homework involved in drawing up a budget can be instructive since you may find that you are spending more than you wish on items like music CDs, electronic gadgetry or restaurant meals.

Not that drawing up a budget is any barrel of laughs. On the contrary, it's pure drudgery enlivened only by the occasional anguish of staring your own foolish spending habits square in the face. In fact, one of the chief impediments to budgeting is that most people would rather not know how they really use their money. It's bad enough to learn this kind of information on your own. It's even worse when a spouse or significant other finds out, since it usually confirms his or her worst fears -- and provides new ammunition for future "discussions."

Take heart. However unwise you are about spending your money, others are likely to be just as foolish in their own way. Moreover, the pain of budgeting comes mostly at the beginning. After you have a budget in place, and you've fine-tuned it with a couple of months of actual spending, then tracking your expenditures becomes almost automatic. If your boss at work were to ask you for an analysis of the department's spending, you'd figure it out quickly enough. Budgeting your household should be approached in the same businesslike fashion. And there are a variety of ways that electronic tools can make the process easier.

Listing expenses

To build a realistic budget, start by figuring out where your money goes now.

There are three steps to creating a budget: 1) identify how your money is currently being spent, 2) evaluate that spending to see if it meets the financial priorities you specified in Lesson 1, and 3) track your ongoing spending to make sure it stays within those guidelines (or to understand how your budget needs to be revised).

If you happen to use Quicken, Microsoft Money or other such software, you're in luck. These programs generally make it easy to draw up a budget.

In Quicken, for example, every time you make a deposit, write a check, pay a credit card bill or dispatch an electronic payment you are asked to assign it to a particular category, such as "salary," "clothing," "groceries," "child care" or "health insurance." You can also create subcategories, dividing "auto" expenses into "fuel," "insurance" and "service." The program comes with a set of categories that handle most of the basics. You can edit the list to create categories that make better sense for your particular household. And if you're away from home, you can track expenses at the Quicken website and then download the transactions to your hard disk later.

The drawback, of course, is that entering and categorizing all of your income and outflow is a truly tedious chore.

You can reduce the tedium to some degree by judicious selection of categories. Let's say you are only worried about tracking your spending for recreation and leisure pursuits. You could create categories that cover those types of expenses, and let everything else accumulate under "miscellaneous revenue" or "miscellaneous expense."

The problem with that approach is that you forgo the opportunity to spot problems in other spending areas that you may not even be aware of. So a better solution is to track expenses using electronic banking. That way, you can download your payments and deposits directly from the bank, rather than having to enter them by hand.

The downloaded banking transactions generally show up without any categorization -- meaning you'll have to add the categories by hand. But if you use a credit card that is issued by a bank that permits electronic access, then the downloaded charges from your card sometimes do come with categories attached (they aren't always right, so check them).

Either way, once you've got your spending tracked by category, then drawing up a report requires only a few clicks of the mouse. Even better, such programs often have an automatic budget-creation feature that scans your spending in the past in order to estimate how much you'll spend going forward.

If your finances aren't wired, you can still get a good handle on your spending the old-fashioned way. Start by getting all your records together from the past 12 months, including pay stubs, loan proceeds, withdrawal slips, canceled checks and itemized credit-card statements. Then go through them and compile totals for your income and expenses in a set of categories that make sense for you.

At the end of this exercise, you may still have a sizable lump of spending that's undocumented -- typically, the money you withdraw in cash and then spend on day-to-day needs. If this portion of your budget is more than about 5 percent of your total spending, you ought to go through one further step to understand where it is going. That is, keep a journal for the next four weeks in which you record every nickel you spend. You can use those results to extrapolate how your cash is being spent throughout the year.

Now that you've got a good picture of where your money is going, you can proceed to evaluate which parts of that spending should be raised or lowered.

Setting goals

Next you should analyze your spending habits to see where you need to make changes.

Once you have a budget, it's time to go through your spending and figure out where you need to cut back.

This is especially urgent, obviously, if you spend more that you -- a scary position, for sure, but not uncommon. In fact, the Labor Department numbers show that many families making about $50,000 or less are spending at least a few percentage points more money each year than they actually derive in revenue.

That doesn't mean that they -- or you -- are headed for bankruptcy. But it does show that Americans are in the habit of borrowing to cover both short-term expenses, like those on credit cards, and long-term ones, such as buying cars and homes. Let's just say that if your spending exceeds your income, then your top priority in constructing a budget should be to slash your spending, pronto.

If your household runs in the black, you may still want to reallocate some of your spending. The calculator helps identify trouble spots by highlighting categories where your annual expenses are sharply higher or lower than average for households with similar demographics.

In some cases, a divergence will be perfectly reasonable. The average family spends only a few percent of its income on education, for example. But if you've got a child in college or private school, or are taking courses yourself, your education spending will be a lot higher -- and more power to you. On the other hand, if the calculator shows that you're spending twice as much as the average family on meals away from home, and there's no obvious reason why that should be so, you may want to consider eating in more often.

When projecting your income, don't include money that you can't be sure to receive, such as highly variable year-end bonuses, tax refunds, gains on investments or gambling winnings. Instead, wait until the extra cash arrives, then save or invest it to produce more revenue for the future.

Your goal should be to reduce your spending to about 90 percent of your income, with the aim of plowing the rest of that money into the financial objectives you deem most important.

Once you've set your budget goals, you need to develop the habit of tracking your expenses on an ongoing basis -- something that's most easily accomplished using personal-finance software. The aim here is to make sure the spending stays within the limits you've set. But there's a second aim: Very likely you will discover that some of the goals you set were unrealistic. If so, adjust them. No point in giving yourself an unreachable hurdle. Often it takes two or three revisions before you achieve a budget that you can really stick to. And if juggling the numbers leaves you wishing you could free up some extra cash, push on to the next section of this lesson for suggestions.

Cutting costs

Here's how to pare spending in order to free up money for use elsewhere.

The most common spending problems are caused by a house that's too large, a car that's too luxurious, or a credit-card lifestyle that's too lavish for your income. Whatever your situation, here are some common ways that people can reduce monthly bills.

Eliminate trivial but needless costs.
Look first for small savings -- not because they'll end your budget problems, but simply because they're easy to find and take advantage of. For example, swear off mid-afternoon Danish or expensive premium latte. Shop for clothes and household furnishings only during sales. Keep your house warmer in summer and cooler in winter. Take on chores that you usually pay someone else to perform, such as mowing the lawn or shoveling snow. Seemingly inconsequential savings do in fact add up. But they usually won't be enough, either, which is why you should also begin to...

Reduce larger expenses.
These recommendations are decidedly more painful. If you smoke, for instance, quit. Don't buy season tickets to anything. Trade in your luxury car or sport utility vehicle for something a lot cheaper to buy, fuel and maintain (we said this was painful). Okay, on the assumption that those kinds of changes may be too wrenching, here are some other

specific areas where many people can find savings:

Refinance your mortgage.
If new mortgages are costing at least two percentage points less than the rate you're paying, refinancing may save you significant dollars; check our refinancing calculator to be sure.

Cut your taxes.
Usually this means taking better advantage of itemized deductions, and it's a lot easier to do if you are either self-employed or have some income from work you do outside of a regular job. That opens up a range of new deductions -- from expenses for work-related items to a home office -- that are much harder to claim if you're an ordinary working stiff.

On the investment side, you can save some money by selling -- and then writing off -- investments that have lost money. You can use such losses to offset any gains you may have in a given year. And if your losses outweigh your gains, you can deduct as much as $3,000 of investment losses from your ordinary income each year. Those with higher incomes may also be able to save some money by shifting money out of taxable bonds into tax-free municipal bonds.

Appeal your home assessment.
If you're a homeowner, you may even be able to cut your real estate taxes by challenging the value that the local assessor puts on your property. You have to have good evidence, of course. And you should call the assessor's office first to make sure you understand the formula for determining the house's value (the assessment listed on tax bills is often only a fraction of the real value that determines your tax).

But if recent home sales in your neighborhood lead you to believe that your house is worth less than its assessment and a qualified real estate agent writes an appraisal in support of your claim, then you can file a grievance with the assessor's office and possibly get your bill reduced. The cost: $200 to $300 for the written appraisal. If an attorney handles the appeal for you, he or she will typically charge 50 percent of the first year's tax savings.

The above suggestions won't work for everyone, and you may have considered them already. But since you alone are privy to the numbers in your budget, you alone know how radically you need to cut. If our suggestions don't appeal, find your own alternatives.

One last caution:
Over time, your income should rise as your career progresses and you manage to save money for investing. But, also over time, inflation will raise the cost of living. A mere 3 percent annual rise in prices will double the cost of everything within 24 years. At that time, you'll need twice as much money as you do today to live as well as you do now. So don't start spending your rising income on luxuries you've been denying yourself until you're sure that you're staying ahead of inflation.

3. Banking and Saving

Top things to know

1. Money in a bank account is safe.
A bank is one of the safest places to stash your cash since your account is insured against loss by the federal government for up to $100,000 per depositor.

2. You pay for the convenience of a bank account.
Banks pay lower rates on interest-bearing accounts than brokerages and mutual fund companies that offer check-writing privileges. What's more, bank fees can be high -- account costs easily can add up to $200 a year or more unless you keep a minimum required balance on deposit.

3. Inflation can eat what you earn from a bank.
Even at a low rate of inflation, the annual creep in the cost of goods and services usually outpaces what banks pay in interest-bearing accounts.

4. Not all interest rates are created equal.
Banks frequently use different methods to calculate interest. To compare how much money you'll earn from various accounts in a year, ask for each account's "annual percentage yield." Banks typically quote both figures, but only APYs are calculated the same way everywhere.

5. You can get better rates (but there's a hitch)
Certificates of deposit (CDs) offer some of the best guaranteed rates on your money and are insured up to $100,000 each. The catch: you have to lock up your money for three months to five years or more. If interest rates fall before the CD expires, the bank is out of luck and must give you the rate it quoted. If rates climb, you're stuck with the lower rate.

6. ATM fees can take a significant bite out of your budget.
The convenience of using automated teller machines is an increasingly pricey one. On average, the fee a bank charges you to use another institution's ATM is $1.36, according to a Bankrate.com survey in fall 2001. That's on top of the average $1.45 that other institution charges you to use its ATM.

7. Getting the best deal takes work.
You won't get a great deal on a car if you just walk into a dealer and plunk your money down. Likewise, you won't get a great banking deal unless you comparison-shop and ask about price breaks. For example, a bank might offer free checking if you are a shareholder or if you direct deposit your paycheck.

8. Use the Internet to shop for bank services.
You can use the Internet to compare fees, yields and minimum deposit requirements nationwide. To find out what a local bank is offering, plug its name into any Internet search engine or compare what different banks offer at CNN/Money's Banking section.

9. Banking online can make bill-paying easier.
Electronic bill-paying can save you the monthly hassle of paying your bills. And if you couple online banking with a personal-finance management program, such as Quicken or

Microsoft Money, you'll be able to link your banking with your budgeting and financial planning as well.

10. You can bank without a bank.
A number of financial institutions offer accounts that resemble bank services. The most common: Credit union accounts; mutual fund company money market funds; and brokerage cash-management accounts.

Pick the right account

Knowing your money habits will help you find the best and least costly account

Banks offer several different types of checking and savings accounts: Some pay interest, some don't. Some offer perks, some don't. Some are specifically for senior citizens or students, while others are geared to those with low incomes. They all share one thing in common, though. They each have restrictions, fees and opportunities to waive fees if you meet certain requirements.

When shopping for a bank, consider:

How much money you plan to park at the bank -- The higher your average balance, the more likely you are to get "free" checking with interest. Though minimum balance requirements vary widely from bank to bank, in a fall 2001 survey Bankrate.com found the average balance required for a no-fee, interest-bearing account was $2,434.

The cost of maintaining a checking account without having the minimum balance requirement is $228 a year, according to a study by the Public Interest Research Group.

How many checks you write a month -- Some no-fee accounts limit the number of checks you may write and charge high fees if you exceed that limit. On the other hand, PIRG suggests if you only write a few checks a month and probably won't meet the minimum balance required to avoid fees, you might benefit from a no-frills, flat-fee checking account.

How many related banking services you'd like -- If you want to direct-deposit your paycheck, ask if that entitles you to free or low-cost checking. If you use ATMs frequently, make sure the bank has plenty conveniently located near you. If you use another bank's ATM, you might pay as much as $3.00 for the privilege, once you combine the surcharge imposed by the other bank and the fee your bank charges for going to a competitor's machine.

How many different types of accounts you want to set up at the bank -- The more relationships you have with your bank, the greater your chances of getting price breaks and perks on its services and products. So if you have a checking and savings account and are taking out a mortgage or signing up for the bank's credit card, be sure to ask if you're entitled to any discounts.

Using the Internet is one of the easiest ways to compare fees, yields and minimum deposit requirements nationwide. To comparison shop, use the search fields on CNN/Money's Banking page.

Banking fee averages
Regular checking account: $228/year

Big banks: $266/year
Small banks: $191/year
Credit unions: $101/year

Minimum for checking with interest: $2,434.50
Minimum for checking without interest: $408.16

ATM surcharge: $1.45
ATM foreign fee: $1.36

Bounced check fee: $24.85

Sources:
Checking account fees from Public Interest Research Group, November 2001 survey. Figures assume customers don't meet the minimum req uired balance. Includes all service fees, account fees and ATM fees.
All other figures from Bankrate.com, Fall 2001 survey. Figures for minimums is the amount required to open an account without fees. An ATM foreign fee is the fee a bank charges you, its customer, to use another institution's ATM. An ATM surcharge is what the other institution charges you to use its ATM.

Take an interest in interest

Consider CDs and money market accounts for higher yields

Deciding to put your money in an interest-bearing account may seem like a no-brainer. But sometimes a no-interest checking account may be more cost-effective. Here's why:

Interest-bearing checking and savings accounts offer the lowest rates around. Sometimes banks offer to add or increase the interest on your account if you maintain a higher average balance. As tempting as this may seem, make sure the expense of maintaining the account doesn't exceed the interest paid. Even if the bank waives its fees when you keep a high average balance, there is an opportunity cost to tying up all that cash in a low-yielding account.

Say you pay $4 a month (or $48 a year) in account and ATM fees. If you earn 2 percent interest, you need to keep at least $2,400 in your account just to break even. And you'll have a hard time earning any real return on your deposits, even if you don't pay fees. That's because the interest rates you earn on a checking or savings account often don't exceed the average annual inflation rate, which was 3.1 percent from 1926 through 2000. In short, you end up losing purchasing power.

There are, however, other ways to get better returns at a bank. Instead of parking the majority of your cash in a savings account, you could open a certificate of deposit (CD). If you've opened one at your bank, ask if your CD, checking and savings accounts can be "linked" -- that way, you'll have an easier time meeting minimum balance requirements in your checking account. When you open a CD, you agree not to withdraw your money for a period of time ranging from three months to five years or more. The shorter the term of the CD, the lower the rate you'll get.

If interest rates fall, you're in luck because the bank must give you the rate it quoted when you bought the CD. If rates climb, however, you're stuck with the rate you agreed to even though it's lower than one you could get if you bought a new CD.

You can get money out of a CD prematurely, but you'll pay a penalty -- typically three months' interest. And if you have more than $100,000, you can put it into a so-called jumbo CD that pays even higher rates. However, any amount over $100,000 isn't insured, so the excess is only as secure as the bank itself.

When opening a CD, be sure you understand whether the rate is fixed or variable, and how often the interest compounds. A CD interest rate can yield different sums of money depending on whether a rate is compounded daily, weekly, monthly, quarterly or yearly.

Banks also offer money market deposit accounts (MMDAs) that invest your money in short-term loans to government agencies and corporations. Typically, they require you to keep between $2,000 and $3,000 on deposit. Because the minimum is high, a money market account is often free, and you're likely to get free checks to write against your account's balance. However, there may be a minimum check-writing amount (usually $100 per check or more), and you may be limited to the number of checks you may write a month.

When shopping for an interest-bearing account, keep the following in mind:

Banks frequently review the yields they offer, often on a weekly basis, and may lower or raise the rates just as often. That means the rate that's offered when you open your account may be dramatically different a year later, or even a month later.

Banks can quote rates that compound daily, weekly, monthly, quarterly or yearly. Over a period of 12 months, interest that compounds yearly could yield less money than a lower interest rate that compounds daily. To compare how much money you'll earn from various accounts in a year, ask for each account's "annual percentage yield" in addition to its interest rate. Banks typically quote both figures, but only APYs are calculated the same way everywhere.

Beating fees

Checking can cost $200-plus a year, but you can pay less if you know how

Few people would pay a bank $15 or $20 a month for an account that pays no interest if they knew how to avoid it -- and if avoiding it didn't take too much work.

Here are several easy, cost-cutting tips:

Direct deposit your paycheck. If you do, some banks will give you free checking -- but you might have to ask for it.

Buy cheap checks. Some banks charge as much as $24 for a box of 200 checks. You can get that same box for less than $10 by ordering direct from the printer. There are a numerous services, including Checks in the Mail (800-733-4443) or Checks Unlimited (800-426-0822) for more information.

Get overdraft protection. It's usually free to set up. The average bounced check fee - also known as a non-sufficient funds (NSF) fee -- is $25. If ever you write a check that exceeds your account balance, overdraft protection automatically covers the extra money needed. You'll be charged a fee - usually $4 or $5 -- for the service plus a high, credit-card-like interest rate for the loan, but in most cases since the loan is short-term it's likely to cost you less than a bounced check.

Be proactive about asking for discounts. Periodically check with your bank to see if there are better deals for your money. Over time, your financial situation changes, and you may qualify for a higher-interest, lower-cost account.

If you have a debit card, ask for cash. Another way to dodge ATM surcharges is to ask for extra cash when you make a purchase with your bank's debit card. Just ask your grocer for an extra $50 in cash, and you'll pay no fees.

Invest in the bank. Some small- and mid-size banks offer free checking and free checks to shareholders. Contact a few local banks and ask if they offer special deals to shareholders. If they do, invest in a single share and open an account.

Limit your bank visits and transactions. Some banks offer no-fee checking accounts if you do all your banking at its ATMs. If you must visit a teller, make sure it's for a transaction that you couldn't perform at an ATM, otherwise you'll be charged a fee. Banks also may offer low-fee checking if you confine yourself to 10 or fewer transactions a month, including ATM withdrawals, checks and debit card purchases.

Find out what "free" means. Most banks will give you "free" checking if you maintain a balance of at least $500 to $2,500 in a low- or no-interest account. But say your bank requires a $2,500 minimum to avoid fees, and you need only $1,500 to cover your checks every month. The remaining $1,000 could be earning more interest for you in a money market account at a brokerage or mutual fund company. Of course, the difference may be less than what you'd pay in checking fees if you didn't keep the required minimum balance, but "free" checking it's not.

One way around this hidden cost: ask your bank to link your accounts. For example, if you have a high-yielding CD in addition to a checking account at the bank, you can satisfy the minimum balance requirement if your bank treats the money in all your accounts as one combined balance.

Look for surcharge-free ATMs. If you do your banking at a small bank and have trouble finding ATM machines that don't hit you with a surcharge, try searching online for surcharge-free ATMs in your area. One place to try is ATMsurcharges.com.

Online banking

If you are computer-savvy, banking online can reduce the time you spend balancing your checkbook, transferring money and paying bills.

In 2001, 20 percent of U.S. households performed banking transactions online, up from 15 percent the year before. By 2006, according to estimates by Jupiter Media Metrix, half of all banking households will bank online.

To do your banking on the Internet, you'll need a computer, a modem, Web access, and in a few cases, bank-specific software. Most banks that offer online banking and electronic bill-payment do so for free. Even if they do, however, some banks will charge you extra -- around $8.95 a month -- if you use personal finance software such as Quicken or Microsoft Money instead of the bank's Web site to conduct transactions.

If you pay your bills online, you will save on postage, which can add up to between $49 and $98 a year, if you write 12 to 24 checks a month. If your bank doesn't offer electronic bill payment for free, those savings may be negated, since electronic bill-paying fees usually run between $5 and $8 a month ($60 to $96 a year). Some banks that charge, however, only charge a per-transaction fee, or a fee after the user exceeds a certain number of payments. Any fees you're charged will be in addition to your regular account fees, not in place of them.

To pay bills online, you create an address book of payment recipients. When you get a bill, you select a payment amount, the date it should be sent and the recipient. The bank takes care of the rest. Most bill-paying programs let you schedule recurring payments if the amount you pay to a given recipient is the same every billing period.

If your bank doesn't provide electronic bill payment, others do, including brokerages like Charles Schwab, Internet portals such as Yahoo and AOL (parent of CNN/Money.com), and even the U.S. Postal Service. Typically, these are free services. But they do add a third-party middleman to your banking transactions.

You can also use online banking to reduce the stacks of bills on your desk if you don't mind using the Web to view your billing statements. "Consolidated bill presentment," as it's known, lets you view all of the bills you pay electronically on your bank's Web site. You're alerted by e-mail when bills arrive, then you can check them online and instruct your bank to pay them. If you use a consolidated bill presentment service, you'll typically pay a monthly fee of $4 to $8.

The best bank Web sites go beyond bill payment and balance updates to let you check your credit card accounts, look at both your banking and brokerage accounts, make trades and get free stock quotes. Banks with online services commonly use the most secure data encryption available and offer consumer protection against liability for losses due to fraud, according to the Tower Group, a consulting firm that examines the impact of technology in the financial services industry.

If you think you'll do all your banking online and are in search of better rates, you might be considering an Internet bank. During the economic boom of the 1990s, Internet banks were able to offer higher yields on accounts and lower rates on loans than traditional banks. Since then, however, many Internet banks have closed due to a weakened economy and the difficulty they faced acquiring customers for loans, which are the mainstay of bank revenue. What's more, the number of traditional banks offering online services is on the rise, creating a tougher competitive market.

Still, rates at Internet banks continue to beat those at their brick-and-mortar cousins, and their account fees are somewhat lower. But in exchange you forfeit some of the conveniences of a traditional bank. Any transactions normally requiring a teller, for instance, may be more protracted online. And an Internet bank doesn't have its own ATMs, so you will pay surcharges every time you use one, although you may be offered some reimbursement for these fees by your bank.

Alternatives to traditional bank accounts

You can bank without a bank. Here's how.

Checking and savings accounts are not the exclusive domain of banks. They are also offered by some non-bank businesses. Here are three of the most common:

Credit unions

Credit unions operate much like banks, and deposits are federally insured up to $100,000 by the National Credit Union Share Insurance Fund. The key difference is this: credit unions are non-profit, member-owned cooperatives whose members share something in common, such as a labor union, college alumni association, employer or community. Members' immediate family may also be allowed to join.

Since credit unions return profits to their members, interest rates on credit union accounts tend to be higher than at commercial banks, while fees and minimums tend to be lower. The average fee for a regular checking account at a credit union is $101 compared with $228 at banks, according to PIRG. But a credit union may offer fewer services than a bank and they may have more restricted access to ATMs.

To learn whether you are eligible to join a credit union, or to locate a credit union near you, visit the Credit Union National Association or call 800-358-5710.

Money market mutual funds

Mutual fund companies offer money market accounts that tend to have higher yields than those on banks' money market deposit accounts (MMDAs). The mutual fund company accounts, however, are not insured against loss by the FDIC, whereas MMDAs are. Nevertheless, mutual fund companies make it a practice to kick in extra dollars whenever necessary to make sure that they maintain a constant share price of $1 per share, so in practice your chance of losing money is slim.

Mutual fund money market accounts require a minimum opening balance -- typically $500 to $5,000 -- and may require that you maintain a minimum balance. Many also let you write checks on the account, though there may be a minimum check-writing amount (typically $100 to $500) and/or a limit to the number of checks you can write per month or per year.

Cash-management accounts

A CMA works like a combination bank/brokerage account, consolidating your investments with your day-to-day cash flow.

Cash-management accounts (CMAs) were originally offered by brokerages such as Merrill Lynch for affluent customers who had discretionary income to invest but also wanted a liquid, bank-like account that earned higher interest than a traditional bank account. Increasingly, however, banks have begun to offer CMAs as well.

In a CMA, your cash earns money market rates, and you get checking and credit card privileges, an ATM debit card and often a line of credit or a margin account. If you overdraw your account, the interest you're charged on the loan is likely to be lower than that on a bank overdraft. In many instances, too, the interest may be characterized as margin interest, which can be tax-deductible.

The fee for a CMA typically ranges from $50 to $150 a year, though it may be waived if you have $100,000 or more in your account. In addition, you may pay fees if you make trades through your account or consult with an investment adviser at your brokerage or who is affiliated with a subsidiary of your bank. Cash up to $100,000 in a brokerage CMA is protected by the Securities Investor Protection Corp., while cash up to $100,000 in a deposit account is FDIC insured at a bank CMA.

4. Basics of Investing

Top things to know

1. Over the long term, stocks have historically outperformed all other investments.
From 1926 to 2001, the stock market returned an average annual 10.7 percent gain. The next best performing asset class, bonds, returned 5.3 percent.

2. Over the short term, stocks can be hazardous to your financial health.
If you thought the Dow's 554-point drop on Oct. 28, 1997 was rough, consider the 508-point drop 10 years earlier, on Oct. 19, 1987. The 1997 decline was a mere 7.2 percent, while the 1987 crash -- the worst one-day drop in stock market history -- chopped 22.6 percent off the value of stocks.

3. Risky investments generally pay more than safe ones.
Investors demand a higher rate of return for taking greater risks. That's one reason that stocks, which are perceived as riskier than bonds, tend to return more than bonds. It also explains why long-term bonds pay more than short-term bonds. The longer investors have to wait for their final payoff on the bond, the greater the chance that something will intervene to erode the investment's value.

4. The biggest single determiner of stock prices is earnings.
Over the short term, stock prices fluctuate based on everything from interest rates to investor sentiment to the weather. But over the long term, what matters are earnings. If a stock's earnings rise substantially over the course of 10 years, so will its share price.

5. A bad year for bonds looks like a day at the beach for stocks.
In 1994, the worst year for bonds in recent history, intermediate-term Treasury securities fell just 1.8 percent, and the following year they bounced back 14.4 percent. By comparison, in the 1973-74 crash, the Dow Jones industrial average fell 44 percent. It didn't return to its old highs for more than three years or push significantly above the old highs for more than 10 years!

6. Rising interest rates are bad for bonds.
When interest rates go up, bond prices fall. Why? Because bond buyers won't pay as much for an existing bond with a fixed interest rate of 5 percent as they will for a new one that is paying, say, 6 percent or more. Conversely, when interest rates fall, bond prices go up in lockstep fashion. And the effect is strongest on bonds with the longest term, or time to maturity. That is, long-term bonds get hit harder than short-term bonds when rates climb, and gain the most when rates fall.

7. Inflation may be the biggest threat to your long-term investments.
While a stock market crash can knock the stuffing out of your stock investments, so far -- knock wood -- the market has always bounced back and eventually gone on to new heights. However, inflation, which has historically stripped 3.2 percent a year off the value of your money, rarely gives back what it takes away. That's why it's important to put your retirement investments where they'll earn the highest long-term returns.

8. U.S. Treasury bonds are as close to a sure thing as an investor can get.
The conventional wisdom is that the U.S. Government is unlikely ever to default on its bonds -- partly because the American economy has historically been fairly strong and

partly because the government can always print more money to pay them off if need be. As a result, the interest rate of Treasuries is considered a risk-free rate, and the yield of every other kind of fixed-income investment is higher in proportion to how much more risky that investment is perceived to be.

9. A diversified portfolio is less risky than a portfolio that is concentrated in one or a few investments.
Diversifying -- that is, spreading your money among a number of different types of investments -- lessens your risk because even if some of your holdings go down, others may go up (or at least not go down as much). On the flip side, a diversified portfolio is unlikely to outperform the market by a big margin for exactly the same reason.

10. Index mutual funds often outperform actively managed funds.
In an index fund, the manager sets up his portfolio to mirror a market index -- such as Standard & Poor's 500-stock index -- rather than actively picking which stocks to purchase. And average is often enough to beat the majority of competitors among actively managed funds. One reason: Few actively managed funds can consistently outperform the market by enough to cover the cost of their generally higher trading fees.

The good, bad and ugly

It was easy to invest profitably in the 1990s. It has gotten a lot harder.

Unless you were trapped on the planet Pluto in the 1990s, you know that the decade witnessed the motherhood of Madonna, the return to space by John Glenn and the biggest bull market in U.S. history. Between 1990 and 1999 alone the Dow more than quadrupled.

And while stocks have not always performed so extraordinarily -- compounding at a dazzling 18.1 percent annual rate for that time period -- they have usually been the best performing asset class over time. Since 1926, stocks have returned an annual average of 10.7 percent. Over the same period, government bonds returned 5.3 percent, and "cash," the term used to describe Treasury bills and other short-term investments, has returned just 3.8 percent. (This according to the folks at Ibbotson Associates in Chicago.) In other words, if you're investing for the long-term -- which just about everybody does now that 401(k) plans are the rage -- stocks are the place to be. (To see how each of these asset classes has performed after inflation, jump to "The hidden peril".)

But if you're looking to invest money you may need in a year or two, the stock market can be downright dangerous. Look no further than the Dow's 554-point drop -- a 7.2 percent loss -- on October 28, 1997, and the 508-point drop on Oct. 19, 1987 -- a harrowing 22.6 percent loss -- to see what a difference a day can make. Then there are those bloody bear markets, like 1973-74, when the Dow fell 44 percent, and March 2000-September 2001, when the Nasdaq Composite fell 72 percent, to remind you that the market may not be the best place to keep your downpayment for a house.

To cite a worst case example, if you had bought the stocks in the Dow Jones industrial average at their peak in early 1966, you wouldn't have made any significant profit until mid-1983 -- more than 17 years later!

Bonds of course are another story. And while they won't give your portfolio the kind of kick that stocks will, nor are they likely to give it the same kind of thrashing. In 1994, the worst single year for bonds in recent history, intermediate-term government bonds (that is, Treasury securities with maturities of 7-10 years) fell just 1.8 percent. And in a good year, like the one that immediately followed, they bounced back an impressive 14.4 percent.

In the sections to come, you'll find a brief overview of stocks, bonds and mutual funds and a first look at the deleterious effects of inflation. We have more to say about all of them in later Money 101 lessons.

Stock market movers

Forget the short-term swings. Here are the factors that really send prices up or down.

While the stock market often *seems* to behave like a manic-depressive who's been off his medication, in fact it's quite rational -- most of the time. Information about the economy and the prospects of specific companies comes in, and the market reacts. Sometimes those reactions are extreme, but they usually sift down to a handful of causes.

So why does the market seem so erratic? Because life in general is unpredictable. A war here, a hurricane there. These things can occur without much warning, having effects on the economy that no one could anticipate.

What's harder to explain is why the market can ignore obvious problems for a long time and then suddenly overreact. Here's one explanation: Investors have a hard time gauging the magnitude of problems. Take the dramatic reaction to the Asian crisis in 1997 and the tumult that followed in 1998. Though the experts knew that Asian banks had been overextended for years, few realized how serious the problem was until Thailand devalued its currency in the summer of 1997. Suddenly investors reassessed, and the market took a 544-point, one-day dive -- only to recover most of that ground the very next day.

But if you ignore the occasional surprises that roil the market and focus instead on its long-term behavior, you'll find three factors are key:

Earnings growth
Over periods of five years or more, stock prices closely track corporate profit growth. And the longer the stretch of time, the more important earnings trends are. Indeed, since World War II, an estimated 90 percent of the stock market's gain has come from profit growth. As profits add up over time, the scale tips and prices rise, regardless of how investors have voted in any given day, month or year.

Interest rates
In the short run, changes in interest rates can be more important than earnings. When rates go up, all other things being equal, investors tend to pull money out of stocks and put it into bonds and other fixed-income investments because the returns there are so attractive. That brings stock prices down, and sends bond prices higher. On the other hand, when interest rates come down again, once more with other things equal, then investors tend to shift money into stocks, reversing the previous trend. Note, however, that the operative phrase above is "other things equal." In real life, other things are rarely equal, and so this relationship -- while true in general terms -- is hardly perfect.

Bonding with bonds

Bonds are more predictable than stocks -- but only barely so.

Bonds at their best are basically boring, which is probably a virtue. You loan money to a corporation or government agency, like the Treasury Department, and the borrower agrees to pay it back at a fixed rate of interest (sometimes known as the coupon) over a fixed period of time (the term or maturity). If they don't pay it back, which happens occasionally, that's when things get exciting. But unless you get your kicks poring through hundreds of pages of legalese, you probably don't want to be around when that happens.

Typically, the longer the maturity of a bond, the higher the coupon. For example, the spread between five-year Treasury notes and 30-year bonds is often a full percentage point or two. Why? Because the longer the term of the bond, the longer its owner will be left earning a low rate if interest rates in general rise. And the greater the risk, the greater the reward.

Similarly, the interest rate a bond pays is directly related to the riskiness of the bond. Treasury bonds, for example, are as close to a sure thing as you can get in the world of bonds, since Uncle Sam can always print more money to pay them off. (Even the feds aren't immune to the laws of economics, though; if the government ever did print lots of extra cash to pay off its bonds, that would cause inflation to soar and make the bonds worth less.)

At the other end of the spectrum, however, are low-grade corporate bonds, known as high-yield or junk bonds, which have coupons that are several percentage points higher because of the risk that the corporations that issue them might stumble. In between are several varieties of mortgage-backed security -- Fannie Maes, Ginnie Maes and so forth -- as well as investment-grade corporate bonds from large, blue-chip companies. The grades come from outfits like Standard & Poor's and Moody's, which rate the riskiness of most non-Treasury bonds.

One additional quirk to bonds: If they are issued by a state, county or city agency, their interest earnings are usually free from federal taxes. These municipal -- or muni -- bonds pay less than taxable bonds in nominal terms. But for investors in a high federal tax bracket (say, the 31 percent bracket or higher), they often return more after taxes than comparable taxable bonds. If you happen to live in the municipality or state that issues the bond, it may also be exempt from state and/or local tax -- an added benefit. Similarly, bonds issued by the federal government are exempt from state and local taxes, but the tax rates are lower and the benefit is too.

While bond prices tend to fluctuate less than stock prices, they aren't risk-free. If interest rates rise, bond prices will fall. Why? As new bonds paying higher rates become available on the market, the price of older bonds falls proportionately so that the interest they pay is the same as that of a comparable new bond.

Here's a simplified example of how it works: Let's say that you paid $1,000 for a 30-year bond that yielded 7 percent interest, or $70 a year. A year later, the rate for a comparable new bond falls to 5 percent, which means it yields just $50 a year. Your old bond is now going to be worth more, because investors are willing to pay more to get a $70-a-year income stream than they will to get $50 a year. How much more? Since the interest rate of your bond is now 40 percent higher than normal, its new price will be about $1,400, or 40 percent more than you paid for it. And its yield? Exactly 5 percent, since $70 a year is 5 percent of $1,400. (Note: the equation is not quite that simple, since your bond now has only 29 years left to maturity and will be matched to other 29-year bonds, not new 30-year issues.) Conversely, if rates jump from 7 percent to 9 percent, meaning new bonds are paying $90 a year interest, the value of your bond will fall to about $778 -- because your bond's $70 annual interest is 9 percent of $778.

Eventually, of course, when the bond matures, it will be worth $1,000 again. However, its value will move up and down in the meantime, depending on what interest rates do. And the longer the time to maturity of a bond, the more dramatically its price moves in response to rate changes. That is, long-term bonds get hit harder than short-term bonds when rates climb, and gain the most in value when rates fall. As a result, bond buyers tend to divide into two classes: investors (or speculators), who hope to make money thanks to a decline in interest rates that sends bond prices higher; and savers, who buy bonds and hold them to maturity as a way to earn a guaranteed rate of return.

Mutual fund fundamentals

Mutual funds offer a simple way to diversify your portfolio -- albeit at a cost.

The theory behind mutual funds is simple: Unless you have enough money to create a diversified stock or bond portfolio on your own, you need the advantage of being able to pool your money together with that of a lot of other investors. Then, a professional money manager can invest that pool of money across enough investments to reduce the risk of being wiped out by any single bad bet.

That's how a mutual fund operates. The fund is essentially a corporation whose sole business is to collect and invest money. You join the pool by buying shares in the fund. Your money is then invested by a team of professionals, who research stocks, bonds or other assets and then place the money as wisely as they can. The managers charge an annual fee -- generally 0.5 percent to 2.5 percent of assets -- plus other expenses. That puts a drag on your total return, of course. But in exchange, you get professional direction and instant diversification -- factors that have helped propel the number of funds to something over 10,000.

There are several flavors of mutual funds. Funds that impose a sales charge -- taking a cut of any new money that comes into the fund, or a cut of withdrawals -- are called **load funds**; those that do not have sales charges are called **no-load funds**. Funds can also be divided into open- and closed-end funds. **Open-end funds** will sell shares to anyone who cares to buy; essentially, they are willing to invest any new money that the public wishes to pump into the fund. Their share price is determined by the value of the underlying investments, and is calculated anew each evening after the close of the U.S. markets. **Closed-end funds**, on the other hand, issue a limited number of shares that then trade on the stock exchange like stocks.

Funds also can be broken down by their investment strategy. Here's a quick overview of some of the principal types; we have more to say in later Money 101 lessons:

Index funds
When people talk about the long-term performance of stocks, they're usually talking about the Dow Jones industrial average, the Standard and Poor's 500-stock index, or some other broad market index. Funds based on the S&P 500, by definition, will never outperform the market. But because they are so cheap to run -- you'll typically pay just $2 a year in expenses for every $1,000 invested compared to $14 a year for the average stock fund -- they outperform the vast majority of actively managed funds over time.

Growth funds
These invest in the stock of companies whose profits are growing at a rapid pace. Such stocks typically rise more quickly than the overall market -- and fall faster if they don't live up to investors' expectations.

Value funds
Value-oriented fund managers buy companies that appear to be cheap, relative to their earnings. In many cases, these are mature companies that send some of their earnings back to their shareholders in the form of dividends. Funds that specifically target such income-producing investments are often called **equity-income** or **growth-and-income** funds.

Sector funds
Sector and specialty funds concentrate their assets in a particular sector, such as technology or financials. There's nothing wrong with that approach, as long as you remember that a hot performing sector one year could crash the following year.

Others
Since there is a lot of overlap in the stocks held in each of these fund types, you'll need to branch out to get any kind of meaningful diversification. That's where the more aggressive funds, like **aggressive growth funds**, **capital appreciation funds**, **small-cap funds**, **mid-cap funds** and **emerging growth funds**, among others, fit in. Typically, these funds, which tend to be more volatile than large-cap funds, pursue one or more of the following strategies:

- Invest in smaller companies, where earnings aren't as reliable as at bigger firms but where the potential for gains (and losses) is higher.
- Invest in pricey, high-growth stocks.
- Invest in stocks that are in "hot" industries, such as technology or health-care.
- Invest in just a handful of companies.

International
Funds that invest outside the U.S. come in three basic flavors. The first, **international funds**, typically buy stocks in larger companies from relatively stable regions like Europe and the Pacific Rim. **Global funds** do likewise, but they can also invest heavily in the U.S. And **emerging market funds** invest in riskier regions, like Latin America, Eastern Europe and Asia.

Bond funds
Finally, these tend to be segmented across the risk spectrum, with those that specialize in Treasury securities being the safest (and the lowest-yielding) and those that specialize in junk bonds being the riskiest but offering the highest yield. They also divide according to whether the bonds they hold are taxable or tax-free. One thing to remember: When the market is headed down, funds that invest in Treasuries tend to rise in value and investors flock to the safest investments around. Likewise, when the market is going up, junk bonds funds tend to do the best, as the better things are for business, the more likely that even the riskiest bond bets will pay off.

The hidden peril of inflation

Most people think a market crash is the biggest danger to investors. Think again.

Finally, let's say the market takes a 30 percent dive over the next year. Every time you check your stocks or stock mutual funds, you're going to feel the pain. Likewise, if interest rates rise, your bonds won't let you forget it. But nowhere on your bank or brokerage statement -- or anywhere else, for that matter -- are you likely to get a report on what inflation is doing to the real value of your holdings. So if your money is stowed in a "safe" investment, like a low-yielding savings or money market account, you'll never see how inflation is gobbling up virtually all of your return. Here are some points to bear in mind:

- At an average annual growth rate of 10.7 percent a year, stocks will double your money about every six years. Factor in inflation, which has historically run at about 3.1 percent annually, and it will take closer to ten years to double your actual buying power.

- Likewise, bonds, which have historically grown at 5.3 percent annually, will double your money every 13 1/2 years. After inflation, however, it will take 35 years.
- And talk about risk, if your money is in cash (which is how money market accounts are known in the investment world), you'll have to wait 19 years for the nominal value of your account to double, assuming the cash earns the historical 3.7 percent annual return. But even your grandchildren won't see the real value of your money double. The reason? After inflation, it will take 139 years.

That's why, whenever you add up your gains or losses for a given period of time, you have to add in the effects of inflation to understand how much further ahead or behind you really are.

5. Stocks

Top things to know

1. Stocks aren't just pieces of paper.
When you buy a share of stock, you are taking a share of ownership in a company. Collectively, the company is owned by all the shareholders, and each share represents a claim on assets and earnings.

2. There are many different kinds of stocks.
The most common ways to divide the market are by company size, sector, and types of growth patterns. Investors may talk about large-cap vs. small-cap stocks, energy vs. technology stocks, or growth vs. value stocks, for example.

3. Stock prices track earnings.
Over the short term, the behavior of the market is based on enthusiasm, fear, rumors, and news. Over the long term, though, it is mainly company earnings that determine whether a stock's price will go up, down, or sideways.

4. Stocks are your best shot for getting a return over and above the pace of inflation.
Since the end of World War II, the average large stock has returned, on average, 11 percent a year -- well ahead of inflation, and the return of bonds, real estate and other savings vehicles. As a result, stocks are the best way to save money for long-term goals like retirement.

5. Individual stocks are not the market.
A good stock may go up even when the market is going down, while a stinker can go down even when the market is booming.

6. A great track record does not guarantee strong performance in the future.
Stock prices are based on projections of future earnings. A strong track record bodes well, but even the best companies can slip.

7. You can't tell how expensive a stock is by looking only at its price.
Because a stock's value is depends on earnings, a $100 stock can be cheap if the company's earnings are high enough, while a $2 stock can be expensive if earnings prospects are dim.

8. Investors compare stock prices to other factors to assess value.
To get a sense of whether a stock is over- or undervalued, investors compare its price to revenue, earnings, cash flow, and other fundamental criteria.

9. A smart portfolio positioned for long-term growth includes strong stocks from different industries.
As a general rule, it's best to hold stocks from several different industries. That way, if one area of the economy goes into the dumps, you have something to fall back on.

10. It's smarter to buy and hold good stocks than to engage in rapid-fire trading.
The cost of trading has dropped dramatically -- it's easy to find commissions for less than

$10 a trade. But there are other costs to trading -- including mark-ups by brokers and higher taxes for short-term trades -- that stack the odds against traders.

What is a stock?

Hint: It's not just a piece of paper

When you buy a stock, you're taking an ownership stake in a company. At some point, just about every company needs to raise money, whether to open up a West Coast sales office, build a factory or hire a crop of engineers. In each case, they have two choices: 1) Borrow the money, or 2) raise it from investors by selling them a stake (issuing shares of stock) in the company. Own a share of stock, and you are a part owner in the company, with a claim (however small it may be) on every asset, and every penny in earnings.

Now, typical stock buyers rarely think like owners, and it's not as if they actually have a say in how things are done. Owning 100 shares of Microsoft makes you, technically speaking, Bill Gates' boss, but that doesn't mean you can call him up and give him a tongue-lashing. Nevertheless, it's that ownership structure that gives a stock its value. If stockowners didn't have a claim on earnings, then stock certificates would be worth no more than the paper they're printed on. As a company's earnings improve, investors are willing to pay more for the stock.

Over time, stocks in general have been solid investments. That is, as the economy has grown, so too have corporate earnings, and so have stock prices. Since the end of World War II, the average large stock has returned, on average, 11 percent a year. If you're saving for retirement, that's a pretty good deal -- much better than U.S. savings bonds, or stashing cash under your mattress.

Different kinds of stocks

Not sure what a small-cap is? Or why you should care? Read on.

There are more than 9,000 stocks to choose from, so investors usually like to put stocks into different categories. You can slice and dice the stock market into all sorts of different groups, but the most common ways are by size, style, and sector.

By size

When talking about a company's size, we're referring to its market capitalization, the current share price times the total number of shares outstanding. It's how much investors think the whole company is worth. Ford, for example, has 1.8 billion shares outstanding, and in February 2002, each share was trading for $15, for a total market capitalization of about $28 billion. (Technically, if you had an extra $28 billion lying around, you could buy each share of stock, and buy the whole company.)

Is $28 billion a lot or a little? No official rules govern these distinctions, but below are some useful guidelines for assessing size.

Sizing up a stock

Category	Market Cap
Micro-cap	less than $500 million
Small caps	$500 million to $2 billion
Mid-caps	$2 billion to $10 billion
Large caps	$10 billion to $100 billion
Mega caps	more than $100 billion

Large-cap companies tend to be established and stable, but because of their size, they have less growth potential than small caps. As a result, over the long run, small-cap stocks have tended to rise at a faster pace. Krispy Kreme Doughnuts, which just went public in 2000, has a market cap of more than $2 billion. It is slated to increase earnings at a 33 percent clip over the next five years, and its stock more than doubled in 2001. General Electric, the most highly valued company in the world with a market cap of nearly $390 billion, has posted steady long-term returns, but don't expect a double anytime soon.

But there's a trade-off: With less developed management structures, small caps are more likely to run into troubles as they grow -- expanding into new areas and beefing up staff are examples of potential pitfalls. (Of course, even corporate titans get into trouble. Witness the stock-price collapse of AT&T in 2000 -- stockholders lost more than 60 percent of their money.)

By style

A "growth" company is one that is expanding at an above-average rate. Cisco, for instance, increased its earnings at a rate of nearly 40 percent a year in the late 1990s -- the average tends to run around 10 percent.

Catch a successful growth stock early on, and the ride can be spectacular. If you'd picked up 100 shares of Cisco in 1995, your stake would have cost you a little more than $3,000. By early 2001, that investment grew to $68,400.

But again, the greater the potential, the bigger the risk. Growth stocks race higher when times are good, but as soon as growth slows, those stocks tank. Cisco fell from grace in 2000, with a decline of more than 50 percent.

The opposite of growth is "value." There is no one definition of a value stock, but in general, it trades at a lower than average earnings multiple than the overall market. Maybe the company has messed up, causing the stock to plummet -- a value investor might think the underlying business is still sound and its true worth not reflected in the depressed stock price.

A "cyclical" company makes something that isn't in constant demand throughout the business cycle. For example, steel makers see sales rise when the economy heats up, spurring builders to put up new skyscrapers and consumers to buy new cars. But when the economy slows, their sales lag too. U.S. Steel, the largest steel maker, lost money during the recession of 2001. Cyclical stocks bounce around a lot as investors try to guess when the next upturn and downturn will come.

By sector

Standard & Poor's breaks stocks into 10 sectors, and 59 industries. Generally speaking, different sectors are affected by different things. So at any given time, some are doing well while others are not. Generally speaking, finance, health care, and technology are the fastest growing sectors, while consumer staples and utilities offer stability with moderate growth. The other sectors tend to be cyclical, expanding quickly in good times and contracting during recessions.

Sector watch

Sector	Examples
Basic materials	Nucor (steel) International Paper (paper)
Capital goods	Caterpillar (earth moving equipment) Boeing (aircraft) General Motors (autos)
Communication services	Verizon (local phone) WorldCom/Sprint (long distance)
Consumer cyclicals	Goodyear (tires) Sony (electronics)
Consumer staples	Anheuser-Busch (beverages) Procter & Gamble (household products)
Energy	Exxon/Mobil (petroleum) Schlumberger (oilfield equipment)
Financial	Citigroup (banking) Wells Fargo (banking)
Health care	Merck (drugs) Healthsouth (HMO)
Technology	Cisco Systems (Internet infrastructure) Nokia (cell phones)
Utilities	Southern Company (electric) American Water Works (municipal water)

How much should you pay?

The right way to use P/E and other valuation tools.

When times are good, investors think the happy days will last forever, and they are willing to pay exorbitant amounts for earnings. When times are bad, they assume the world is ending and refuse to pay much of anything. In assessing how much a stock is worth, investors talk about "valuation," the stock price relative to any number of criteria. The P/E, for example, compares a company's stock price to its earnings.

Price/earnings (P/E) ratio Everybody uses it, but not everybody understands it. The actual P/E calculation is easy: Just divide the current price per share by earnings per share. (Just about every finance website with a quote box provides the P/E -- including CNN/Money.) But what number should you use for earnings per share? The sum of the past four quarters? Estimates for next year?

There is no right answer. The P/E based on the past four quarters provides the most accurate reflection of the current valuation, because those earnings have already been booked. But investors are always looking ahead, so most also pay attention to estimates, which also are widely available at financial websites (including CNN/Money). Wall Street analysts generally compute earnings per share estimates for the current fiscal year and the next fiscal year (though there is no guarantee that the company will meet those estimates).

The P/E can't tell you whether to buy or sell -- it is merely a gauge to tell you whether a stock is overvalued or undervalued. Is a $100 stock more expensive than a $50 stock? Maybe not. IBM, for example, was trading at $98 in February 2002 and was expected to earn about $5.50 a share in 2002 -- a P/E of 18. Home Depot, meanwhile, was trading for just $52 -- but it was slated to earn little more than $1.50 per share in 2001, for a P/E of around 35. So IBM, selling for almost twice the price of Home Depot, is actually the cheaper stock (though not, necessarily, the better buy).

What's an appropriate P/E? Different types of stocks win different valuations. Generally, the market pays up for growth. That's one reason Home Depot has a higher P/E than IBM -- its earnings are expected to grow 20 percent annually, versus just 12 percent for IBM.

To quickly compare P/Es and growth rates, use the PEG ratio -- the P/E (based on estimates for the current year) divided by the long-term growth rate. Home Depot, with a P/E of 35 and a growth rate of 20 percent, has a PEG of 1.8. In general, you want a stock with a PEG that's close to 1.0, which means it is trading in line with its growth rate, but for a quality company, you can pay more.

Also, don't get excited by rock-bottom P/Es -- some companies are doomed to low valuations. One group the market tends to penalize is cyclicals, companies whose performance rises and falls with the economy. General Motors, for example, is highly profitable. But its P/E is just 17 -- and that's considered generous for an automaker.

Price/Sales ratio Just as investors like to know how much they're paying for earnings, it's also useful to know how much they're paying for revenue (the terms "sales" and "revenue" are used interchangeably). To calculate the Price/Sales ratio, divide the stock price by the total sales per share for the past 12 months. You could also use revenue estimates for the next fiscal year, which are being published more frequently on financial websites.

Like P/Es, Price/Sales ratios are all over the map, with fast-growers tending to get the highest valuations. Cisco's trailing price/sales ratio is more than 6, for example, while General Motor's is just 0.2.

Picking stocks for your portfolio

Adapted from the Sivy on Stocks column, "Low-risk growth investing"

Although there are some 9,000 publicly-traded companies, the core of your stock portfolio should consist of big, financially strong companies with above-average earnings growth. Surprisingly, there are only about 200 stocks that fit that description, and we narrow down the list even further in the Sivy 100, a collection of our favorites selected by MONEY magazine's editor-at-large, Michael Sivy. A good stock portfolio should consist of 15 to 20 stocks in at least eight different industries -- but you don't have to buy them all at once.

Since you want to be able to hold your stocks for a long time, they should offer a total return higher than the 12 percent historical market average. You can estimate the likely return by adding the dividend yield to the projected earnings growth rate -- a stock with 11 percent earnings growth and a 2 percent yield could provide a 13 percent annual total return.

As a general rule, stocks with moderately above-average growth rates and reasonable valuations are the best buys. Statistically, high-growth stocks are usually overpriced and have a harder time meeting inflated investor expectations. The first thing to look at is the stock's price/earnings ratio compared with its projected total return. Ideally, the P/E should be less than double the projected return (a P/E of no more than 30 for a stock with 15 percent total return potential).

A well-balanced portfolio might include a couple of industrials with 9 percent growth rates and 3 percent yields, selling at 17 P/Es. Consumer growth stocks with 13 percent growth rates and 1 percent yields, at 23 P/Es. And perhaps a couple of tech stocks with 25 percent growth rates and 60 P/Es (don't overdo it on those). If you can average a 14 percent return over the next 10 to 20 years, you'll reach your financial goals -- and probably outperform most pros as well.

How to buy stocks

Adapted from Talking Money, (Warner Books 2001) by MONEY editor-at-large Jean Chatzky

When you're looking for a broker, you have three distinct choices. From the most to the least expensive, they are: full-service brokers, discount brokers and online brokers. What differentiates them is the advice they provide and cost. Full-service brokers will call with stock ideas, and back this advice with reports from their firm's research department. They'll keep an eye on your picks and let you know when they think changes are necessary. Discounters do less of this. And while there's typically plenty of research available on the best online brokerage sites, it's up to you to dig for it.

You may want to choose different kinds of brokers for different purposes. I believe that full-service brokers should get paid for their stock ideas. That seems only fair. But if you've done your research yourself, I don't see any reason to pay a hefty commission -- discounters probably are fine. The nice thing about the way the brokerage world is shaping up is that you may be able to have both of those things in one account at one firm. Merrill Lynch and many other full-service brokers are quickly coming around to the fact that they need an online component -- and need to charge you lower commissions when you use it. And discounters like Schwab and Fidelity have both started offering a fuller range of services in recent years, while retaining their low-cost structure.

If you decide to sign on with a full-service broker, you should make sure that person has nothing to hide. To get a report on any broker, call the National Association of Securities Dealers at 800-289-9999, or visit their website.

Full-service brokers

Cost: Commissions are typically based on a percentage of your purchase (or sale) price, but start at about $70 for a 100-share trade.
Notable names to choose from include Merrill Lynch, Morgan Stanley Dean Witter, Salomon Smith Barney.

Discount brokers

Cost: Schwab charges $29.95 for a trade, and on average, discounters charge one-third the price of full-service brokers.
Notable names to choose from include Charles Schwab, Waterhouse Securities, Quick & Reilly, and Fidelity.

Online brokers

Cost: At $8 to $15 a trade, it doesn't get any cheaper than this.
Names to choose from include Ameritrade, Datek, and E-Trade.

When trying to place a buy or sell order, you'll be faced with all sorts of questions: Market or limit order? "Day only" or "Good 'till cancelled"" Here's the vocabulary you need to know to place a trade.

If you place a **market order** with your broker, then you are saying that you're willing to buy at whatever happens to be the prevailing price for the stock. If you have a specific price in mind, you can set a **limit order** specifying the price you're willing to pay. If the stock dips down to that level, your order will be automatically filled. Limit orders can be left open for a single day (a **day order**) or indefinitely (**good until canceled**).

After you've bought a stock, you can instruct your broker to sell it if the price drops to a level you specify (a stop loss order). That's a kind of insurance; it means that no matter what happens to a stock's price you'll never lose more than a specified amount. In a volatile market, however, setting a **stop-loss order** at 10 or 20 percent below the purchase price will sometimes cause you to cash out of the stock on a momentary dip -- thus locking in a loss even though the shares may immediately head back upward.

6. Mutual Funds

Top things to know

1. What exactly is a mutual fund?
A mutual fund pools money from hundreds and thousands of investors to construct a portfolio of stocks, bonds, real estate, or other securities, according to its charter. Each investor in the fund gets a slice of the total pie.

2. Mutual funds make it easy to diversify.
Most funds require a minimum investment of only a few thousand dollars, enabling investors to construct a diversified portfolio much more cheaply than they could on their own.

3. There are many kinds of stock funds.
The number of categories is dizzying. Some examples: growth funds, which buy shares of burgeoning companies; sector funds, which buy shares of companies in a particular sector, such as technology or health care; and index funds, which buy shares of every stock in a particular index, such as the S&P 500.

4. Bond funds come in many different flavors too.
There are bond funds for every taste. If you want safe investments, consider government bond funds; if you're willing to gamble on high-risk investments, try high-yield bond funds, also known as junk bond funds; and if you want to keep down your tax bill, try municipal bond funds.

5. Returns aren't everything -- also consider the risk taken to achieve those returns.
Before buying a fund, look at how risky its investments are. Can you tolerate big market swings for a shot at higher returns? If not, stick with low-risk funds. To assess risk level, check these three factors: the fund's biggest quarterly loss, which will help you brace for the worst; its beta, which measures a fund's volatility against the S&P 500; and the standard deviation, which shows how much a fund bounces around its average returns.

6. Low expenses are crucial.
In order to cover their expenses -- and to make a profit -- funds charge a percentage of total assets. At no more than a few percentage points a year, expenses may not sound substantial, but they create a serious drag on performance over time.

7. Taxes take a big bite out of performance.
Even if you don't sell your fund shares, you could still end up stuck with a big tax bite. If a fund owns dividend-paying stocks, or if a fund manager sells some big winners, shareholders will owe their share of Uncle Sam's bill. Tax-efficient funds avoid rapid trading (and high short-term capital gains taxes) and match winning trades with losing trades.

8. Don't chase winners.
Funds that rank very highly over one period rarely finish on top in later ones. When choosing a fund, look for consistent long-term results.

9. Index funds should be a core component of your portfolio.
Index funds track the performance of market benchmarks, such as the S&P 500. Such

"passive" funds offer a number of advantages over "active" funds: Index funds tend to charge lower expenses and be more tax efficient, and there's no risk the fund manager will make sudden changes that throw off your portfolio's allocation.

10. Don't be too quick to dump a fund.
Any fund can -- and probably will -- have an off year. Though you may be tempted to sell a losing fund, first check to see whether it has trailed comparable funds for more than two years. If it hasn't, sit tight. But if earnings have been consistently below par, it may be time to move on.

What is a fund?

Adapted from *The Right Way to Invest in Mutual Funds* (Warner Books, 1996) and *Investing for the Financially Challenged* (Warner Books, 1999), both by Money senior editor Walter Updegrave.

You've probably heard so much about mutual funds that even if you don't own any, you may already know what they are and how they work. But just to clear up any misconceptions and to make sure we're all starting on the same page, let's quickly go over a few of the basics.

A mutual fund pools money together from thousands of small-time investors and then its manager buys stocks, bonds, or other securities with it. When you contribute money to a fund, you get a stake in all its investments. That's a big deal: Since most funds allow you to begin investing with as little as a couple thousand dollars, you can attain a diversified portfolio for much less than you could buying individual stocks and bonds. Plus, you don't have to worry about keeping track of dozens of holdings -- that's the fund manager's job.

The price for a share of a fund is determined by the net asset value, or NAV, which is the total value of the securities the fund owns divided by the number of shares outstanding. If a mutual fund has a portfolio of stocks and bonds worth $10 million and there are a million shares, the NAV would be $10. A fund's NAV changes every day, depending on the price fluctuations of the fund's holdings.

The NAV is the price at which you can buy and sell shares, as long as you don't have to pay a sales commission, or "load." You have to pay loads when you buy from a broker, financial planner, insurance agent, or other adviser.

Different types of stock funds

When searching for stock mutual funds, you're going to run into all sorts of names and categories. They are usually pretty broad, and funds don't always live up to their names -- but at least they give you an idea of what you are getting yourself into. Here are some of the most common categories and sub-categories.

Value funds

Value fund managers look for stocks that they think are cheap on the basis of earnings power (which means they often have low price/earnings ratios) or the value of their underlying assets (which means they often have relatively low price/book ratios).

Large-cap value managers typically look for big battered behemoths whose shares are selling at discounted prices. Often these managers have to hang on for a long time before their picks pan out.

Small-cap value managers typically bottom-fish for small companies (usually ones with market value of less than $1 billion) that have been shunned or beaten down by other investors.

Growth funds

There are many different breeds of growth funds. Some growth fund managers are content to buy shares in companies with mildly above-average revenue and earnings growth, while others, shooting for monster returns, try to catch the fastest growers before they crash.

Aggressive growth fund managers are like drag-car racers who keep the pedal to the metal while taking on some sizeable risk. The result: These funds often lead the pack over long periods of time -- as well as over short periods when the stock market is booming -- but they also have some crack-ups along the way. Consider them only if you can afford to put away your money for at least five years and if you won't bail out when faced with downdrafts of 20 percent or more.

Growth funds also invest in shares of rapidly growing companies, but lean more toward large established names. Plus, growth managers are often willing to play it safe with cash. As a result, growth funds won't zoom as high in bull markets as their aggressive cousins, but they hold up a bit better when the market heads south. Consider them if you're seeking high long-term returns and can tolerate the normal ups and downs of the stock market. For most long-term investors, a growth fund should be the core holding around which the rest of their portfolio is built.

Growth and income funds, Equity income funds, Balanced funds

These three types of funds have a common goal: Providing steady long-term growth while simultaneously throwing off reliable income. They all hold some combination of dividend-paying stocks and income-producing securities, such as bonds or convertible securities (bonds or special types of stocks that pay interest but can also be converted into the company's regular shares).

Growth and income funds concentrate more than the other two on growth, so they generally have the lowest yields. Balanced funds strive to keep anywhere from 50 to 60 percent of their holdings in stocks and the rest in interest-paying securities such as bonds and convertibles, giving them the highest yields. In the middle is the equity-income class. All three types hold up better than growth funds when the market turns sour, but lag in a raging bull market.

All of these are for risk-averse investors and anyone seeking current income without forgoing the potential for capital growth.

Specialty and other types of funds

Rather than diversifying their holdings, sector and specialty funds concentrate their assets in a particular sector, such as technology or health care. There's nothing wrong with that approach, as long as you remember that one year's top sector could crash the following year.

Different types of bond funds

U.S. government bond funds

These funds invest primarily in bonds issued by the U.S. Treasury or federal government agencies, which means you don't have to worry about credit risk. But because of their higher level of safety, however, their yields and total returns tend to be slightly lower than those of other bond funds.

That's not to say government bonds funds don't fluctuate -- they do, right along with interest rates. If you can't tolerate swings of more than a few percentage points, stick to short-term government bond funds. If fluctuations of five percent or so don't cause you to break out in a cold sweat, then you can pick up a bit more yield with intermediate government bond funds. If you plan on holding on for several years and can handle 10 percent swings, long-term government bond funds will provide even more yield.

Corporate bond funds

Funds in this category buy the bonds issued by corporations that may range from well-known household names to relatively obscure widget makers most of us have never heard of. When researching corporate bonds funds, consider the credit quality of the individual bonds they hold (most hold highly rated bonds, AAA to BBB, but some take more risk by adding small doses of high-yielding junk bonds.) Also consider the average maturity of the bonds -- the longer the average maturity, the greater the volatility.

High-yield bond funds

Let's spare the euphemisms. These are junk bond funds. They invest in debt of fledgling or small firms whose staying power is untested as well as in the bonds of large, well known companies in weakened financial condition. The potential that these companies will default on their interest payments is much higher than on higher quality bonds, but since these funds usually hold more than 100 issues, a default here and there won't capsize the fund.

There is more risk, however, and for that, you get higher yields -- usually three to 10 percentage points more than safer bond funds. These funds tend to shine when the economy is on a roll, and suffer when the economy is fading (increasing the chance of default).

Who should buy them: Investors who want to boost their income and total returns and can tolerate losses of 10 percent or so during periods of economic turbulence.

Municipal bond funds

Tax-exempt bond funds -- also known as muni bond funds -- invest in the bonds issued by cities, states, and other local government entities. As a result, they generate dividends that are free from federal income taxes. The income from muni bond funds that invest only in the issues of a single state is also exempt from state and local taxes for resident shareholders. Once you factor in the tax benefits, muni funds often offer better yields than government and corporate funds.

Guidelines for choosing stock funds

1) Opt for low expenses

Fund expenses directly reduce your returns, so you'll increase your odds of success by avoiding funds with bloated expense ratios; that's the annual cost, divided by your investment.

2) Look for consistency
For a fund to fit into a diversified portfolio, it's important that the manager stick to a particular investing style. If you bought a fund because you want your portfolio to include, say, small value stocks, then you don't want a fund manager jumping into large growth.

3) Consider risk
Returns may vary, but funds that are risky tend to stay risky. So be sure to check out the route the fund took to rack up past gains and decide whether you would be comfortable with such a ride. Here are some risk measures to consider.

- **Beta** measures how much a fund's value jumps around in relation to changes in the value of the S&P 500, which by definition has a beta of 1.0. A stock fund with a beta of 1.20 is 20 percent more volatile than the S&P - that is, for every move in the S&P, the fund will move 20 percent more in either direction.
- **Standard deviation** tells you how much a fund fluctuates from its own average returns. A standard deviation of 10 means the fund's monthly returns usually fall within 10 percentage points of their average. The higher the standard deviation, the more volatile the fund.
- **Worst quarter** This is a very straightforward measure of risk: It merely shows the fund's worst quarterly return on record, giving you a feel of what to brace yourself for.

4) Check out past performance relative to peers
When examining a fund's performance, you should look at its long-term record (at least three years and preferably five years) versus that of its peers, as well as how it has fared over shorter stretches. And you should compare those results to category averages -- you can't really fault a small-cap fund manager for a lousy year if all small-cap funds did poorly. But it's a lot harder to be forgiving if a fund does much worse than all its peers.

5) Seek low taxes
You can't forget about taxes just because you don't have any intention of selling your fund shares. As a fund owner, you also own all the stocks in the fund's portfolio. If the fund manager sells a stock for a huge capital gain, you'll have to report that gain on your tax return.

6) Steer clear of asset bloat
This is more of an issue with small-cap funds than with large-cap funds. Since the latter buy big stocks with a lot of shares outstanding, the manager shouldn't have too much of a problem buying more GE and IBM as investors pour money into the fund. But since small-cap funds are buying stocks with very few shares outstanding, an extra billion or two in total assets can tie the manager's hands. To put the additional money to work, the small-cap fund manager may have to drop his standards.

Guidelines for choosing bond funds

1) Think low expenses
The single most important thing you can do to earn competitive returns in a bond fund is to opt for those with low expenses. As a general rule, bond index funds will have lower expense ratios than managed funds that invest in, say, munis and junk. With the latter, at least stick with below-average expenses.

2) Stick with short to intermediate maturities
Over the past 20 years or so, long-term bond funds have provided the highest returns. But that may not always be the case. What's more, long-term bond funds can be surprisingly volatile. If interest rates rise just one percentage point, a long-term bond fund can drop 10 percent or more, wiping out more than a year's interest. That may be fine if you're a long-term investor and you don't mind such setbacks.

But if you're investing for shorter periods -- 10 years or less -- or if you're using bond funds to add some ballast to a predominantly stock portfolio, then you're better off with bond funds with short- to intermediate-term maturities -- say, five to 10 years. You can typically get 75 to 80 percent of the return of long-term funds, while incurring roughly 40 percent less volatility.

3) Beware tempting yields
Fund companies know that investors focus on yields. So some do everything they can short of putting the fund on steroids to pump up yields. They may throw some low-grade bonds into a government portfolio, or even throw in international bonds from countries where rates are especially high.

These ploys to boost interest may or may not pay off, but they all involve risks that are difficult to evaluate. If you see a bond fund that's touting much higher yields than funds with similar maturities and the fund doesn't have ultra-low expenses, then move on.

The beauty of index funds

With the best business schools in the country churning out a steady supply of expensively educated MBAs who go to work for fund companies, you'd think funds would have no trouble posting above-average returns. After all, fund shareholders -- that's you -- are paying fund managers big bucks to find the best stocks in the market.

But the fact is, the majority of funds don't beat the market in most years. That is, you're better off buying all the stocks in the Standard & Poor's 500 index or in the Wilshire 5000 index (which includes just about every stock on the New York, American and Nasdaq stock exchanges) than paying someone to select what he thinks are the best ones.

There are several reasons so many funds fall short. First, factor in investing costs that fund companies incur -- the cost of research, administration, managers' salaries and so on. That cost is borne by the shareholders and gets deducted from returns. A fund manager needs to pick a lot of great stocks to make up for those costs. Index funds, meanwhile, are much lower maintenance, and tend to have much lower costs.

There are some caveats. Indexing seems to work better in some areas than others. The case is most solid for large U.S. stocks and bonds, largely because there is so much information on these big securities that it is tough for a fund manager to gain an edge.

Active managers of small-cap funds have traditionally fared better against their index -- the Russell 2000.

When to dump a fund

1) Your fund is a persistent loser

The mere fact that a fund has low returns or even losses isn't a good reason to sell. If the overall market is down, or the specific sector your fund invests in is out of favor, you can't expect your fund manager to be a miracle worker. But if you own a fund that trails similar funds for two years by a substantial margin -- say, two percentage points or more -- then I'd think about moving on.

2) The fund's investment strategy has changed
If you've attempted to create a diversified portfolio, then you're probably counting on the managers of all your funds to invest a certain way. The small-cap fund manager should be sticking to small-cap stocks, and the large-cap value fund manager should be buying large-cap value stocks. If they stray, it puts your entire plan into jeopardy.

3) There's been a manager change
In today's fund world, many managers job-hop as often as NBA coaches. Anytime your fund gets a new skipper, you should closely monitor the situation to assure two things: first, that the new manager is following the same investing style and strategy as his predecessor; second, that performance hasn't suffered. Give a new manager one year (and no more than two) to prove himself.

4) You could use the tax loss
There are times when you might be able to lower your tax bill by dumping a losing fund yet still pretty much maintain your asset mix. For example, say you own shares in a large-cap growth fund that are worth less than you paid for them. If you sell, you can use the loss to offset gains in other securities. Then, you can turn right around and buy another large-cap growth fund. Or, you can buy back the very same fund after 31 days.

7. Bonds

Top things to know

1. Bonds are fancy IOUs
Companies and governments issue bonds to fund their day-to-day operations or to finance specific projects. When you buy a bond, you are loaning your money for a certain period of time to the issuer, be it General Electric or Uncle Sam. In return, bond holders get back the loan amount plus interest payments.

2. Stocks do not always outperform bonds.
Stock and bond returns were a wash from about 1870 to 1940. It is only in the post-World War II era that stocks so widely outpaced bonds in the total-return derby.

3. You can lose money in bonds.
Bonds are not turbo-charged CDs. Though their life span and interest payments are fixed -- thus the term "fixed-income" investments -- their returns are not.

4. Bond prices move in the opposite direction of interest rates.
When interest rates fall, bond prices rise, and vice versa. But if you hold a bond to maturity, price fluctuations don't matter. You will get back the face value of the bond -- along with all the interest you expect.

5. A bond and a bond mutual fund are totally different animals.
With a bond, you always get your interest and principal at maturity, assuming the issuer doesn't go belly up. With a bond fund, your return is uncertain because the fund's value fluctuates.

6. Don't invest all your retirement money in bonds.
Inflation erodes the value of bonds' fixed interest payments. Stock returns, by contrast, tend to keep pace with inflation. Young and middle-aged people should put a large chunk of their money in stocks. Even retirees should own some stocks, given that people are living longer than they used to.

7. Consider tax-free bonds.
Tax-exempt municipal bonds yield less than taxable bonds, but they can still be the better choice for taxable accounts. That's because tax-frees sometimes net you more income than you'd get from taxable bonds after taxes, provided you're in the 28 percent federal tax bracket or higher.

8. Pay attention to total return, not just yield.
Returns are a slippery matter in the bond world. A broker may sell you a bond that is paying a "coupon" -- or interest rate -- of 8 percent. If interest rates rise, however, and the price of the bond falls by, say, 3 percent, its total return for the first year -- 8 percent in income less a 3 percent capital loss -- would be only 5 percent.

9. If you want capital gains, go long.
Gamblers who want to bet on the direction of interest rates should buy long-term bonds or bond funds, especially "zeros." Reason: when rates fall, longer-term bonds gain more in price than shorter-term bonds. So you win big -- scoring a large potential capital gain in addition to whatever interest the bond may be paying. If rates rise, on the other hand, you lose big, too.

10. If you want steady income, stick with short to medium.
Investors looking for income should invest in a laddered portfolio of short- and intermediate-term bonds.

Why bonds?

Think "bonds," and you probably think "safe," "reliable" -- in a nutshell, "boring." But that is only half the story. Bonds can provide a worry-free stream of income. But this class of securities includes a wide array of instruments with varying degrees of risk and reward, some of which offer gains -- or losses -- comparable to those of any white-knuckle stock.

Used improperly, bonds can really mess up your financial life. Handled with care, however, bonds are among the most valuable tools in your investment kit. Here are some of the benefits bonds can provide:

- **Diversification.** Large company stocks have posted compound annual returns of around 11.3 percent since 1926, versus 5.1 percent for long-term U.S. government bonds, according to Ibbotson Associates. But while stocks have returned more than bonds over most of this decade, they are also more volatile. Combining stocks with bonds will net you a more stable portfolio.
- **Income.** Because bonds pay interest regularly, they are a good choice for investors -- such as retirees -- who desire a steady stream of income.
- **Security.** Next to cash, U.S. Treasuries are the safest, most liquid investments on the planet. Short-term bonds are a good place to park an emergency fund or money you'll need relatively soon -- say to buy a house or send a child to college.
- **Tax savings.** Certain bonds provide tax-free income. Although these bonds usually pay lower yields than comparable taxable bonds, investors in high tax brackets (generally, 28 percent and above) can often earn higher after-tax returns from tax-free bonds.

How bonds work

The ins and outs of taxable and tax-free debt

Companies and governments issue bonds to fund their day-to-day operations or to finance specific projects. When you buy a bond, you are loaning your money for a certain period of time to the issuer, be it General Electric or Uncle Sam.

In exchange, the borrower promises to pay you interest every year and to return your principal at "maturity," when the loan comes due, or at "call" if the bond is of the type that can be called earlier than its maturity (more on this later). The length of time to maturity is called the "term."

A bond's face value, or price at issue, is known as its "par value." Its interest payment is known as its "coupon." A $1,000 bond paying 7 percent a year has a $70 coupon (actually, the money would usually arrive in two $35 payments spaced six months apart). Expressed another way, its "coupon rate" is 7 percent. If you buy the bond for $1,000 and hold it to maturity, the "yield," or actual earnings on your investment, is also 7 percent (coupon rate divided by price = yield).

Say you don?t buy the bond right at the offering, and instead buy from somebody else in the ?secondary? market. You?ll likely end up buying it for more -- or selling it for less --

than face value.

If you buy the bond for $1,100 in the secondary market, though, the coupon will still be $70, but the yield will fall to 6.4 percent because you paid a "premium" for the bond. For an similar reason, if you buy it for $900, its yield will rise to 7.8 percent because you bought the bond at a "discount." If its current price equals its face value, the bond is said to be selling at "par."

The bottom line: There are many ways of expressing a bond's return, but "total return" is the only one that really matters. This includes all the money you earn off the bond: the annual interest and the gain or loss in market value, if any. If you sell that $1,000 bond with the $70 coupon for $1,050 after one year, your total return is $120, or 12 percent -- $70 in interest and $50 in capital gains. (Prices are usually expressed based on a par value of 100, by the way, so when you sell that bond for $1,050 the price would be quoted as 105.)

Types of bonds

U.S. Treasuries are the safest bonds of all because the interest and principal payments are guaranteed by the "full faith and credit" of the U.S. government. Interest is exempt from state and local taxes, but not from federal tax. Because of their almost total lack of default risk, Treasuries carry some the lowest yields around.

Treasuries come in several flavors:

- **Treasury bills,** or "T-bills," have the shortest maturities -- 13 weeks, 26 weeks and one year. You buy them at a discount to their $10,000 face value and receive the full $10,000 at maturity. The difference reflects the interest you earn.
- **Treasury notes** mature in two to 10 years. Interest is paid semiannually at a fixed rate. Minimum investment: $1,000 or $5,000, depending on maturity.
- **Treasury bonds** have the longest maturities at 10 years. As with Treasury notes, they pay interest semiannually, and are sold in denominations of $1,000.
- **Zero-coupon bonds,** also known as "strips" or "zeros," are Treasury-based securities that are sold by brokers at a deep discount and redeemed at full face value when they mature in six months to 30 years. Although you don't actually receive your interest until the bond matures, you must pay taxes each year on the "phantom interest" that you earn (it's based on the bond's market value, which usually rises steadily during the time you hold it). For that reason, they are best held in tax-deferred accounts. Because they pay no coupon, zeros can be highly volatile in price.
- **Inflation-indexed Treasuries.** These pay a real rate of interest on a principal amount that rises or falls with the consumer price index. You don't collect the inflation adjustment to your principal until the bond matures or you sell it, but you owe federal income tax on that phantom amount each year -- in addition to tax on the interest you receive currently. Like zeros, inflation bonds are best held in tax-deferred accounts.

Mortgage-backed bonds represent an ownership stake in a package of mortgage loans issued or guaranteed by government agencies such as the Government National Mortgage Association (Ginnie Mae), Federal Home Loan Mortgage Corp. (Freddie Mac) and Federal National Mortgage Association (Fannie Mae). Interest is taxable and is paid monthly, along with a partial repayment of principal. Except for Ginnie Maes, these bonds are not backed by the full faith and credit of the U.S. government. They generally yield up to 1 percent more than Treasuries of comparable maturities. Minimum investment: typically $25,000.

Corporate bonds pay taxable interest. Most are issued in denominations of $1,000 and have terms of one to 20 years, though maturities can range from a few weeks to 100 years. Because their value depends on the creditworthiness of the company offering them, corporates carry higher risks and, therefore, higher yields than super-safe Treasuries. Top-quality corporates are known as "**investment-grade**" bonds. Corporates with lower credit quality are called "**high-yield**," or "junk," bonds. Junk bonds typically pay higher yields than other corporates.

Municipal bonds, or "munis," are America's favorite tax shelter. They are issued by state and local governments and agencies, usually in denominations of $5,000 and up, and mature in one to 30 or 40 years. Interest is exempt from federal taxes and, if you live in the state issuing the bond, state and possibly local taxes as well. Note, though, that Illinois, Kansas, Iowa, Oklahoma, and Wisconsin tax interest on their own muni bonds. And the capital gain you may make if you sell a bond for more than it cost you to buy it is just as taxable as any other gain; the tax-exemption applies only to your bond's interest.

Munis generally offer lower yields than taxable bonds of similar duration and quality. Because of their tax advantages, though, they often return more -- after taxes -- than equivalent taxable bonds for people in the 28 percent federal tax bracket or above.

Sizing up risks

So you think bonds are totally safe and predictable?

Many people believe they can't lose money in bonds. Wrong! Although the interest payments you'll get from owning a bond are "fixed," your return is anything but. Here are the major risks that can affect your bond's return:

Inflation risk. Since bond interest payments are fixed, their value can be eroded by inflation. The longer the term of the bond, the higher the inflation risk. On the other hand, bonds are a classic deflation hedge; deflation increases the value of the dollars that bond investors get paid.

Interest rate risk. Bond prices move in the opposite direction of interest rates. When rates rise, bond prices fall because new bonds are issued paying higher coupons, making the older, lower-yielding bonds less attractive. Conversely, bond prices rise when interest rates fall because the higher payouts on the old bonds look more attractive relative to the lower rates offered on newer ones. The longer the term of the bond, the greater the price fluctuation, or volatility, that results from any change in interest rates.

As you might surmise, there is a close connection between inflation risk and interest rate risk since interest rates tend to rise along with inflation. Interest rate shifts are also a concern for mortgage-backed bondholders, but for a different reason: If interest rates fall, home owners may decide to prepay their existing mortgages and take out new ones at the lower rates. That doesn't mean you'll lose your principal, if you happen to hold such a bond. But it does mean you get your principal back much sooner than expected, forcing you to reinvest it at the newly lower rates. For that reason, the prices of mortgage-backed securities don't get as big a boost from falling rates as other kinds of bonds.

Note, though, that price fluctuations only matter if you intend to sell a bond before maturity, or you invest in a bond fund whose manager trades regularly (more below). If you hold a bond to its maturity, you will be repaid the bond's full face value. But what if interest rates fall and the issuer of your bond wants to lower its interest costs? This brings us to the next type of risk . . .

Call risk. Many corporate and muni bond issuers reserve the right to redeem, or "call," their bonds before they mature, at which point the issuer is required to pay bondholders only par value. Typically, this happens if interest rates fall and the issuer sees it can lower its costs by selling new bonds with lower yields. If you happen to own one of the called bonds, not only do you get less than the market price of the bond, but you also have to find a place to reinvest the money. Because of the risk that you won't get the income you expect, callable bonds usually pay a higher rate of interest than comparable, noncallable bonds. So, when you buy bonds, make sure to ask not only about the time to maturity, but also about the time to a likely call.

Credit risk. This is the risk that your bond issuer will be unable to make its payments on time -- or at all -- and it depends on the type of bond you own and the borrower's financial health. U.S. Treasuries are considered to have virtually no credit risk, junk bonds the highest. Bond rating agencies such as Standard & Poor's and Moody's evaluate corporations and municipalities for their credit worthiness. Bonds from the strongest issuers are rated triple-A. Junk bonds are rated Ba and lower from Moody's, or BB and lower from S&P. (You can check out a bond's rating for free by calling S&P at 212-438-2000 or Moody's at 212-553-0377, or by checking some of the bond websites we identify in "Buying bonds.") The highest-quality municipal bonds are backed by bond insurance companies, but there is a trade-off: Insured munis typically yield up to 0.3 percentage points less than comparable uninsured munis. Further, the insurance only guarantees your interest and principal; it won't shield you against interest rate or market risk. Some higher-coupon munis are also "pre-refunded," meaning that, for esoteric reasons, they are effectively backed by U.S. Treasuries. When a muni is pre-refunded by an issuer, its credit quality and price rise.

Liquidity risk. In general, bonds aren't nearly as liquid as stocks because investors tend to buy and hold bonds rather than trade them. While there is always a ready market for super-safe Treasuries, the markets for other bonds, especially munis and junk bonds, can be highly illiquid. If you are forced to unload a thinly-traded bond, you will probably get a low price.

Market risk. As with most other investments, bonds follow the laws of supply and demand. The more popular or less plentiful a bond, the higher the price it commands in the market. A recent example: The price of U.S. Treasuries -- that ultimate safe haven -- rose dramatically during the economic meltdown in Asia and Russia.

You can't eliminate these risks altogether. But now that you understand them, you may be able to reduce their impact by some of the methods described in the next section of this lesson.

Buying bonds

How and where to invest wisely

If you've stuck with the lesson to this point, you are probably interested in knowing more about how to purchase bonds. Here are the main ways:

Directly from the feds. U.S. Treasuries are sold by the federal government at regularly scheduled auctions. You can buy them through a bank or broker for a fee, but why pay for something you can get for nothing? The easiest and cheapest way to participate in this market is to buy them directly from the Treasury. You can check out the so-called

Treasury Direct program on the Web or by calling 202-874-4000. You also can sell bonds you already own before maturity through the Treasury's newer Sell Direct program.

Through a broker. With the exception of Treasuries, buying individual bonds isn't for the faint of heart. Most new bonds are issued through an investment bank, or "underwriter," rather than directly to the public. The issuer swallows the sales commission, so you get the same price big investors pay. That's why, when buying individual bonds, you should buy new issues directly from the underwriter whenever possible -- since you're getting them at wholesale. Older bonds are another matter. They are traded through brokers on the "secondary market," usually over the counter rather than on an exchange, such as the New York Stock Exchange. Here, transaction costs can be much higher than with stocks because spreads -- the difference between what a dealer paid for a bond and what he'll sell it for -- tend to be wider.

You will seldom know what spread you paid, unfortunately, because the markup is set by the dealer and built into the price of the bond. There is no fixed commission schedule. One ray of sunshine: The Bond Market Association recently began posting some muni bond prices on its Website. Alas, the prices include dealer markups because dealers protested listing commissions separately.

If you do plan to invest in individual bonds, you should probably have enough money to invest -- say $25,000 to $50,000 at a minimum -- to achieve some degree of diversification, as we'll explain below. (If you have less, consider bond funds, also described below.)

Exactly how you invest it depends largely on your objective:

- **If your objective is to achieve capital gains, concentrate on long-term issues.** Reason: as noted in "Sizing up risks," the longer the term of a bond, the more pronounced are its price swings when interest rates move. That works to your advantage if interest rates fall. Your long-term bonds -- especially zero-coupon bonds -- will suddenly be worth a lot more. Of course, it works to your distinct disadvantage if interest rates rise, and your portfolio drops in value. This kind of bond investing is essentially a bet that interest rates will fall, and its subject to all the same risks -- including that of substantial losses -- as any other market-timing investment.
- **If your objective is a steady, secure stream of income, adopt a more conservative approach.** Specifically:
    - **Stick to shorter terms.** Bonds with maturities of one to 10 years are sufficient for most long-term investors. They yield more than shorter-term bonds, and are less volatile than longer-term issues.
    - **Spread your money around.** Invest in a variety of bonds with different maturities, either by buying a bond fund or buying a half-dozen or more individual bonds.
    - **Build a laddered portfolio.** Each rung of your ladder consists of a different maturity bond, from one year right on up to 10 years. When the one-year bond matures, you reinvest the money in a new, 10-year issue. In this way, you always have more money to reinvest every year, and you are somewhat protected from interest rate shifts because you have locked in a range of yields.

Through a mutual fund. It can make sense to buy individual bonds if you own a lot of them and hold them to maturity, but most people are better off buying bonds through mutual funds. The biggest reason is diversification. Because bonds are sold in large units, you might only be able to purchase one or a handful of bonds on your own, but as a bond fund holder you'll own stakes in dozens, perhaps hundreds, of bonds. You will also get the benefit of professional research and money management. Another advantage: Dividends are paid monthly, versus only semiannually for individual bonds, and can be reinvested automatically. Lastly, bond funds are more liquid than individual bond issues.

The biggest drawback to bond funds -- and it's a whopper -- is that they don't have a fixed maturity, so that neither your principal nor your income is guaranteed. Fund managers are constantly buying and selling bonds in their portfolios to maximize their interest income and capital gains. That means your interest payments will vary, as will the fund's share price.

For this reason, don't choose a fund based only on its yield. Look at its total return, which combines the income the fund paid out with any change in the value of the fund's shares. Also, look for a fund with low expenses. Because bond funds with similar investment objectives tend to hold similar types of securities, which perform similarly, there are only two ways a fund manager can goose the yield: cut expenses or take on more risk. If a fund's yield is more than one percentage point higher than the average for its peers and the difference can't be explained by lower fees, the manager is probably dabbling in exotica.

8. Buying a Home

Top things to know

1. Don't buy if you can't stay put.
If you can't commit to remaining in one place for five years or more, then owning is probably not for you, at least not yet. With slow appreciation and the costs of buying and selling a home, you may end up losing money if you sell any sooner.

2. Start by shoring up your credit.
Since you most likely will need to get a mortgage to buy a house, you must make sure your credit history is as clean as possible. A few months before you start house hunting, get copies of your credit report. Make sure the facts are correct. Fix any problems you discover.

3. Aim for a home you can really afford.
The rule of thumb is that you can buy housing that runs about two-and-one-half times your annual salary. But you'll do better to use one of the Internet's many calculators to get a better handle on your income, debts, and expenses and how those affect what you can afford.

4. Don't worry if you can't put down the usual 20 percent.
There are a variety of public and private lenders who, if you qualify, offer low-interest mortgages that require a down payment as small as 3 percent of the purchase price.

5. Buy in a district with good schools.
This advice applies even if you don't -- and won't -- have school-age children. Reason: When it comes time to sell, you'll learn that strong school districts are a top priority for many homebuyers -- thus helping to boost property values.

6. Get professional help.
Even though the Internet gives buyers unprecedented access to home listings, it's still a good idea to use an agent. Look for an exclusive buyer agent, if possible, who will have your interests at heart and can help you with strategies during the bidding process.

7. Choose carefully between points and rate.
When picking a mortgage, you usually have the option of paying additional points -- a portion of the interest that you pay at closing -- in exchange for a lower interest rate. If you stay in the house for a long time -- say five to seven years or more -- it's usually a better deal to take the points. The lower interest rate will save you more in the long run.

8. When house hunting, bring your camera.
Or at least a notebook to jot down reminders, since after you look at a half-dozen or so houses the details begin to blur in your mind. The best choice would either be an electronic camera that lets you take notes right on the image, or a Polaroid so that you can scribble comments in the margins.

9. Do your homework before bidding.
Your opening bid should be based on the sales trend of similar homes in the neighborhood. So before making it, consider sales of similar homes in the last three months. If homes have recently sold at 5 percent less than the asking price, you should make a bid that's about eight to 10 percent lower than what the seller is asking.

10. Hire a home inspector.
Sure, your lender will require a home appraisal anyway. But that's just the bank's way of determining whether the house is worth the price you've agreed to pay. Separately, you should hire your own home inspector -- preferably an engineer with experience in doing home surveys in the area where you are buying. His or her job will be to point out potential problems that could require costly repairs down the road.

Are you ready?

Don't buy just because you can afford to

Sure, owning a home is one of the key elements of the American Dream -- and not by accident. Home ownership means you no longer pay monthly rent for the roof over your head. Now you own it, and most of what's under it too. You can do what you want with your house (within reason). And when you leave, you can sell it to recoup the purchase price and -- with any luck -- perhaps earn a profit too.

Don't kid yourself. Like most good things in life, home ownership comes with a slew of disadvantages, responsibilities, and downright headaches. In fact, it's probably the second biggest financial commitment most people ever make -- the biggest being children. So before going any further, consider whether your lifestyle and finances make homebuying a smart move.

Let's start with lifestyle. Except in a roaring real estate market, it usually doesn't make sense to purchase a home that you'll be departing in less than four or five years. Reason: the high cost of buying and selling homes, and their generally slow price appreciation, mean you'll lose money on the deal. So ask yourself, Can you can really stay put for that long? Will you need to move because you are transferred by your current employer or a new one? Are you thinking of going back to school? And will your income remain steady or grow, or is it likely to decrease?

Some more mundane, but equally important, questions: Do you really want to call the plumber -- and pay for his services -- every time a pipe leaks? Or would you rather leave it to the landlord to fix the plumbing, paint the walls, patch the roof and buy a new refrigerator? There's nothing wrong with that.

On the financial side, one key question is whether it costs more, on average, to rent or own in your area. If you want to do it by hand, the rule of thumb is that if you pay 35 percent less in rent than you would for owning -- including the monthly mortgage, property taxes and any homeowner's fees -- then it's smarter to continue renting. You could also ask a real estate or rental agent to help you figure this out.

Lining up cash

Forget location, location, location. Think credit, credit, credit

For most people, buying a house involves a double financial whammy. First you have to assemble a huge pile of cash for the down payment and closing costs. Then you must convince a bank to lend you an even more staggering sum -- generally 80 percent or more of the purchase price. So your first step, even before you start the actual hunt for a property, should be to get your financial house in order.

Start with your credit. All mortgage lenders do a thorough financial analysis of applicants, including looking over your credit reports. These reports are kept by the three major credit agencies, Experian, Equifax and TransUnion. They contain a lot of basic information --

your name, age, address, years at that address, even your income, if the agency can obtain the data. They also list all the open credit lines you are now responsible for, including credit cards, gasoline cards, revolving charge accounts, student loans, and the like. A credit report will show whether you are habitually late with payments and whether you have run into serious credit problems in the past, such as a bankruptcy within the last seven years.

Blemishes here can delay or kill your chance for getting financing. So get a copy of your own report -- try ConsumerInfo.com, which charges about $30 for a combined report from all three agencies -- and make sure it's correct. If there are errors, you must contact the agencies directly to correct them -- which can take two or three months to resolve. And if the report is accurate but shows past problems, be prepared to explain them to a loan officer.

Next you need to determine how much house you can afford. The best way to do so is to use one of the Web's many calculators, like the ones on CNN/Money.com and Quicken.com. If you're doing the calculation at home using a spreadsheet or calculator, here's what the results are based on. Banks generally insist that: 1) your monthly housing costs, including mortgage principal and interest, property taxes, homeowner's insurance and private mortgage insurance, should equal no more than 28 percent of your gross monthly income; and 2) that sum plus your minimum monthly payment on any long term debts should equal no more than 36 percent of your gross income.

The rule of thumb here is to aim for a home that costs about two-and-a-half times your gross annual salary. Use this only as a general guide, though. Many factors can change that equation. If you have significant credit card debt or other financial obligations like alimony or even an expensive hobby, then you may need to set your sights lower.

You must also raise cash for the down payment and closing costs. Most lenders like to see at least 20 percent of the home's price as a down payment. If you can put down more than that, the lender may be willing to approve a larger loan. If you have less, you'll need to find loans that can accommodate you. Various private and public agencies -- including Fannie Mae, Freddie Mac, the Federal Housing Administration and the Department of Veteran Affairs -- provide low down payment mortgages through banks and mortgage companies. If you qualify, it's possible to pay as little as 3 percent up front for a loan. For more, check out their Web sites at Fanniemae.com or Freddiemac.com.

One caveat: With a down payment under 20 percent, you will probably wind up having to pay for private mortgage insurance, a safety net protecting the bank in case you fail to make payments. PMI adds from 0.5 percent to 1.25 percent of the total loan amount at the closing, plus annual fees that will be built into your monthly mortgage payments.

Also, make sure you've got enough to cover fees and closing costs. These may include the appraisal fee, loan fees, attorney's fees, inspection fees and the cost of a title search. They can easily add up to $5,000 to $7,000 -- and often run to 5 percent of the mortgage amount.

If your available cash doesn't cover your needs, you have several options. First-time homebuyers can withdraw up to $10,000 without penalty from an Individual Retirement Account, if you have one, though you must pay taxes on the amount. You can also receive a cash gift of up to $11,000 a year (the limit for 2002) from each of your parents without triggering a gift tax. Gift taxes are paid by the donor, not the recipient. (In fact, if your and your spouse's parents are both well-heeled, they can give you a total of $88,000 in one year -- $22,000 from each set of parents to each of you. This is a good type of family to have.) Check on whether your employer can help; some big companies will chip in on the down payment or help you get a low-interest loan from selected lenders. You can also tap a 401(k) or similar retirement plan for a loan from yourself.

The thing you cannot do is use borrowed money to meet the down payment. Banks will recognize that for what it is, a loan, and treat it as one of your debt obligations, not cash on hand.

Picking a team

Don't buy a home without professional help

With all the tools and advice available today -- ranging from the Internet to books and magazines and online advice like this lesson -- it would theoretically be possible for you to buy your home almost completely without the aid of real estate professionals.

That's not necessarily recommended. The housing market, like politics, is basically local, and each state, city, and even neighborhood has a thicket of local laws or customs that you need to understand. For that, it helps to have a team of professionals to guide you.

You might want to start by finding an agent who can represent your interests in the search. This is not as simple as it sounds. Sure, 85 percent of sellers list their homes through an agent -- but those agents are working for the seller, not you. They're paid based on a proportion (usually 6 percent) of the purchase price, so their interest will be in getting you to pay more. What you need is one of the newer, smaller groups of agents who call themselves "exclusive buyer agents." Sometimes buyer agents are paid directly by you, on an hourly or contracted fee. Other times they split the commission that the seller's agent gets upon sale. A buyer's representative has the same access to homes for sale that a seller's agent does, but his or her allegiance is supposed to be only to you.

To complicate matters, there are hybrid agencies called either single-agency or dual-agency brokers. In both cases, an individual agent in the firm may represent either sellers or buyers, but never both in the same transaction. Potential conflicts of interest abound in this situation, so if you are seeking a buyer agent but no exclusive buyer agent is available, make sure to ask the agent about conflicts of interest.

Most good real estate Web sites have resources for finding an agent. Realtor.com is operated by the largest member association of real estate agents. Also try the National Association of Exclusive Buyer Agents. And iOwn.com offers a list of questions to pose to an agent to help you find one who best understands your needs.

Next start looking for a mortgage lender. Take your time, since you could be paying this loan for 30 years. Start on the Internet at places like iOwn.com, Quickenmortgage.com and E-loan.com. You may also want to check out the rates at CNN/Money, Bankrate or HSH. These sites carry nationwide listings of mortgage interest rates and other related information.

Don't limit your search to the Net, though. Once you have an idea of the best rates from national lenders, get on the phone to your community banks and any other institutions -- including credit unions -- with which you may have a relationship. Ask if they can beat the national rates. Often, the local lender can offer a better deal simply because he or she knows the local market and wants to keep your business.

You might also consider using a mortgage broker, a middleman who keeps tabs on rates from a multitude of lenders. The mortgage broker isn't paid directly by you but gets paid by the bank. However, the fee -- usually 1.5 percent to 2 percent of the loan amount -- gets transferred to you in the closing costs. Most search engines have extensive listings of mortgage brokers. There's also a trade group, the National Association of Mortgage Brokers.

There are several different loan types, each suitable for different homebuyers. First determine whether you want a fixed-rate or an adjustable rate mortgage. With a fixed rate, you lock in a monthly payment amount that will remain constant throughout the life of the loan, even if interest rates rise. If interest rates fall, you can either continue paying your higher preset rate, or you could refinance your loan, though that would mean paying additional closing costs.

An adjustable rate mortgage (ARM), on the other hand, has an interest rate that rises or falls in step with a financial index, such as the one-year or three-year Treasury rate. Banks typically offer an initial "teaser" rate on ARMs that is 2 percent lower than that for fixed-rate loans. For this reason, you might choose an ARM if you plan to sell your home within four or five years. During that short period of time, you will almost certainly pay less than you would with a fixed-rate mortgage. Alternatively, you can look into a hybrid loan, which offers a fixed rate initially -- usually for the first five to 10 years -- and then converts to an adjustable rate for the rest of the term.

You may also want to pay points to lower the interest rate on your loan. Basically, points -- or the "loan discount cost," as they're more formally known -- represent a portion of the interest that you pay up front in exchange for a lower rate thereafter. One point equals one percent of the loan amount.

The longer you plan to stay in your home, the more you should consider paying points. For instance, a lender may offer an 8 percent loan at no points, or a 7.6 percent loan with two points. If you have a 30-year, fixed-rate mortgage of $100,000, your monthly payment for a no-point loan would be $734; on the two-point loan, it would be $706. That's a small difference, just $28 a month. But if you pay the points, you'll recoup the $2,000 you spent in a little under six years of payments. And over the life of the loan, you'll save $10,000. So in this case, if you planned to stay put for six years or more, it would make sense to go with the points.

Once you choose a lender, try to get yourself "prequalified," which merely means that the lender has determined the maximum home price for which it will approve a loan. If the housing market in your area is very competitive, with homes selling just days after they go on the market, then you might also consider getting "pre-approved." That means the lender agrees to provide a mortgage even before you have selected a house. Not only will this help you to move quickly to close on a home once you find one, it can also give you an edge if others are competing to buy the same property. Pre-approval can cost $150 or more.

The last person you need on your team is a lawyer. He or she will review the purchase contract, and an attorney may be an excellent middleman in negotiating finer points, like who must pay to fix the leaky faucet, before the deal is set in stone.

Use recommendations from friends or colleagues, or even from your real estate agent, to help you find one who knows local real estate customs. You can expect to pay an hourly fee of anywhere from $70 to $250. Depending on local rates and the complexity of the sale, the total fee could run anywhere from $500 to $2,500.

The hunt

Now it's time to hit the pavement, or the Web, in search of a home

Your first step here is to figure out what city or neighborhood you want to live in (remember the old saw about "location, location ..." ?).

For overall demographics and data on metropolitan areas, you can visit a city site like

CNN/Money's annual Best Places to Live list. For more detailed neighborhood information, though, you'll want to use sites like Yahoo! Real Estate and Microsoft's HomeAdvisor that offer comprehensive school and demographic information on a number of communities. Look for signs of economic vitality -- a mixture of young families and older couples, low unemployment and good incomes.

Pay special attention to districts with good schools (high teacher-student ratios and graduation rates are among the hallmarks), even if you don't have school-age children. When it comes time to sell, you'll find that a strong school system is a major advantage in helping your home retain or gain value.

Try also to get an idea about the real estate market in the area. For example, if homes are selling close to or even above the asking price, that shows the area is desirable. Try Homegain.com, which is free, or Dataquick.com, which is available only to paid subscribers, to check out recent home sales. Your real estate agent may also be able to show you listings. Incidentally, if you have the flexibility, consider doing your house hunt in the off-season -- meaning, generally, the colder months of the year. You'll have less competition and sellers may be more willing to negotiate.

Next, take your search to real estate sites like Realtor.com, iOwn.com, Homeadvisor.msn.com and realestate.yahoo.com. Some of these sites (e.g., realtor.com) automatically show you homes that only partially meet your requirements. But for most sites, if you say the home needs two fireplaces, you will see only homes that meet that criterion. So be wary of choosing search criteria that are too restrictive. For example, select a price range 10 percent above and 10 percent below your true range. Add a 10-mile cushion to the location you specify. If you see a house you are interested in, save it, print it, add it to your bookmark or favorites list, and take note of the MLS code; your agent will want that code to arrange to show you the home in person.

If you're a first-time buyer, pay special attention to condominiums and cooperatives, or co-ops. Condos generally sell for 15 percent to 20 percent less than the cost of comparable detached homes, so you get much more space for your money.

What's the difference between the two? In a condo, each owner has absolute ownership of his own unit, which may be an apartment or townhouse. But owners pay a monthly fee to maintain shared areas like the lobby, the pool or the laundry room. The chief financial risk to a condo owner is that the common charges can rise, or, in the event of a major problem such as a roof repair or boiler replacement, the condo board can assess fees to cover expensive repairs.

It's a good idea, when considering a condo, to find out how much the common charge has changed over the last five years, and whether there have been major assessments during that time. Also ask what percentage of the residents actually own their units as opposed to just renting them (many condos include both). A complex with lots of renters has fewer owners who care about the upkeep, and it may be harder to get a loan on such a property.

A co-op is a rarer animal limited to major metropolitan areas. Essentially, the complex is run by a corporation where each owner is a shareholder. The monthly maintenance fees are generally higher than those of a condo, but prices tend to be lower. Their chief downside is that the co-op board usually has to approve new owners and may discourage you from renting your unit if you move out without selling. As with a condo, check on the group's financial health, whether shareholders have been hit with special assessments recently, and whether the unit includes many renters.

When you actually start touring homes, bring a notebook and a digital or Polaroid camera to help you remember details. Your real estate agent should supply you with a description of each house and the lot it sits on, the property tax assessment, the asking price and sometimes a diagram of the rooms. Your camera and notebook are there to record other details, ranging from the cost of heating to the view out the rear window.

One note: Don't automatically reject a home just because it doesn't measure up to your desires -- either in features or price. You can always add a deck, for instance, or update a kitchen. And since the asking price is just a starting point for negotiation, you will be making offers and counteroffers as both parties seek an acceptable price.

Closing the deal

Here's where you exercise your haggling muscles

Once you find the home you want, you need to move quickly to make your bid. If you're working with a buyer's broker, then get advice from him or her on an initial offer. If you're working with a seller's agent, devise the strategy yourself.

Try to line up data on at least three homes that have sold recently in the neighborhood. Calculate the difference between the original list price and the final price of the homes sold. If the average difference is, say, 5 percent below the asking price, then you know you can make an offer 8 percent to 10 percent below, leaving yourself a little room to negotiate. Don't lowball -- that is, submit a bid that's 20 percent or more below list -- if you really want the house. The seller is likely to give up in disgust.

Another factor to consider in determining your bid is whether the trend in recent home sales is up or down over the past year. For instance, if homes a year ago were selling for 10 percent below list, and recent ones are going at 3 percent below, then you might want to tighten your opening bid to just 5 percent below list.

There's no foolproof system for negotiating a fair price. Occasionally it's best to deal directly with the seller yourself. More often it's better to work exclusively through intermediaries. In general, don't let the other side begin to believe you are negotiating in bad faith or being deceptive -- any deal you eventually reach has to involve trust on both sides. And be creative about finding ways to satisfy the seller's needs. For instance, ask if the seller would throw in kitchen and washroom appliances if you meet his price -- or take them away in exchange for a lower price. Remember, too, that your leverage depends on the pace of the market. In a slow market, you've got muscle; in a hot market, you may have none at all.

Once you reach a mutually acceptable price, the seller's agent will draw up an offer to purchase that includes an estimated closing date (usually 45 to 60 days from acceptance of the offer). Have your lawyer review this document to make sure the deal is contingent upon 1) your obtaining a mortgage; 2) a home inspection that shows no significant defects; and 3) a guarantee that you may conduct a walk-through inspection 24 hours before closing. This last clause allows you to check the home after the sellers have moved out so that if the movers cause any damage, or that big living room sofa was hiding a hole in the floor, you have time to negotiate payment for repairs.

You also need to make a good-faith deposit -- usually 1 percent to 10 percent of the purchase price -- that should be deposited by your lawyer into an escrow account. The seller will receive this money after the deal has closed. If the deal falls through, you will get the money back only if you or the home failed any of the contingency clauses.

Now call your mortgage broker or lender and move quickly to agree on terms, if you have not already done so. This is when you decide whether to go with the fixed rate or adjustable rate mortgage and whether to pay points. Expect to pay $50 to $75 for a credit check at this point, and another $150 to $300 for an appraisal of the home. Most other fees will be due at the closing.

If you don't already have one, look into taking out a homeowner's insurance policy, too. Ask for recommendations from friends, your lawyer or your real estate agent. Most lenders require that you have homeowner's insurance in place before they'll approve your loan.

In addition to the appraisal that the mortgage lender will make of your home, you should hire your own home inspector. Again, ask for referrals, or check with the American Society of Home Inspectors -- a trade group. An inspection costs about $200 to $350 and takes up to two hours. Ask to be present, because you will learn a lot about your home, including its overall condition, construction materials, wiring and heating. If the inspector turns up major problems, like a roof that needs to be replaced, then ask your lawyer to discuss it with the seller. You will either want the seller to fix the problem before you move in, or deduct the cost of the repair from the final price.

About two days before the actual closing, you will receive a final HUD Settlement Statement from your lender that lists all the charges you can expect to pay at closing. Review it carefully with your lawyer. It will include things like the cost of title insurance that protects you and the lender from any claims someone may make regarding ownership of your property. Title insurance can cost 2 percent of the home's price.

The lender might also require you to establish an escrow account, which it can tap if you fall behind on your mortgage or property tax payments. Lenders can require deposits of up to two months' worth of payments.

After all this rigmarole, the actual closing -- nerve-wracking though it may be -- is often somewhat anticlimactic. It's a ritual affair, with customs that differ by region. Your lawyer or real estate agent can brief you on the particulars. In essence, once you pay all the settlement charges you then sign a bond or note that commits you to repaying your loan. Next you sign the mortgage. The lender then writes you a check for the amount of the loan. Rather than taking possession of this check, however, you endorse it to the seller. Once the seller accepts this check, he hands you the deed and the keys and you own the home!

For sellers only

Preparation and timing can help you get the best price

When you decide to sell, the first thing to do is investigate the local housing market. Consult the large real estate sites, like Realtor.com and iOwn.com, to see how similar homes are priced in your neighborhood. Many newspapers also list the selling prices and asking prices of recent sales, plus how long the homes were on the market. Note the prices for your neighborhood during the last month or so. And check how sales were running, say, a year ago, so you get an idea of whether the market is heating up, cooling down, or staying put. This exercise should give you a sense of what your home is worth.

You may decide that you can sell your home without an agent. It's an attractive thought, since you would save the 6 percent of the selling price that a broker typically collects. But balance that against the work involved in advertising a home and being available at all hours to show it.

If you do decide to work through an agent, ask for referrals from friends or check the Net and local newspapers for advertisements. Don't simply accept any recommendation.

Make an appointment with an agent and interview him or her for the job.

For help in this process, you might check out iOwn.com for a list of questions to ask the agent. You want to be sure he or she is experienced at selling homes like yours, in your area, and is willing to go out and market your home to prospective buyers. Ask to see advertisements the agent has placed on the Net and in print. Evaluate the person as though you were a buyer: Is he or she professional and personable? Does he say the right things to make you want to see the home? Also, since the agent will likely be able to advise you on a selling price, how well does his or her price jibe with the homework you did on your own? Don't be fooled by an agent who is merely flattering you with an inflated price. Go by what you already know about your home and the current housing market.

Once you find an agent you like, you have to formally sign a listing agreement. This is like a contract, laying out the specifics of your arrangement, including how long you will let the agent represent your home and what the compensation will be. Many agents prefer an exclusive listing, meaning you agree to pay a commission regardless of whether the agent is actually responsible for finding the seller. You should commit for no longer than three months (one month, in a hot market). In case you find the agent lacking in enthusiasm, you don't want to be locked into a bad situation.

When you discuss the listing agreement, discuss other issues as well. For instance, if there are certain times when you want the house off-limits for walk-throughs, let the agent know. Also, consider negotiating the commission. If your house is expensive, an agent might not flinch if you suggest 4 or 5 percent instead of the usual six. Conversely, if you know it's a buyer's market, consider offering the incentive of a higher commission if the agent can land you a sale within 5 percent of your asking price.

After you've signed a listing agreement, give your lawyer a call to notify him that you're selling your home and will need him to review bids and contracts sometime in the next few months. If your lawyer is not familiar with real estate contracts, then find one who is.

Next, you need to spruce up your home. Take an objective look at it: Is it cluttered? A little worn and tired? Consider a new paint job. Tidy up. Move unneeded furniture into the attic, basement or rented storage. Mow the lawn. Plant flowers, if it's the right season. And so forth. These seemingly insignificant details can add many thousands of dollars to your eventual sales price.

Speaking of which, you'll need to settle on an asking price. In doing so, forget what you originally paid for the house, how much you've spent on renovations or remodeling, and even how much money you need to move on to your next home. When it comes to pricing your property, the only yardstick that matters is what comparable homes are selling for in your neighborhood now -- which may be more, or less, than you sank into it.

Your Net research (see above) will already have given you a good idea of how the market is faring. Your agent can also dig up comparable sales, and discuss key elements that make the homes similar to yours. For instance, if you have four bathrooms, you should see how sales for four-bath homes have gone. Also note how long the homes were on the market. If you're in a seller's market, with homes moving in a week or two, think about adding a premium to the asking price. But be careful: The critical selling time is within the first month after your home hits the market. If the price is too high, you'll turn off potential buyers and agents and then have a hard time attracting them back, even if you lower your sights later.

When you receive a bid, consult your agent to figure out how to respond. If it's within 5 percent of your asking price, then counteroffer 2 or 3 percent less than you're asking and tell the prospective buyer that if that's acceptable, you have a deal. However, if the bid comes in at a discount of 10 percent or even more, then decide with your agent if you will entertain the bid or deny it and move on. You can also throw in furnishings or appliances to make your price more palatable.

Make sure your lawyer reviews the contingency clauses included with the bid. Do not agree to a clause that states that the deal goes through only if the buyer is able to sell his own home. Also make sure that all the buyer's contingencies are restricted within specific amounts of time. For instance, if the deal is contingent upon the home passing an inspection, then the inspection must occur within a week to 10 days of an accepted bid. The same is true of the closing date: Make the buyer commit to a reasonable date, usually 45 to 60 days from acceptance.

The best part of selling your home is that on closing day, your only responsibility is to show up with the keys. You may have to write the buyer a few checks to settle shared payments. For instance, if you've prepaid the property tax for the entire year, but are selling after just six months, then the buyer must reimburse you for the difference, or vice versa. When you receive the check for the agreed-upon sales price, you then write a check to your lender to cover the outstanding principal on your mortgage. Hand over the deed and keys and you're done!

9. Controlling Debt

Top things to know

1. Americans are loaded with credit-card debt.
The average American household with at least one credit card has over $8,000 in credit card debt, according to CardWeb.com, and the average interest rate runs in the mid- to high teens at any given time.

2. Some debt is good.
Borrowing for a home or college usually makes good sense. Just make sure you don't borrow more than you can afford to pay back, and shop around for the best rates.

3. Some debt is bad.
Don't use a credit card to pay for things you consume quickly, such as meals and vacations, if you can't afford to pay off your monthly bill in full in a month or two. There's no faster way to fall into debt. Instead, put aside some cash each month for these items so you can pay the bill in full. If there's something you really want but it's expensive, save for it over a period of weeks or months before charging it so that you can pay the balance when it's due and avoid interest charges.

4. Get a handle on your spending.
Most people spend thousands of dollars without much thought to what they're buying. Write down everything you spend for a month, cut back on things you don't need, and start saving the money left over or use it to reduce your debt more quickly.

5. Pay off your highest-rate debts first.
The key to getting out of debt efficiently is to first pay down the balances of loans or credit cards that charge the most interest, while paying at least the minimum due on all your other debt. Once the high-interest debt is paid down, tackle the next highest, and so on.

6. Don't fall into the minimum trap.
If you just pay the minimum due on credit-card bills, you'll barely cover the interest you owe, to say nothing of the principal. It will take you years to pay off your balance and potentially you'll end up spending thousands of dollars more than the original amount you charged.

7. Watch where you borrow.
It may be convenient to borrow against your home or your 401(k) to pay off debt, but it can be dangerous. You could lose your home, or fall short of your investing goals at retirement.

8. Expect the unexpected.
Build a cash cushion worth three months to six months of living expenses in case of an emergency. If you don't have an emergency fund, a broken furnace or damaged car can seriously upset your finances.

9. Don't be so quick to pay down your mortgage.
Don't pour all your cash into paying off a mortgage if you have other debt. Mortgages tend to have lower interest rates than other debt, and you may deduct the interest you pay on the first $1 million of a mortgage loan. (If your mortgage has a high rate and you

want to lower your monthly payments, consider refinancing.)

10. Get help as soon as you need it.
If you have more debt than you can manage, get help before your debt breaks your back.

Good debt vs. bad debt

Sometimes it makes sense to borrow -- a lot of times it doesn't.

It's almost impossible to live debt-free; most of us can't pay cash for our homes or our children's college educations. But too many of us let debt get out of hand. Ideally, experts say, your total monthly long-term debt payments -- including your mortgage and credit cards -- should not exceed 36 percent of your gross monthly income. That's one factor mortgage bankers consider when assessing the creditworthiness of a potential borrower.

But it is far too easy to spend more than you can afford, especially when you pay by credit card. The average U.S. household with at least one credit card carries over an $8,000 balance, according to CardWeb.com, and personal bankruptcies have hit record highs in recent years.

Of course, avoiding debt at any cost is not smart either if it means depleting your cash reserves for emergencies. The challenge is learning how to judge which debt makes sense and which does not, and then wisely managing the money you do borrow.

Good debt includes anything you need but can't afford to pay for upfront without wiping out cash reserves or liquidating all your investments. In cases where debt makes sense, only take loans for which you can afford the monthly payments.

Bad debt, on the other hand, includes debt you've taken on for things you don't need and can't afford (that trip to Bora Bora, for instance). The worst form of debt, of course, is credit card debt, since it carries the highest interest rates.

Sometimes the decision to borrow doesn't hinge on how much cash you have but on whether there are ways to make your money work harder for you. If interest rates are low, compare what you'll spend in interest on a loan versus what your money could earn if it were invested. If you think you can get a higher return from investing your cash than what you'll pay in interest on a loan, borrowing a small amount at a low rate may make sense.

Three examples of good debt

Home, school and your chariot qualify

Buying a home. The chance that you can pay for a new home in cash is slim. Carefully consider how much you can afford to put down and how much loan you can carry. The more you put down, the less you'll owe and the greater your chances of getting a lower mortgage interest rate.

Although it may seem logical to plunk down every available dime to cut your interest payments, it's not always the best move. You need to consider other issues, such as your need for cash reserves and what your investments are earning. Also, don't pour all your cash into a home if you have other debt. Mortgages tend to have lower interest rates than other debt, and you may deduct the interest you pay on the first $1 million of a mortgage loan. (If your mortgage has a high rate, you can always refinance.

A 20 percent down payment is traditional and usually helps buyers get the best mortgage deals. But many homebuyers put down less - as little as 3 percent to 5 percent in some cases. Those who do, however, pay higher monthly mortgage bills and a higher interest rate. They also pay for primary mortgage insurance (PMI), which protects their lender in the event they default.

Paying for college. When it comes to paying for your children's education, allowing your kids to take loans makes far more sense than liquidating or borrowing against your retirement fund. That's because your kids have plenty of financial sources to draw on for college, but no one is going to give you a scholarship for your retirement. What's more, a big 401(k) balance won't count against you if you apply for financial aid since retirement savings are not counted as available assets.

It's also unwise to borrow against your home to cover tuition. If you run into financial difficulties down the road, you risk losing the house.

Your best bet is to save what you can for your kids' educations without compromising your own financial health. Then let your kids borrow what you can't provide, especially if they are eligible for a government-backed Perkins or Stafford Loan, which are based on need. Such loans have guaranteed low rates; no interest payments are due until after graduation; and interest paid is tax deductible under certain circumstances.

Financing a car. Figuring out the best way to finance a car depends on how long you plan to keep it, since a car's value plummets as soon as you drive it off the lot. It also depends on how much cash you have on hand.

If you can pay for the car outright, it makes sense to do so if you plan to keep the car until it dies or for longer than the term of a high-interest car loan or pricey lease. It's also smart to use cash if that money is unlikely to earn more invested than what you would pay in loan interest.

Most people, however, can't afford to put down 100 percent. So the goal is to put down as much as possible without jeopardizing your other financial goals and emergency fund. Typically you won't be able to get a car loan without putting down at least 10 percent. A loan makes most sense if you want to buy a new car and plan to keep driving it long after your loan payments have stopped.

You may be tempted to use a home equity loan when buying a car because you're likely to get a lower interest rate than you would on an auto loan and the interest is tax deductible. But before going this route, make sure you can afford the payments. If you default, you could lose your home. If you do opt for a home equity loan, be sure to pay it off while you still have the car -- say, no more than five years -- since it's painful to pay for something that has been consigned to the junkyard.

Leasing a car might be your best bet if the following applies: you want a new car every three or four years; you want to avoid a down payment of 10 percent to 20 percent; you don't drive more than the 15,000 miles a year allowed in most leases; and you keep your vehicle in good condition so that you avoid end-of-lease penalties.

Whatever route you choose, shop for the best deals. Remember, it's in the car dealer's best interest to finance at the highest rate possible, so look at what you'll pay overall, not just the monthly amount. If you tell your car dealer you can spend $400 a month, you could end up with a new car for $400 a month based on an uncompetitive interest rate.

Borrowing for other expenses

A home-equity loan is smart in some instances

Besides life's big-ticket items -- home, car and college -- you may be tempted to borrow money to pay for an assortment of other expenses such as furniture, appliances and home remodeling.

Generally speaking, it's best to pay upfront for furniture and appliances, since they don't add value to your home and are depreciating assets. If you do finance such purchases, however, read the fine print. Retail stores often charge high interest rates. And even if they offer a low-interest or no-payment period for several months on a purchase, you may be required to pay for the item in full at the end of that period or risk being charged a high interest rate dating back to the day of sale.

Taking a home equity loan makes sense if you're making home improvements that increase the value of your house, such as adding a family room or renovating your kitchen. The interest you pay in many cases is deductible and you increase your equity.

If, however, a home project doesn't boost your house value, consider paying cash or taking out a short-term, low-interest loan that will be paid off in five years or less.

Managing your debt

Simple steps put you, not your bills, in charge

Outside of fixed monthly bills such as your rent or car payment, you probably don't have a precise idea of how you spend most of your money. If you want to get your debt under control, start by figuring out your spending patterns and identifying unnecessary expenses. "People who don't want to quantify where they're at are in the danger zone," said CFP Paul Weiner of Los Angeles.

For one month, write down every cent you spend. And by "every" we mean "every," including that $2 cup of coffee that starts your workday or that $4 magazine you buy on a whim. That will clarify in black and white how much of your spending is fixed and how much is variable - and hence easier to curb.

Tally that list and compare it to your monthly income. How much do you bring in after taxes? And how much do you have left at the end of the month after paying fixed expenses? Consider, too, whether there's any way to boost your take-home pay. If you get a big tax refund every year, that means you're having too much withheld from your paycheck. If that's the case, you can reduce your withholding by changing your W-4 at work.

Next, make a list of all your debt obligations and the interest you're charged for each.

Once you've done all that, you're ready to start lightening your debt load.

The basics of debt reduction are simple: Cut down on your variable spending and put the extra money toward your debt payments. Once you determine the maximum amount you can pay off each month, pay down the debt with the highest interest rate first - that usually means your credit card balance -- while paying at least the minimum monthly amount due on all other revolving bills

Once the debt with the highest rate is wiped out, put your money toward paying the debt with the next highest rate. One exception: If you have a credit card with a low teaser rate that will go up after a fixed amount of time, strive to eliminate that balance before the low rate expires.

You might also consider moving some of your high-interest credit card balances to one card with a lower interest rate. But read the fine print on any invitation to transfer balances. Sometimes such low-interest-rate offers are only in effect for short periods of time, after which the rate skyrockets. What's more, consolidating your debt on one card may lower your credit score if your debt-to-credit ratio worsens.

For many people, reining in discretionary spending for a few months goes a long way toward tackling debt. But if that's not enough, try to reduce your fixed expenses. Take steps to lower your household bills; refinance your mortgage to get a lower interest rate; or, if you have a good payment history, ask your credit card company to lower the interest rate you're charged.

Five red flags of debt overload

- Your discretionary income drops.
- You max out your credit card after paying off the balance.
- You only pay the minimum on your credit cards.
- You don't have an emergency fund.
- You can't sleep at night.

Getting your credit reports

Know what information lenders have on you

While you're cleaning up your debt, order copies of your credit reports, since the information contained in them will directly affect the interest rates you're offered on credit cards, mortgages and other loans.

There are three major credit bureaus: Experian, Equifax and Trans Union. Reports cost about $8.50 each, but they're free if you've been turned down for credit, employment or housing in the past 60 days. You can order all three at once for $34.95 from MyVesta.org.

When you get your reports, check for inaccuracies; the bureaus are required to investigate and correct them once you report them. Look, too, for things that may lower your credit rating, including open lines of credit you don't need, such as credit cards you never use or accounts you thought had been closed long ago. When lenders review your report, they take into account not only how much you owe, but also how much debt you are able to rack up. Too much, and they may not loan you any more money.

Also, consider ordering your credit score -- the number lenders use to assess your creditworthiness. Your score is based on information in your credit reports. FICO is the most widely used score and can be ordered in conjunction with your Equifax report.

10. Stock Options

Top things to know

1. Employee stock options are no longer reserved for the executive suite.
From cash-poor Silicon Valley start-ups to old-line manufacturing and service firms, more and more companies are offering stock options to the rank and file as well.

2. ESO's are popular these days.
The National Center for Employee Ownership estimates that employee’s control 8.3 percent of total U.S. corporate equity, or $663 billion, up from less than 2 percent just a decade ago. Employee stock option plans account for at least $200 billion of that total.

3. More workers are getting stock options.
Ten years ago there were only about 1 million workers covered by a few hundred stock option plans. Today there are probably seven times that many employees participating in some 3,000 plans.

4. You'll see these common terms.
An employee stock option gives you the right to buy ("exercise") a certain number of shares of your employer's stock at a stated price (the "grant," "strike," or "exercise" price) over a certain period of time (the "exercise" period).

5. There are two common types of plans.
Employee stock options come in two basic flavors: nonqualified stock options and qualified, or "incentive," stock options (ISOs). ISOs qualify for special tax treatment. For example, gains may be taxed at capital gains rates instead of higher, ordinary income rates.

6. Nonqualified plans are special.
Unlike ISOs, nonqualified stock options can be granted at a discount to the stock's market value. They also are "transferable" to children and charity, provided your employer permits it.

7. There are three main ways to exercise options.
You can pay cash, swap employer stock you already own, or borrow money from a stockbroker while, simultaneously, selling enough shares to cover your costs.

8. It's usually smart to hold options as long as you can.
Conventional wisdom holds that you should sit on your options until they are about to expire to allow the stock to appreciate and, therefore, maximize your gain.

9. There may be compelling reasons to exercise early.
Among them: You have lost faith in your employer's prospects; you are overdosing on company stock; you want to lock in a low cost basis for nonqualified options; you want to avoid catapulting into a higher tax bracket by waiting.

10. Tax consequences can be tricky.
Unlike with nonqualified options, an ISO spread at exercise is considered a preference item for purposes of calculating the dreaded Alternative Minimum Tax (AMT), increasing taxable income for AMT purposes.

Getting started

If you save early and wisely, college may be affordable after all.

Few people question the value of a college education, but the cost is enough to break the bank for a lot of families. With the cost of higher education rising faster than inflation, parents of today's four-year-olds may face college bills of more than $200,000.

Sure, the numbers are scary. But if you start saving regularly while your child is in diapers, you'll put yourself in a good position financially by the time your son or daughter is ready to hit the co-ed bathrooms.

But don't forget: the availability of financial aid, loans, and education credits and deductions means you may not have to foot the entire bill yourself.

Indeed, you shouldn't if you're short on retirement savings. As a parent, you might think your most important financial duty is to pay for your children's education. But you're wrong. Saving enough money for your own retirement is even more crucial. Your children have a lot of resources besides you to help feed the tuition monster, but no one is going to help you finance your golden years. And don't worry that socking money into a 401(k) will be held against you if you apply for financial aid. Formulas used to assess need generally don't consider retirement savings as an available asset when determining how much parents can contribute to tuition.

But putting too much money in your child's name might. Although it's true that a child's income is usually taxed at a lower rate than a parent's income, keeping funds in a child's name can reduce your financial aid package. Colleges use a formula for aid that assesses a family's need based on up to 5.65 percent of parents' available assets and on 35 percent of assets in a child's name or custodial account.

Expected family contribution to college bills
Parents' income assessed up to 47% Parents' assets assessed up to 5.65% Child's income assessed up to 50% Child's assets assessed at 35% **Source:** Savingforcollege.com and The Princeton Review's Paying for College Without Going Broke. Based on the federal formula used to assess financial need.

What's the best way to invest?

Make sure your investments grow with your children

With college tuition rising faster than inflation, stocks are the best investment to help your education-savings portfolio keep pace long-term. But bonds and cash should play an increasingly significant role as your child nears college age.

Keep your investments simple, and stick to mutual funds that have solid three- to five-year track records and low expenses. You can even opt to have the fund company make automatic monthly withdrawals from your bank account to force you to save.

Most planners recommend that you base your asset allocation on your child's age. If your child is eight or younger, you can keep 60 percent to 95 percent of your money in stocks. You can choose a balanced fund, which holds a prescribed ratio, usually 60-40, of stocks to bonds. Or you can choose your own mix of funds and invest proportionately.

When your child is between ages nine and 13, your portfolio should get more conservative, not by moving money out of your earlier investments, but directing more of your new contributions to bond funds and tamer stock funds. For example, if you were putting 90 percent of your contributions into stock funds, and 10 percent into bond funds, switch to a 50-50 allocation. And if you want to curb the volatility that stock funds can create, put your contributions into equity-income funds, which invest in stocks paying high dividends and tend to ride market dips better.

When your child turns 14, start to shelter the returns you've earned so far. You can do this by moving 20 percent to 30 percent of your equity assets into money market and short-term bond funds every year, so that by the time your child enters college, you are out of equities entirely and you can cash out quickly.

If the bond portion of your savings has exceeded $10,000, you may consider purchasing government short-term Treasury notes directly from the U.S. Treasury, to avoid paying any management fees to a fund company.

Tax-savvy savings options

529s, Education IRAs and college savings trusts may work for you.

Saving for college is hard not just because it's a huge expense, but because you can't predict how much, if any, financial aid you'll get.

That's why you need to save what you can now. Fortunately, you have a number of tax-advantaged federal and state college-savings vehicles at your disposal. The best option is the state-sponsored **529 plan**, which comes in two flavors: the prepaid tuition plan and the savings plan.

A state's prepaid plan allows you to pay now at today's rates for school tomorrow. In return, your account (or contract as it's often known) is guaranteed to pay for the tuition and fees at the state's public universities and colleges by the time your child graduates from high school. A pre-paid plan often does not, however, cover the costs for room and board.

Your child also may use the pre-paid account to attend a private or out-of-state school but you might risk forfeiting some of its value depending on how the plan values its contracts. Note, too, that most pre-paid plans require that the account owner (you) or the beneficiary (your child) be a resident of the state in which the plan is offered.

The 529 college savings plan, now offered in most states, is far more flexible. The money may be used at any school you choose and for all qualified higher education expenses, including room and board.

Each state determines what the lifetime contribution limit or account balance cap will be in its 529 plan, but typically such limits range between $100,000 and $270,000. Investment minimums are low (most plans let you sock away as little as $25 a month), and there is no restriction on how much you may contribute every year unless the account is nearing the lifetime cap. However, since 529 contributions are treated as gifts subject to gift-tax limitations, if you want to make a tax-free contribution, it shouldn't exceed $11,000 annually ($22,000 if you're contributing with your spouse). Actually, you may contribute as much as $55,000 tax-free in one year ($110,000 with your spouse), but that contribution will be treated as if it were being made in $11,000 installments over the next five years. That means you can't make other tax-free gifts to the beneficiary during that time.

Most 529 savings plans offer a menu of age-based portfolios, and some also offer a small selection of stock and bond funds. In the former case, your annual contributions get invested in a pre-selected portfolio of stocks and bonds. Early on, the portfolio is tilted toward stocks, and as the time for college nears, the weighting shifts more heavily toward bonds. Note, however, that once you choose an investment track, it can be cumbersome to change.

The quality of 529 college savings plans may vary by state, but in most instances you may open an account in any state you'd like.

All 529 plans offer generous tax breaks, provided you use the money for qualified expenses. While your contribution is not deductible on your federal taxes, your investment will grow tax-deferred and withdrawals will not be subject to federal tax. In prior years your money had grown tax-deferred and earnings withdrawals were taxed at the student's income tax rate. (Note, however, the federal tax-free provision is set to expire in 2010 unless Congress passes a law to extend it.) What's more, you may get state-tax deductions on contributions or exemptions on withdrawals.

One caveat: Having a 529 is likely to reduce your chances of getting financial aid. The 529 college savings account is considered the parent's asset, and hence is assessed at a much lower rate than if it were the child's. Yet withdrawals from a savings plan are considered the child's income, which is assessed up to a 50 percent rate for financial aid assessment purposes. A prepaid tuition plan is treated somewhat differently. The amount in benefits paid out essentially reduces dollar-for-dollar your child's aid eligibility.

Another tax-advantaged option is the **Coverdell Education Savings Account** (formerly known as the Education IRA). The contribution limit increased from $500 to $2,000 in 2002 and withdrawals are tax-free. To qualify for a full or partial contribution, your adjusted gross income must be less than $110,000 if you're single; $220,000 if you're married and filing jointly. One of the drawbacks is that the annual contribution cap is per child, meaning if you and your parents want to contribute to an account for your daughter, your combined contributions can't exceed $2,000.

You may now contribute to both a 529 and a Coverdell Education Savings Account on behalf of the same beneficiary in the same year without penalty, but your contributions will be treated as gifts subject to gift-tax limitations.

What kind of aid is out there?

From grants to loans, you have a lot of options

Even if you follow a regular savings plan for college, you may still come up short. Rest assured, you won't be alone. In 2001, the federal government, states, individual schools and private lenders offered $74 billion in aid to families needing to bridge the gap between their savings and college costs, according to the College Board.

Several factors are considered for aid-eligibility, principal among them your income; your non-retirement savings; how many kids you have, and their income and assets.

There are several sources of financial aid for college. Grants and scholarships are the best because the money is usually tax-free and never has to be repaid. These include federal Pell Grants, primarily for low-income families, which will offer a maximum of $4,000 per student for the 2002-2003 academic year, based on need. The federal Supplemental Educational Opportunity Grant, which is administered by colleges, offers awards ranging from $100 to $4,000 a student per year. Most students who receive need-based grants also are expected to participate in the federal Work-Study program, whereby students work part-time jobs to meet the family's remaining financial need.

Finally, there are loans, which come in two basic varieties: need-based, which help families who can't afford college costs; and non-need-based, designed to fill a gap when the family doesn't have available cash, but may have illiquid assets. Loans represent 59 percent of all financial aid for college.

The two most common and attractive need-based loans are the Perkins and the Stafford, both federally funded.

The Perkins loan is made directly to students; parents need not co-sign this loan. Students don't need to begin repaying the loan until nine months after they graduate, leave college or fall below half-time student status; and they have 10 years to repay the loan. With a Perkins, one pays a low interest rate (5 percent), and interest doesn't accrue until repayment begins. A school's financial aid office determines how much a student gets, but the cap on borrowing is $4,000 per year for a lifetime total up to $20,000.

Interest rates for Stafford loans are variable, but the lifetime cap is 8.25 percent. With the subsidized Stafford, interest does not accrue until six months after a student graduates, leaves or falls below half-time status. Students can borrow up to maximums that rise the longer a student remains in school, between $2,625 freshman year and $5,500 senior year.

The unsubsidized Stafford is a non-need-based loan for which most students who apply for aid are eligible. Interest accrues immediately, but payment may be postponed until after graduation. Students can borrow up to maximums that rise the longer a student remains in school. Freshmen, for instance, can borrow up to $4,000 above any subsidized Stafford loans they may receive.

Another common, non-need-based loan is the PLUS, or Parent Loans for Undergraduate Students. This loan is made to parents, not students. Parents can borrow up to the annual cost of attending college, minus any financial aid received. This loan is dependent on your credit rating, although the requirements are not as stringent as those for a mortgage. If you have a bad credit rating, such as that resulting from judgments or liens against you, you may still be eligible for a PLUS if you can find a co-signer willing to take responsibility to pay the loan if you can't. The drawback of PLUS loans is that repayment begins 60 days after you receive the money, although the repayment period can last 10 years. The interest rate is variable, tied to the short-term Treasury bill rate, with a maximum of 9 percent.

Top strategies to maximize aid eligibility

1. Save money in the parent's name, not the child's name.
2. Spend down student assets and income first.
3. Pay off consumer debt, such as credit cards and car loans.
4. Maximize contributions to your retirement fund.
5. Accelerate necessary expenses, to reduce available cash.

Source: FinAid.org

There are also private loan options such as bank lines of credit; home-equity loans; Signature Student loans, which are offered by Sallie Mae; and Excel loans, which are offered by Nellie Mae. Private loans such as these are less appealing than the unsubsidized Stafford, however, because the interest rate is usually at a premium to the prime rate, and repayment may start immediately, rather than being postponed until the student graduates.

11. Saving for College

Top things to know

1. Saving for your own retirement is more important than saving for college.
Your children will have more sources of money for college than you will have for your golden years, so don't sacrifice your retirement savings.

2. The sooner you start saving, the better.
Even modest savings can pack a punch if you give them enough time to grow. Investing just $100 a month for 18 years will yield $48,000, assuming an 8 percent average annual return.

3. Stocks are best for your college savings portfolio.
With tuition costs rising faster than inflation, a portfolio tilted toward stocks is the best way to build enough savings in the long term. As your child approaches college age, you can shelter your returns by switching more money into bonds and cash.

4. You don't have to save the entire cost of four years of college.
Federal, state and private grants and loans can bridge the gap between your savings and tuition bills, even if you think you make too much to qualify.

5. With mutual funds, investing for college is simple.
Investing in mutual funds puts a professional in charge of your savings so that you don't have to watch the markets daily.

6. 529 savings plans are a good way to save for college and get great tax breaks.
Qualified withdrawals are now free of federal tax and most plans let you save between $100,000 and $270,000 per beneficiary. Plus, there are no income limitations or age restrictions, which means you can start a 529 no matter how much you make or how old your beneficiary is.

7. Tax breaks are almost as good as grants.
You may be able to take two federal tax credits - the Hope Credit and Lifetime Learning Credit - in the years you pay tuition. Or, if your income is too high to qualify for those credits, you may qualify for a new higher education expense deduction that will be in effect from 2002 through 2005.

8. The approval process for college loans is more lenient than for other loans.
Late payments on your credit record aren't automatic grounds for refusal of a college loan.

9. Lenders can be flexible when it's time to repay.
There are still ways to cut costs after you graduate and begin repaying your student loans. For instance, if you make 48 consecutive on-time payments, most private lenders will knock two percentage points off your interest rate.

10. Taxpayers with student loans get a tax break.
You may deduct the interest you pay up to $2,500 a year if your adjusted gross income is $65,000 or less if you're single; $130,000 or less if you're married filing jointly.

Want free money from the IRS?

Take advantage of tuition tax credits and deductions

Parents who qualify should take advantage of two federal tax credits for tuition costs. The HOPE Credit and Lifetime Learning Credit are almost as good as getting money outright, since they are a dollar-for-dollar reduction of the tax you owe. And you can use these credits against tuition payments that you make using student loans.

To qualify for these credits, your adjusted gross income must be less than $51,000 if you're single or less than $102,000 if you're married and filing a joint return.

The HOPE Credit lets you slash your taxes by up to $1,500 a year per child for qualified tuition and fees paid during the first two years of college -- 100 percent of the first $1,000 in tuition, and 50 percent of the next $1,000. That means you need to have at least $2,000 in tuition expenses to get the full credit.

The Lifetime Learning Credit currently maxes out at $1,000, regardless of how many children you have in college at one time. You can take 20 percent of up to $5,000 in qualified tuition and fees but you can't claim it in the same year that you take the Hope Credit for the same student. Starting in 2003, the Lifetime Learning Credit is set to increase to $2,000, or 20 percent of up to $10,000 in qualified expenses.

The education toward which you're applying a federal credit must occur within the tax year in which tuition was paid, or within the first three months of the following year. Since academic years aren't the same as calendar or tax years, you need to be careful how you claim a credit on your tax return.

If you make too much to qualify for the HOPE or Lifetime credits, you may qualify for a new education deduction compliments of the Tax Relief Act of 2001 that's only in effect from 2002 through 2005. The maximum deduction you can take is $3,000 in 2002 and 2003, and $4,000 in 2004 and 2005. To qualify, your adjusted gross income may not exceed $65,000 ($130,000 for married couples filing jointly). And, starting in 2004, if your AGI is above those limits but does not exceed $80,000 ($160,000 for joint filers), then you're entitled to a $2,000 deduction.

If your income qualifies you to take the HOPE and Lifetime credits as well as the new deduction, you may only take one for the same child in the same year. Remember, a deduction reduces your taxable income by a percent of every dollar, whereas a credit offers dollar-for-dollar reduction of the tax you owe. If you're in the 27 percent tax bracket, a $100 deduction means you'll pay $27 less in taxes, whereas a $100 credit means you'll pay $100 less.

For grads only: Payback time

Good fiscal behavior can save you dollars and cents

As heavy a burden as student loans are to repay, there are five ways to lighten the load, or at least make it more manageable:

1. If you make 48 consecutive on-time payments, most private lenders will knock two percentage points off your interest rate. Plus, if you direct your bank to transfer payments electronically from your checking account, many lenders will trim a quarter point off your rate.

2. If you have difficulty meeting your payments, ask about alternate repayment plans.

Assuming your salary will go up over time, you can arrange a graduated repayment plan. You begin with a low monthly payment that slowly rises over a period of 12 to 30 years, depending on the size of the loan. Or, if your income fluctuates because you're self-employed, you can set up an income-sensitive or income-contingent repayment plan. As your income rises and falls, so does the amount you owe. Under the income-contingency plan available through the Department of Education for direct-loan borrowers, any balance remaining after 25 years is forgiven, although the amount forgiven will be taxed as income. One caveat: Alternate repayment plans will cost you more in interest because you'll pay back your loan over a longer period of time.

3. The federal government offers relief for taxpayers with student loans. Presuming your income makes you eligible, you may deduct the interest you pay up to a maximum of $2,500 a year. In 2002, the income limits to qualify for a full or partial deduction increased to $65,000 or less annually for singles, and to $130,000 or less for couples filing jointly.

4. If you have more than one loan, you can consolidate them. That means a new interest rate is applied to your outstanding principal. The rate will be equal to the weighted average of all your loans but will not exceed 8.25 percent. During the course of your repayment, lenders may offer discounts, especially if you have a record of timely repayments. But since this method spreads your debt over as many as 30 years, it can substantially increase the total interest you will pay.

5. If you've exhausted your options and can't get relief, you may be able to suspend your payments temporarily. If you lose or quit your job, or return to school, you can ask your lender to temporarily defer your loan payments. If you get a deferment for a subsidized Stafford loan, the government will actually pay the interest that comes due during your suspended payment period. If you can't get a deferment, you can still hold off on payments for up to a year by asking for forbearance. The interest will continue to accrue, but you avoid defaulting and getting a nasty strike on your credit record.

12. Kids and Money

Introduction

Up until they start earning a living, and sometimes well beyond that, kids are apt to spend money like it grows on trees. This lesson will help you put your children on the road to handling money responsibly.

Long before most children can add or subtract, they become aware of the concept of money. Any four-year-old knows where their parents get money -- the ATM, of course. Understanding that parents must work for their money requires a more mature mind, and even then, the learning process has its wrinkles. For example, once he came to understand that his father worked for a living, a five-year-old asked, "How was work today?" "Fine," the father replied. The child then asked, "Did you get the money?"

Instant gratification aside, once they learn they can buy things they want with money -- e.g., candy, toys -- many children will begin hoarding every nickel they can get their hands on. How this urge is channeled can determine what kind of financial manager your child will be as an adult.

It's important to work on your child's financial awareness early on, for once they're teenagers, they are less likely to heed your sage advice. And besides, they're busy doing other things -- like spending money.

For a quick overview, click on "The details" sections for more information on the topics in this lesson (calculators and other interactive features are marked with a symbol).

Making allowances

Perhaps the most important decision parents face regarding their children's attitudes toward money is how to handle allowances.

There's a strong argument that an allowance is the best way to teach children to handle financial responsibility. There's an equally convincing case that nothing could be further from the truth. Whichever is the case, before they get an allowance, children should be old enough to count money. The key to a successful allowance is structuring it right from the outset. Make it clear to your child what kinds of expenditures the money is for, and that they are expected to save some of it. Younger children -- ages 7-10 -- shouldn't be held accountable for items like school lunch money as part of their allowance, but it's not a bad idea for older kids, and has the added benefit of fewer payments changing hands.

Some experts think parents should not link the allowance money to household chores. Children should be expected to help out around the house and in the yard because they are members of the family, not because they are paid. Linking the allowance to household duties may sap this community spirit that you are trying to engender.

Yet with children over 8 or 9 years old, giving an allowance doesn't preclude paying them for specific chores, especially the occasional type that you might otherwise pay outsiders to perform, such as shoveling the sidewalk or washing the car. Why not keep the money in the family?

Some parents complain that giving their child an allowance puts the parent in a position where their kids are often begging for a raise or an advance. Jayne A. Pearl, author of *Kids and Money: Giving Them the Savvy to Succeed Financially* (1999, Bloomberg Press), would say these parents are missing the point. "Remember, allowance is supposed to be a teaching tool," she says. "Negotiation skills are an important part of that, which they're going to need for dealing effectively with friends, teachers, and eventually, their bosses."

So instead of grimacing when your child hits you up for a raise, decide when the time is right, and then engage them in fruitful negotiations. How long since the last raise? Will new expenditures be covered? What amount of the raise will be saved long-term for expenditures requiring your approval?

The most vexing decision on allowances is how much -- a decision affected by personal values, family income, and common sense. Don't let your child influence the amount by saying what they're friends are getting: Any normal child will bring in high figures.

Many parents like to give their children the equivalent in today's dollars of the allowance they received at the same age. Assuming that these parents have more or less the same means as their parents did, this can be a comfortable solution. Use the calculator provided with this lesson to figure out what the allowance you received in a given year of your childhood would be worth today.

Saving and spending

Your kid doesn't like to save? Try the carrot -- and then the stick.

One way to encourage your child to develop sound money discipline is to make savings a condition of their allowance. So try to account for this when deciding on a weekly or monthly figure.

This, of course, means setting a budget -- no easy task for people of any age. Kids' budgets will vary widely with their needs and circumstances. The challenge is what to do when children run afoul of their own guidelines and end up dipping into savings illegitimately.

One answer is to require them to save their allowance in a locked box so that each deposit is irretrievable. Yet, as this doesn't teach restraint and you won't always be around to oversee savings deposits, there are more instructive ways to make the point.

Neale S. Godfrey, co-author of *Money Doesn't Grow on Trees: A Parent's Guide to Raising Financially Responsible Children* with Carolina Edwards (Fireside, 1994), recommends what she calls the Bill-Paying Game, inspired by a scene in the film, *I Remember Mama*.

Count out a reasonable "salary" in play money, like that from a Monopoly game. Then, take some old bills and write the amount due on the back of the envelope of each. Show the child the entries in each for "date due," "minimum payment due" and "balance due," then let them decide how much to pay. If the allotted money is enough to pay the bills, everyone wins.

Use the leftover money to introduce the concept of savings. The younger your child, the more limited his or her concept of time. As a result, younger children aren't apt to realize the necessity of long-term savings. Indeed, for a six-year-old, long-term could mean spending the savings this weekend. Yet other children the same age tend to have an intuitive grasp of savings for savings' sake. Long before you give your child an allowance, his or her savings sense will be clear from the way he or she deals with money from the tooth fairy or from Grandma's birthday cards.

If they've been receiving your sage financial teachings from an early age, older children shouldn't have trouble understanding the concepts of long-term and short-term saving. If not, illustrate the concepts by using goals, as with a new video game a month from now versus a bicycle this summer, or college when they are 18. Remind of them of these goals to keep them from straying.

The more worthy and ambitious the long-term goal, the more you may want to consider matching grants to reward your child's savings discipline. These grants can be anywhere from 1.25-to-1 to 3- or 4-to-1, depending on the goal and your means. Matching grants are a great way to save for large items like computers, or even a first car.

Younger children understandably have trouble grasping off-site savings, so the best mechanism for them is often a piggy bank for coins and a wallet for bills. Count the money with them periodically, and tell them how close they've come to their goals. Above all, praise their progress.

Once children reach the age of 9 or 10, they're more amenable to banks. Quantitatively adept children of this age can understand the concept of interest rates, especially when you demonstrate with coins to show how their money will grow. Until they're old enough to handle a checking account, children may take withdrawals as cashier's checks or money orders.

The best way to encourage sound spending habits is to exhibit them. When planning a trip to the grocery or discount store, get your children involved in making a judicious list and sticking to it. This will teach them to avoid the bane of all savers: impulse buying.

For big-ticket items like appliances, show them how to do the research: reading articles and reviews, phoning stores to see if your choices are in stock, negotiating with salesmen on price, going to several places to see what's available and compare values.

Doubtless, an occasional purchase will be defective. No problem. Use this to demonstrate the importance of saving sales receipts and reviewing warranties. When you return the goods, take your children along and show them how to overcome salesmen's arguments.

Don't forget the lessons that can be learned from tipping. Studies have shown that the quality of service received is not an important criterion for many tippers. Instead, people often tip to impress the waiter, or in accordance with their opinion of themselves. To ensure that your child tips for service, go over the good and bad points of your server with them, then arrive at an appropriate figure (e.g., 20 percent for excellent service). Make sure they understand that, while the waiter relies on tips to make a living, poor service begets poor tips. This attitude toward value will carry over into purchases of consumer goods.

Before you and your child calculate the tip, add up the items on the check and make sure the total is correct. Surveys have shown that the errors on many restaurant check totals are often mysteriously high, but rarely too low. Given the frequency of this phenomena, there will likely be an opportunity in a restaurant to show your children how to protect themselves from unscrupulous merchants.

Teen years: Investing

After teaching your children the hard lessons, show them the rewards of self control.

Once your teenagers get a grip on credit, introduce them to the flip side -- investing. After all, that's when they extend the credit and collect the interest. Since your teens may have too much money collecting no interest in a checking account and probably write few checks, the best way to start is with a money-market account on which they can write checks.

From there, introduce them to simple, set-term investments like savings bonds and certificates of deposit. Though returns from these will be meager in today's market, they serve an important lesson and will build their confidence about investing.

From there, introduce them to the stock market, but not as a prelude to picking stocks. Instead, advise them to get into some diversified mutual funds or a solid index fund. Some of the stock investing games available on the Internet are a fun and educational way to introduce a teenager to stocks.

Once you get your child to understand the ups and downs of the stock market, you've probably accomplished all that you can reasonably hope for.

13. Retirement

Top things to know

1. Save as much as you can as early as you can.
Though it's never too late to start, the sooner you begin saving, the more time your money has to grow. Gains each year build on the prior year's -- that's the power of compounding, and the best way to accumulate wealth.

2. Set realistic goals.
Project your retirement expenses based on your needs, not rules of thumb. Be honest about how you want to live in retirement and how much it will cost. Then calculate how much you must save to supplement Social Security and other sources of retirement income.

3. A 401(k) is one of the easiest and best ways to save for retirement.
Contributing money to a 401(k) gives you an immediate tax deduction, tax-deferred growth on your savings, and -- usually -- a matching contribution from your company.

4. An IRA can also give your savings a tax-advantaged boost.
Like a 401(k), IRAs offer huge tax breaks. There are two types: a traditional IRA offers tax-deferred growth, meaning you pay taxes on your investment gains only when you make withdrawals, and, if you qualify, your contributions may be deductible; a Roth IRA, by contrast, doesn't allow for deductible contributions but offers tax-free growth, meaning you owe no tax when you make withdrawals, but contributions are not deductible.

5. Focus on your asset allocation more than on individual picks.
How you divide your portfolio between stocks and bonds will have a big impact on your long-term returns.

6. Stocks are best for long-term growth.
Stocks have the best chance of achieving high returns over long periods. A healthy dose will help ensure that your savings grows faster than inflation, increasing the purchasing power of your nest egg.

7. Don't move too heavily into bonds, even in retirement.
Many retirees stash most of their portfolio in bonds for the income. Unfortunately, over 10 to 15 years, inflation easily can erode the purchasing power of bonds' interest payments.

8. Making tax-efficient withdrawals can stretch the life of your nest egg.
Once you're retired, your assets can last several more years if you draw on money from taxable accounts first and let tax-advantaged accounts compound for as long as possible.

9. Working part-time in retirement can help in more ways than one.
Working keeps you socially engaged and reduces the amount of your nest egg you must withdraw annually once you retire.

10. There are other creative ways to get more mileage out of retirement assets.
You might consider relocating to an area with lower living expenses, or transforming the equity in your home into income by taking out a reverse mortgage.

What should I do first?

The path to a successful retirement starts with creating an overall plan

To live well in retirement, you can no longer rely on the largesse of a company pension plan or Social Security. Instead, you will have to depend on how skillfully you plan and invest, and whether you make good use of tax-advantaged savings plans such as 401(k)s and IRAs.

First, estimate how much you will need. One rule of thumb is that you'll need 70 percent of your annual pre-retirement income to live comfortably. That might be enough if you've paid off your mortgage and are in excellent health when you kiss the office goodbye. But if you plan to build your dream house, trot around the globe or get that Ph.D. in philosophy you've always wanted, you may need 100 percent of your income or more. Remember, too, that your health care expenses are likely to go up in retirement, if only because you'll be paying more for insurance.

Second, figure out how you'll meet those expenses. There are three main sources of retirement income: Social Security, pensions and annuities, and your savings. Start by determining your estimated Social Security benefits. (If you haven't already received a statement in the mail, you can order one online or use an online calculator to make estimates based on expected earnings.) Next, add in any annual payouts you expect from an annuity or company pension.

If it's not enough, it's time to think about where that money will come from. Count on needing at least $15 to $20 in investment savings to cover each dollar of that shortfall. If your projected retirement expenses exceed Social Security and pensions by, say, $20,000 a year, that means you'll need a nest egg of $300,000 to $400,000 to bridge the gap.

How should I invest?

Tilt your portfolio mix toward stocks to keep ahead of inflation

Your retirement savings are sacred, so you don't want to take crazy risks. But that doesn't mean you should rely solely on such safe investments as bank CDs and money-market funds. To build a nest egg large enough to see you through retirement, which may last 30 years or more, you'll need the growth that stocks provide.

Over the past 75 years, stocks have posted an average annual return of just over 11 percent versus just over 5 percent for bonds. Given stocks' superior returns, some financial advisers recommend that investors whose retirement is still 20 years or more away put the lion's share of their portfolio in stocks and stock funds.

Of course, a 100 percent stock portfolio can give you some hair-raising moments. In the 1973-74 bear market, for example, U.S. stocks lost 43 percent of their value and took three-and-a-half years just to get back to where they started. And who knows when stocks will get back to the highs reached in early 2000?

If you don't have the stomach for such a steep downturn, a more prudent course is to throw some bonds into the mix. Putting 70 percent of your portfolio into stocks and 30 percent into bonds, for example, will let you capture most of the long-term growth of stocks while sheltering your investments somewhat during meltdowns. As you approach retirement age, the idea is to shift more into bonds. But even in retirement, which can last 20 or 30 years (or more), it pays to maintain a healthy dose of stocks (maybe upwards of 50 percent in your seventies, and up to 30 percent in your eighties).

The virtues of the 401(k)

Uncle Sam doesn't offer many gifts. This is one.

If someone offered you free money, would you refuse it? Probably not. But that's just what you're doing if you don't contribute to your 401(k). The more you contribute, the more free money you get. Here's why.

Contributing part of your salary to a 401(k) gives you three compelling benefits:

- You get an immediate tax break, because contributions come out of your paycheck before taxes are withheld.
- The possibility of a matching contribution from your employer -- most commonly 50 cents on the dollar for the first 6 percent you save.
- You get tax-deferred growth -- meaning you don't pay taxes each year on capital gains, dividends and other distributions.

Thanks to the Tax Relief Reconciliation Act of 2001, there are a few changes to 401(k)s that will be of greater benefit to you.

For starters, the federal limit on annual contributions is increasing gradually from $11,000 in 2002 to $15,000 in 2006. The Tax Relief Act also offers catch-up provisions for workers 50 and older. Starting in 2002, if you're 50 or older, you may contribute an additional $1,000 above your maximum allowable 401(k) contribution, a catch-up amount that will increase gradually to $5,000 by 2006. (See table.)

Keep in mind, however, while federal law sets the guidelines for what's permissible in 401(k) plans, your employer may set tighter restrictions. Plus, it will take time for the administrators of your plan to implement the changes.

What's more, there are other federal non-discrimination tests a 401(k) plan must meet, one of which applies to "highly compensated" employees. So if you make more than $90,000 a year (the limit in effect in 2002), you may not be permitted to contribute as high a percentage of your salary as some of your lower paid colleagues.

For all its tax advantages, the 401(k) is not a penalty-free ride. Pull out money from your account before age 59-1/2, and with few exceptions, you'll owe income taxes on the amount withdrawn plus an additional 10 percent penalty.

Also, be aware of your plan's vesting schedule -- the time you're required to be at the company before you're allowed to walk away with 100 percent of your employer matches. Of course, any money you contribute to a 401(k) is yours.

(For a more detailed look at the 401(k), read Money 101: 401(k)s.)

WHY A 401(k) PAYS

Your contribution:

$3,000 (6% of $50,000 salary)

Employer match:

$1,500 (50% match on first 6 percent)

Total investment:

$4,500

Taxes you save:

$930 (assuming 31% combined federal and state tax bracket)

Free Money:

$2,430 (Employer match plus tax saving)

FEDERAL LIMITS ON 401(k) CONTRIBUTIONS*

In 2001:

$10,500

In 2002:

$11,000 ($12,000 if you're 50+)

In 2003:

$12,000 ($14,000 if you're 50+)

In 2004:

$13,000 ($16,000 if you're 50+)

In 2005:

$14,000 ($18,000 if you're 50+)

In 2006:

$15,000 ($20,000 if you're 50+)

***** From 2002 on, the limits also apply to 403(b)s for nonprofit workers; 457s for state and local government workers and salary-reduction SEPs, also known as SAR-SEPs.

The IRA advantage

Even if you've got a 401(k), an IRA can give your savings a big boost.

Whether or not you have a 401(k) or other tax-advantaged savings plan at work, consider investing in an IRA to augment your retirement savings plan. As with a 401(k), you don't pay taxes each year on capital gains, dividends and other distributions from securities held in your IRA. Beyond that, there are different tax advantages, depending on what type of IRA you open.

There are two types: traditional and Roth. A traditional IRA offers tax-*deferred* growth, meaning you pay taxes on your investment gains only when you make withdrawals. A Roth, by contrast, offers tax-*free* growth, meaning you owe no tax when you make withdrawals.

A traditional IRA comes in two flavors: deductible and nondeductible. To see if you qualify for a deductible IRA, which lets you deduct all or part of your contributions from your taxable income, use the following guidelines:

- If you have no retirement plan at work and you're under 70-1/2, you can invest in a deductible IRA and deduct the entire amount from your taxes. (A nonworking spouse may also invest up to the federal limit and deduct the full amount if the couple's combined earned income is at least $4,000.)
- If you have a 401(k) or other retirement plan at work, you may fully or partially deduct your contribution only if your adjusted gross income (AGI) qualifies. (In 2002, your AGI must be below $44,000 if you're single, or $64,000 if you're married and filing jointly. These income limits will increase gradually to $60,000 for singles by 2006 and $100,000 for couples by 2007.)
- If you're not covered by a retirement plan, but your spouse is, you may qualify for a full or partial deduction if you file jointly and your AGI is below $160,000.

If you're not allowed to contribute to a deductible IRA, a nondeductible IRA is a valid option. You miss out on the immediate tax deduction, but at least your savings grow tax-deferred.

You may invest in a Roth IRA if your AGI is below $110,000 (for singles) or $160,000 (for married couples).

So which IRA is best for you? The nondeductible is the least attractive, so open one only if you don't qualify for the other two. The choice between a deductible and a Roth is more difficult, but generally you're better off in a Roth if you expect to be in a higher tax bracket when you retire. Plus, the Roth offers more flexibility: You aren't required to make mandatory withdrawals from your account when you turn 70 1/2 -- as you are with other IRAs -- making the Roth a great way to leave money to your heirs. And, if you need the money before retirement, there are more opportunities for penalty-free withdraws.

FEDERAL LIMITS ON IRA CONTRIBUTIONS

In 2001:	$2,000	
In 2002:	$3,000	($3,500 if you're 50+)
In 2003:	$3,000	($3,500 if you're 50+)
In 2004:	$3,000	($3,500 if you're 50+)
In 2005:	$4,000	($4,500 if you're 50+)
In 2006:	$4,000	($5,000 if you're 50+)
In 2007:	$4,000	($5,000 if you're 50+)
In 2008:	$5,000	($6,000 if you're 50+)

What to do when you switch jobs

Don't let the IRS siphon your savings.

When you change employers, you must decide what to do with your 401(k) money at your old job. You have three choices:

- Cash out. This is the financial equivalent of shooting yourself in the foot, since you pay income taxes plus a 10 percent penalty if you're under 59-1/2, and you diminish your retirement savings.
- Move your money into your new 401(k) or a rollover IRA.
- Leave your money where it is. (You old employer has to allow this if you have more than $5,000 in the plan.)

If you decide to move it, make sure to do so as a trustee-to-trustee transfer. That means you never touch the money. You simply direct the company housing your new account to arrange the transfer with your old employer.

That method lets you avoid the costly traps involved in a "rollover," where your old employer writes a check to you, which you then must deposit in the new account within 60 days.

Sounds easy, but your former employer automatically will withhold 20 percent of your money for income taxes. You get it back the next time you file your income taxes, but you are required to rollover the *full* amount within 60 days, leaving you to come up with the missing 20 percent yourself. If you fail to roll over the full amount within the time limit, the IRS deems the shortfall a taxable withdrawal and imposes income taxes plus a 10 percent penalty.

How can I get the most out of my money in retirement?

These strategies can help you get more mileage out of your assets in retirement.

Once you hit retirement, you get to kick back and enjoy your savings. But you'll enjoy them a lot more and a lot longer if you manage your withdrawals smartly. To give yourself the best chance of outliving your money, financial experts recommend you withdraw no more than 4 percent to 5 percent of your total nest egg every year.

You also want to minimize your tax bite. Generally speaking, the more money you leave tax-deferred in a 401(k) or IRA, the more your nest egg will grow, because a large balance can compound faster without the drag of taxes. But taxes will eventually come due on that money. The key is to manage it so that you pay the lowest possible tax rates on your withdrawals. That's why experts suggest in the early years of retirement you draw some of your income from your taxable accounts and some of it from your tax-deferred accounts. To find the right mix for you, consult a professional tax adviser.

You might stretch your money even farther if you convert your traditional IRA to a Roth and tap it only after depleting your taxable accounts. Remember, too, if you have a traditional IRA, you must start taking minimum required distributions when you turn 70-1/2. There are no such withdrawal requirements for a Roth.

If you need to make any portfolio adjustments in retirement, do so in your tax-deferred accounts, says Don Boegel, a certified financial planner in Plymouth, Minn. That way, you won't pay any taxes -- or, in many instances, broker fees -- to move your money around, as you do when you sell off a taxable investment and buy another.

Your taxable account, in turn, is the best place to harvest tax losses -- a process in which you sell an investment on which you've lost money and apply that loss against future capital gains, in effect reducing your tax bill.

If you find your nest egg isn't quite large enough when you retire, there are still things you can do to stretch the assets you have accumulated. For instance, you might:

- Take a job in retirement. Imagine taking a part-time job that reduces your withdrawals from an IRA by $15,000 a year for 10 years. By letting that money grow tax-deferred longer, after 10 years you would have almost $220,000 that you otherwise wouldn't have had, assuming you earned an 8 percent annual return.
- Get money from your home. If you are age 62 or older, you can convert your home equity into tax-free retirement income by taking a reverse mortgage.
- Move to less expensive area. Doing so could stretch your retirement income by 15 percent or more.

14. Asset Allocation

Top things to know

1. Time is on your side.
Those with more years until retirement can afford to put a greater percentage of their assets in the stock market.

2. Stocks mean risk and return.
Those with a higher tolerance for volatility should put more money in the stock market than those in the same age group who have a lower tolerance.

3. College savings funds need stocks.
Since college costs are rising faster than inflation, no other investment will keep pace as well as stocks. Invest more in stocks when your kids are young, and as they get older move more money into bonds.

4. Get professional advice.
One of the best ways to develop an effective asset allocation plan is to consult a qualified financial planner.

5. Allocation is the key to achieving your goals.
Studies have shown that asset allocation is the single most important factor in determining returns from investing.

6. Know your stock funds.
Before you set up your asset allocation plan, you must find out the nature of the companies purchased by the mutual funds you own.

7. Know your bond funds.
Similarly, you must learn the same about the bond funds you own.

8. Don't rely on software alone to build a savings plan.
Software programs might not go far enough to devise your asset-allocation plan.

9. Determine your long-term goals.
Do you want to buy a sailboat after you retire? Or pay off your mortgage so you can write a novel? Figure out what your long-term goals are, and what they will cost.

10. Get started.
It's never too late to get started, and it's never too late to revamp or revise an asset-allocation plan.

What is asset allocation anyway?

Once you've amassed two nickels to rub together, it's a good idea to keep them in separate pockets -- and not in the same pants.

Asset allocation is all about not putting your eggs in one basket. It's the ultimate protection should things go wrong in one investment class or sector, as is likely to be the case from time to time.

For example, many people loaded up on technology stocks in the late 1990s. When the market corrected in 2000, many investors experienced steep losses. Depending on what your holdings are and how they're affected by market conditions, this could leave you hurting, indeed.

Or, you may put your money into bonds. Yet the bond market, too, has its up and down swings. Disgusted with that market, you put your money in a money market account. However, though virtually bomb proof, this market provides far lower returns. After all, less risk means lower rewards.

Moreover, a bad year in the stock market may show up as nothing more than an insignificant blip by 2010 or certainly by 2020. This is because the stock market is historically the best long-term investment vehicle -- one that can deliver an average return of more than 10 percent annually for those willing to stick it out for the long haul.

In the short term, however, the stock market is more volatile than other investments. Consequently, investors with less risk tolerance -- and this generally includes people who are close to retirement age -- should put less money into the stock market and invest more in bonds. Younger people, however, can take on more risk because they have a longer investing horizon.

Your risk tolerance and goals will determine how much you put into each of the three investment categories. If you make careful choices with your asset allocation you'll earn better returns without losing sleep.

Finding the right mix

Your goals, risk tolerance and time horizon are the key.

The ultimate financial goal, of course, is retirement. How soon you retire -- and in what style -- can be greatly affected by your decisions on asset allocation earlier in life. In accounting for risk in your asset allocation, it's more productive to think in terms of your tolerance for volatility. This is because one of the greatest investment risks is the risk of doing nothing -- and missing out on superior returns.

An individual planning to retire in 15 years who has a high tolerance for volatility may want to have 70 percent of his or her holdings in the stock market, 28 percent in bonds, and 2 percent in money markets. If this person is planning to retire in 25 years, he or she might ratchet the securities holdings up to 80 percent.

Those retiring in 15 years but with less stomach for volatility may want to keep 50 percent in stocks and 38 percent in bonds. For equally volatility-shy people 10 years younger, the percentage in stocks could be around 65 percent.

Those retiring in five years are faced with the daunting task of allocating their assets for maximum return without betting the farm. A nasty market dip could occur immediately before retirement, leaving your nest egg drastically short.

Individuals close to retirement who can live with higher volatility may want to put all of their holdings in stocks, weighted mainly in large-cap issues that are more dependable in the medium term than smaller caps and internationals. Those who can't take as much heat may want to put as much as 48 percent in bonds (principally intermediate-term bonds), 2 percent in money markets and 50 percent in stocks -- again, primarily large-cap stocks.

If your investment goal is putting your kids through college -- that is, if you're using a separate pool of funds for this with a separate asset-allocation plan -- you may want to consider putting a bit more in the stock market while they are young For example, those with high volatility tolerance might put 80 percent in stocks, while those who sleep more fitfully might limit their securities investments to 65 percent or even less. As they get older, move more of the money into bonds.

Achieving the right mix of stock types (small-, mid- and large-caps and internationals) and bonds (short, medium and long-term) to achieve maximum return for your volatility tolerance while maintaining adequate diversification is a tricky business, so you may want to consider consulting a qualified financial planner or adviser.

Before you actually invest in accordance with your newly minted allocation plan, you will want to do something that few individual investors do: Find out specifically what you own. Most people don't know precisely what they own because their portfolios are dominated by an accumulation of mutual funds. If you strip away the marketing veneer of each fund and do some investigating, you can not only find out what the fund says it invests in, but what it actually owns.

For example, some funds may call themselves small-cap. But, these same funds may veer into large-cap territory to boost their returns if their sector is out of favor. Your fund's 800-number reps should be able to give you information on this. If they won't or say they can't, find another fund.

The need to determine what you already own is another reason to hire a qualified financial adviser; he or she would have a good handle on most funds. As your advisor would tell you, you must break these funds into their component parts to know what percentage of your assets is in small caps versus large, or in long-term bonds versus short-term. Without this awareness, you could, for example, labor under the assumption that your stocks are diversified across companies by size, when, in fact, every dime you have in securities is in large caps. Moreover, you should know what types of stocks your fund is buying by sector.

Similarly, don't take your short-term bond fund's word that its holdings are all short-term. Find out what they think is short-term, mid-term and long-term, and determine what they actually own. Moreover, check out their credit criteria. Are they strictly into top drawer AAA's? Or are they dabbling far lower on the pecking order by exploring junk bonds?

The whole idea is to have a chair to sit down on in one area when the music stops in another.

15. Hiring Financial Help

Top things to know

1. Anyone can call himself a planner.

To avoid amateurs, hire a planner who's earned special credentials (such as a Certified Financial Planner or Personal Financial Specialist designation), by meeting training standards and/or has a certain level of experience.

2. Planning is more than investing

Not all planners offer comprehensive services. Some just give investment advice or focus on one aspect of planning, such as insurance or taxes.

3. Expand your choices.

When hiring a planner, interview at least three pros to find the one that can deliver the services you need and who's compatible with your style.

4. Personal references are a good place to start -- but not the last stop.

A reference from a friend or family member is a great way to search for a financial planner. But make sure you've got similar needs as the person who's giving the referral. Go to groups, like the Certified Financial Planner Board of Standards and the Financial Planning Association, for additional references.

5. Understand how your planner is getting paid.

The three most common set-ups are: Fee-only, fee-based and commission-based. Fee-only planners don't get commissions for the products they sell -- fees are for the advice they give.

6. Check credentials.

Check to see if a planner's record is tarnished by disciplinary problems or complaints. Groups that award credentials or state agencies keep tabs on planners and can provide help.

7. Get references.

Ask a planner for two or more of his clients - then follow up and call to find out how a planner performs in specific circumstances, such as during a financial crisis.

8. Express yourself.

The quality of a planner's advice is correlated to how well he or she knows you. Make sure a planner asks questions about your finances, goals, risk tolerance and philosophy. If they don't ask, they probably aren't paying adequate attention.

9. Know what they're selling.

Find out what financial products a planner sells and how much he or his firm earns for making a sale. Be wary of planners who push one product - say, one family of mutual funds or one kind of insurance - as they may not give you the unbiased or comprehensive advice you need.

10. Know yourself.

The best planner will take his cues from you. Before you hire someone, identify the financial goals you want to meet, your assets and liabilities, your risk tolerance and investment style. Are you self-directed or do you want specialized help?

Need Help? Here are your options.

Let's face it -- making financial decisions is hard. And while there's a lot you can figure out on your own, we can all use help when it comes to something as important as how to save, invest and plan for the future.

Nevertheless, just 17 percent of all American households have a personal financial planner. Why such a low number? Chalk it up to confusion and fear. After all, it can be daunting entrusting your financial future to a stranger. And it's tough knowing where to turn for help because a changing marketplace has blurred the line between the likes of insurance salesmen and your stockbroker. In fact, these days everyone -- from law firms to tax planners, mutual fund families and brokerages -- is competing hard to manage your money.

What's more, because there are no state or federal regulations for the planning industry, anyone can call himself a financial planner. As a result, you'll want to hire a planner who's earned credentials, such as a Certified Financial Planner (CFP) or a Personal Financial Specialist (PFS).

The credentials are awarded only to those advisers who've demonstrated a certain degree of knowledge and experience -- and who've passed exams covering major planning subjects. For example, to earn the CFP credential, a planner must pass an exam that tests knowledge of insurance, investment planning, tax planning, retirement planning, employee benefits and estate planning.

Because qualified planners are trained to deal with myriad personal financial topics, they can help you set financial goals and priorities, then recommend specific steps to meet them. This means they may give advice on how you should allocate your investments, what kind of insurance you really need and explain how certain moves may affect your taxes or estate.

It's then up to you to decide if you want to follow that advice. A good planner also will recommend when you need more specialized help, say, working with a trusts and estates attorney who can help protect assets in a family businesses.

Here's a round-up of the different types of help that is available:

GENERAL

Credential: CFP (Certified Financial Planner)

What they do: Roughly 39,000 CFPs nationwide provide financial planning and advice on topics from retirement planning, investments, and tax and estate planning, insurance needs.

Requirements: Pass college-level courses in topics including retirement planning, estate planning, tax planning, investment analysis, employee benefits. Then pass a two-day, 10-hour exam. Planners also must have a bachelor's degree and a minimum of three year's professional experience working with clients. If they have no degree, a planner must have five years experience.

Credential: CPA/PFS (Certified Public Accountant/Personal Financial Specialist)

What they do: Provide overall financial planning with an emphasis on taxes and accounting.

Requirements: The PFS credential is given to CPAs who have a certain level of professional experience and are members of the American Institute of Certified Public Accountants. A CPA must have practiced a minimum of 1,200 hours of financial planning over a five-year period prior to applying for the PFS exam, which covers risk management, retirement planning, investment planning, goal setting, tax planning and estate planning. The 3,100 CPAs nationwide who've earned the PFS title must submit client references and reapply for the PFS credential every three years.

INVESTMENT PLANNING:

Credential: IA or RIA (Investment Adviser or Registered Investment Adviser)

What they do: As their name suggests, an IA advises clients about securities. Note: a financial planner or broker may be an investment adviser but not all investment advisers are planners or brokers.

Requirements: Investment advisers who manage at least $25 million must register with the federal Securities and Exchange Commission (www.adviserinfo.sec.gov)

IA's who manage less than $25 million have to register with their state securities agency. To find your agency, check the Investment Adviser Registration Depository or www.iard.com/reg_directory.asp or ask your adviser to see their "Form ADV." This is the registration form that he or she must file with the SEC or his state. This two-part form lists complaints, disciplinary actions, the adviser's education, employment history, fees and investment strategies.

Title: Broker

What they do: Brokers are paid to trade securities on behalf of customers. Note, this is different than giving investment advice, though some brokers may also be registered investment advisers. Some firms may call a broker different titles such as an "account executives" or a "registered representative," and some brokers may specialize in one type of investment.

Requirements: Before they can buy or sell securities for clients, brokers must pass exams on trading procedures by the National Association of Securities Dealers, such as the Series 7 in general securities or Series 6 in variable annuities and mutual funds. Brokers must register with the NASD, so before you do business with one, check his or her background by calling the NASD's Central Registration Depository at 800-289-9999.

Credential: CFA (Chartered Financial Analyst)

What they do: CFAs are generally portfolio managers and analysts for institutional clients, such as banks or a mutual funds. But some of the nation's 44,000 CFAs advise wealthy individuals or families who have sophisticated investment needs.

Requirements: Candidates must take three, six-hour exams in three years covering financial accounting, debt, equity analysis and portfolio management. They also must have at least three years of professional experience in investments. To keep a CFA status current, a CFA must re-sign an ethics pledge each year.

Credential: CIMC (Certified Investment Management Consultant)

What they do: Advise high-net worth private clients on investments although a few CIMCs advise institutional clients such as pension funds or trusts.

Requirements: Candidates must pass two, two-hour exams on topics like risk management, performance measurement, development of investor policy statement, and asset allocation. They also must have three-years of professional experience as financial advisers and be a member of the Institute for Investment Management Consultants. Additionally, CIMCs must take 30 hours of continuing education over a running 24-month period to keep their credential.

Credential: CFS (Certified Fund Specialist)

What they do: Planners advise clients on mutual funds, and may buy and sell funds for clients if they have the broker license from the NASD. Some CFS holders also provide general financial planning services for clients as well.

Requirements: Candidates must pass a test comprised of 100 multiple-choice questions covering the use of mutual funds as well as annuities and financial planning. They must sign code of ethics before they can use the CFS credential. To keep the CFS status, a designee must take 15 hours of classes annually.

TAX PLANNING

License:CPA (Certified Public Accountant)

What they do: Those CPAs who specialize in taxes can help clients with tax planning and preparation. (Some CPAs may not deal with tax planning but instead focus on audits or accounting.) Unlike some other tax advisers, CPAs are authorized to represent clients before the IRS.

Requirements: Candidates must pass the rigorous Uniform CPA Examination. A CPA also must be licensed by the board of accountancy in the state where he or she works.

License: EA. (Enrolled Agent)

What they do: Enrolled Agents are licensed by the IRS to represent clients before the agency during audits, hearings or collection procedures. An EA may also provide tax-planning advice and tax-preparation services.

Requirements: Candidates must take a two-day exam on major points of tax law, including income-, corporate-, estate- and gift-taxes. Former IRS employees may qualify for EA license without taking the test if they have relevant tax experience when they worked for the agency. All EA candidates must pass a background check by the IRS.

How to find a planner

Talk to experts and they'll tell you to interview at least three financial planners before hiring the one who will, presumably, help guide you to success and riches.

Of course, the thought of tracking down one prospective planner, much less three, can be daunting. How are you supposed to find them? Sure, plenty of people advertise planning services on, oh, subway car advertisements or in the phone book. But let's face it, responding to these come-ons doesn't sound exactly prudent.

That's why references from friends and colleagues are a valuable way to start your search. After all, if your sister-in-law can vouch that she's had five years of great experience with a planner, then by all means, follow up on the referral. But you also have to be careful that you have similar financial needs as the person who gives you a recommendation.

If you and your spouse are saving for your first home, for example, you probably shouldn't hire a planner whose typical client is worth millions. You may be able to get good advice, but you'll likely end up paying fat fees to obtain it, and you can count on being less of a priority to your adviser than his wealthy clients.

That's why you should to turn to groups who certify planners with special credentials or certifications. While no credential or license can provide 100-percent guarantee against fraud or incompetence, they do provide good assurance that you'll work with an expert who's trained and reputable. That's because many industry groups will strip planner of a credential if that person fails to do business in a professional, ethical manner.

Moreover, some groups require advisers to reapply for credentials by demonstrating that they've kept current with relevant planning issues. If you've obtained professional references from friends or co-workers, use planning groups to check up on these referrals.

If you have no idea how to find a planner, or you need a few more candidates to interview, start with the Financial Planning Association (www.fpanet.org or 800 322-4237), which lets you search for planners by state, city or zip code. Look at your search results and seek out financial planners who have a C.F.P. (Certified Financial Planner) credential from the Certified Financial Planner Board of Standards.

At that point, you're job is half done. The Financial Planning Association does not verify credentials; it just lists planners. You'll next have to verify a planner's C.F.P. status and background with the CFP Board of Standards, which you can easily do by going to its website (www.cfp-board.org).

Another option? Look for a Certified Public Accountant who's earned the Personal Financial Specialist credential (C.P.A./P.F.S.) from the American Institute of Certified Public Accountants. You'll get a double dose of assurance that you're hiring a trustworthy pro. C.P.A.'s must be licensed by the state they work in, so you can check their records to see if they've had complaints or disciplinary actions filed against them. (The National Association of State Boards of Accountancy, www.nasba.org, can put you in touch with officials in your state.)

Of course, being a C.P.A. doesn't necessarily make someone a planning whiz, which is why you should also look for the P.F.S. credential, too. In order to earn it, an accountant must pass the AICPA exam covering major planning aspects such as retirement planning to risk management, sign an ethics pledge, have a minimum amount of professional experience and keep current with tax and planning issues. (For more information about what advisers have to do to earn the P.F.S. and other credentials, see our breakdown. You can find a state-by-state directory of Certified Public Accountants with P.F.S. credentials at www.cpapfs.org.

Finally, be aware that training, credentials and professional reputation only go so far. Ultimately you've got to feel comfortable with your financial adviser, and no reference or degree can tell you if a planner is right for you. For that, you've got to meet her face-to-face and ask the right questions.

8 Questions to Ask

8 Questions to ask a planner

It doesn't matter if you're in the market for a new car or a pound of tomatoes. If you're smart, you inspect the merchandise before you buy it. But how easy is it to do due diligence when you're scouting around for a financial planner?

Ideally, you've got the names of planners who've been referred to you by a personal contact or from professional groups. Now's the time to make the final call, and the best way to do that is during a face-to-face interview. Many advisers give initial meetings without charging a fee so this shouldn't cost you anything but time. Now, to make sure that's not wasted -- here's what to ask:

1. What do you charge and what method do you use to get paid?

Planners use different methods to bill clients. You can choose between fee-only, fee-based, and commissioned planners. Either way, you should know exactly what you're getting yourself into. Fee-only planners, for example, may charge flat rates or an annual retainer. Sometimes they bill by the hour or charge a percentage - usually 1 percent to 2 percent - of a client's assets. For more about how planners charge clients see "What's it cost?"

2. What are your credentials?

A planner can point to a college or grad-school diploma. But does he really know about retirement and tax planning? Can he help you determine how much insurance you need while suggesting the best way to fund your teenager's college education?

That's where credentials come in. Many special designations are awarded to men and women who have trained for and passed exams on major points of financial planning. Find out what a planner had to do to earn her credentials and who awarded them.

3. How much experience do you have?

The key here is *relevant* experience. A planner may have decades' worth of experience catering to the rich, helping set up tax-saving trusts for spoiled grandchildren, for example. But if you have more simple needs, like planning for retirement and saving for a first home, you want someone who has plenty of experience in those areas. A good way to find out if someone has relevant experience is by asking a planner to describe his or her typical client.

4. What planning services to you provide and how often do you see your clients?

There's a big difference between tax planning and tax preparation. Ditto for insurance planning and retirement planning. Needless to say, you should know what services you'll get from any one planner -- then make sure they mesh with the kind of help you want.

"So often people call themselves a financial planner but all they do is mange your money," says Dee Lee, a CFP from Harvard, Mass., and author of *Let's Talk Money*. "So what you want to know is, Are they going to look at your financial life in detail? Will they review your insurance needs and your retirement needs?"

5. Does your planning include specific recommendations for investments or other products?

It doesn't matter if your planner makes money by commissions or is fee-only. Find out ahead of time if you'll get specific hand-holding or more general directions. Depending on how self-directed you are, you may want someone who' s going to tell you exactly what kind of insurance to get, how much to purchase and where to buy it. On the other hand, you may feel more confident with say, your ability to pick mutual funds, and not want any input in that department.

6. What are you selling and who's paying your commissions?

It's not just enough to know whether or not a planner earns commissions. You should know specifically how much he makes from various products he sells and/or recommends. For example, is this person going to get more from selling annuities than bonds? If you have a clear understanding of how a planner earns his living, you can determine if you're getting advice that's in your best interest.

7. Can I get references from other clients?

If possible, get two or more references, ideally from longtime clients. When following up with references, focus on specifics: How helpful was the planner when someone had to handle a financial crisis, such as a death in the family or a big investment loss? Is it easy to get appointments?

8. Do you have any questions for me?

It's fairly obvious that there's a correlation between how well an adviser understands your needs and the quality of the advice you get. That said, it's important that your planner asks the kinds of questions to help you meet your goals - even the ones you haven't thought to identify.

"They should be asking questions like 'Tell me about your parents?' ' said Lee. "You may have a child who's going to college in 10 years, but what if your mother is 70 years old? Will you be financially responsible for her when you're paying school costs? If so, they should talk about looking into buying your mother long-term care insurance to pay for her care. A planner should be looking at your total picture."

What should it cost?

What it costs

First priority when it comes to getting financial help: You feel comfortable with your financial planner, and he understands your needs.

A close second: You're comfortable with the cost of the help.

Generally, you face three basic billing structures:

Fee-Only Planners are paid only for the advice they give. They do not earn commissions by selling financial products such as life insurance or mutual funds. **Fee-Based Planners** earn fees from advice and they make commissions. **Commission-Based Planners** make money from the products they sell.

There are a couple of key advantages to going the fee-only route. First, you don't have to worry that your planner is making a recommendation to generate fees. Second, you get a better idea up front how much you'll be paying for advice.

However, that's not to say that there aren't differences in how fee-only planners bill clients.

Some fee-only planners charge a percentage of a client's assets, and individuals who hire them tend to spend the most of all -- typically $1,596 per year. Planners generally charge 1 percent to 2 percent of clients' assets.

There are potential perks and pitfalls to hiring someone whose paycheck depends on what you're worth. On one hand, they have great incentive for you to make a lot of money.

But they also have a disincentive for you to cut into your nest egg, and they may urge you to invest rather than pay off a mortgage or other debt. Second, these planners tend to pay attention to assets under their direct management rather than consider a client's entire financial situation.

"Money managers will almost universally not pay attention to your 401k at work," says Gary Schatsky, past chairman of National Association of Personal Financial Advisers, which represents fee-only planners.

Some fee-only charge an annual retainer or a flat fee. Individuals who pay flat fees tend to have the lowest costs of all, spending an average of $464 per year, according to Forrester Research. However, if you plan on seeing a planner often, an annual retainer may be less expensive in the long run.

Other fee-only planners charge hourly rates. These days, planners' hourly rates average $120. Always get an estimate of the total hours you'll be billed before you hire a planner who bills by the hour, says Doug Nogami, assistant director of communications at the Certified Financial Planner Board of Standards.

You can find fee-based planners through the National Association of Personal Financial Advisors. Search under the consumer link at the NAPFA Web site www.napfa.org or call 800-366-2732. You also can check for Certified Financial Planners, some of whom are fee-only, at the Financial Planning Association Web site (www.fpanet.org).

16. Health Insurance

Top things to know

1. Insurance costs a lot but having none costs more.
There are sensible ways to save money on insurance, but skipping coverage isn't one of them. Medical bills from even a minor car accident can deplete your savings -- a major illness can push you into bankruptcy.

2. If your employer offers insurance, grab it.
Group coverage, particularly when it's employer-subsidized, is almost always a better deal than anything you can get on your own, even if you're young and healthy. If you're NOT young and healthy, it's definitely a better deal.

3. Comparing plans is tough but necessary.
Unfortunately, there is no such thing as standard coverage. Benefits and costs vary widely from plan to plan. If you have choices, you'll have to examine each one closely to find the best deal.

4. The lowest premium isn't always the cheapest plan.
What your insurance covers is just as important as, and sometimes more important than, what you pay up front. Ultimately, the cheapest plan is the one with the best price for the benefits you're most likely to use.

5. Even good coverage can have big loopholes.
You can count on your health insurance to cover you for a hospital stay. Most policies cover doctor visits, but benefits for mental health, prescription drugs and dental care are strictly optional.

6. You'll pay more for freedom.
Plans with the most comprehensive coverage at the lowest out-of-pocket cost require you to use a specified network of hospitals, doctors, labs and other providers. The more flexibility you demand, the more you'll pay, in either premiums or co-payments.

7. You can check out networks before signing up.
A growing number of public and private sources compile information on the track records of individual doctors, hospitals and health plans.

8. You can keep your insurance if you lose your job.
State and federal regulations protect you from losing your health coverage just because you lose your job. Unfortunately, they offer little protection from high premium costs.

9. Working couples have more to think about.
If you and your spouse both get health insurance at work, you must sort out whether it makes more sense to have two policies or for one of you to cover the other. If you have kids, you need to decide who's going to cover them.

10. Tax breaks can help.
Ordinarily medical expenses, including insurance premiums, are not tax deductible until they exceed 7.5% of your income. However, if you're self-employed or your employer offers a flexible spending account, you can get a tax break without meeting the threshold.

The basic flavors

There are two types of plans, each of which has far-reaching consequences.

There are two basic types of insurance: indemnity plans and managed care. In general, indemnity insurance -- also called "fee-for-service" -- gives you greater freedom and flexibility than managed care. However, you'll pay more out of pocket for the health care you get. With indemnity coverage, you can choose any doctor, hospital, laboratory or other medical provider. As long as your insurance contract includes the service performed, insurance will cover it. However, it won't pay the entire charge. You'll have to satisfy an annual deductible -- generally a few hundred dollars -- before insurance even kicks in. Then, you'll owe a portion of each bill, called a co-payment, normally 20%. If the provider you choose charges unusually high fees, your share may be considerably higher. That's because your insurer will base its 80% share on the "usual and customary" fee for the service in your area, not on the actual bill. As a rule, indemnity insurance covers only illness or accidents; it doesn't pay for preventive care such as flu shots or birth control. Depending on your policy, it may or may not pay for prescription drugs or psychotherapy.

In its pure form, managed care flips indemnity coverage 180 degrees. With a health maintenance organization (HMO), there are no deductibles. Co-payments are fixed and low -- generally $15 or less -- and preventive care, drugs and mental health treatment are usually covered. However, you can choose only among doctors, hospitals and other providers who have contracts with your HMO, and you can receive only medical services authorized by the plan. If you use non-authorized providers or receive nonauthorized care, your HMO will not pay any portion of the bills.

Because many people are uncomfortable with these restrictions, managed care has evolved to include hybrid plans that blend HMOs with some of the features of indemnity coverage. With a point-of-service plan (POS), for instance, you can keep your costs low by using a network of doctors and hospitals that have contracts with your insurer. However, if you choose, you can go outside the network, but you'll pay a deductible and higher co-payments. Competitive marketing has produced other permutations, such as the "open access" HMO that allows you to see a network specialist without a referral.

The only way to know for certain what your options and costs are is to carefully read the descriptive materials and question anything that's not clear. For general help in understanding health insurance, check the federal Agency for Health Care Policy and Research. Your state insurance department may also offer online help. Check this guide to find your state health agency's Web site. Websites like Insure.com can help you to understand different types of health insurance.

Once you grasp the basics, you're ready to make informed choices. The next section tells you how to find the coverage that best suits your needs.

Which plan is right for you?

It all comes down to which plan gives you the services you're most likely to need at the lowest out-of-pocket cost.

If you get coverage through your job, your employer picks your insurance and you may or may not get any choices about it. If you buy your own, you're in charge, but your choices are limited by the plans available to individual purchasers and by how much you can afford to spend.

Unfortunately, there's no such thing as standard coverage. Details vary enormously from one plan to another. The best value is not necessarily the plan with the cheapest premium or the one with the most benefits. It's the plan that covers the health services you want and need for the lowest out-of-pocket expense (see "types of insurance"). In essence, differences among plans come down to three intertwined elements: benefits, costs and restrictions.

Benefits: Every insurance plan will cover you for doctor and hospital bills, with various limits, discussed below under "costs." Virtually everything else, including prescription drugs, glasses, psychotherapy and preventive care, such as immunizations and screenings, may or may not be covered, depending on the specific plan. To figure out how well a plan suits your needs, first make a list of the health services you and your family normally use. For each plan, note the amount of coverage for each of those services -- for instance, "100%," "80%," "not covered." Once you've got a handle on how fully each plan covers your health needs, you can evaluate cost differences.

Costs: If you don't use many medical services, your primary cost for indemnity coverage will be the premium. If you do use a lot of services, it will be hard to gauge your actual costs, since you must factor in the deductible, co-payments, and any excess charges or uncovered services. In contrast, cost is easy to gauge with a true HMO -- a managed-care plan with no out-of-network option. Once you've paid your premium, nearly everything will be covered and you'll be liable only for small co-payments. Estimating the cost of a managed-care plan with an out-of-network option is tricky, because your ultimate cost depends on whether or not you actually go out-of-network. If cost considerations make you lean toward a managed-care plan, read its literature thoroughly to decide whether you can live with the restrictions it imposes.

Restrictions: Generally speaking, a managed-care plan will limit your choice of providers and require you to get pre-approval for services. If your beloved pediatrician shuns HMOs or you have a difficult health problem, you may decide that you can't abide limits like these. Keep in mind, however, that indemnity insurance also comes with limitations in the form of deductibles, co-payments and uncovered services. These financial roadblocks can inhibit freedom of choice as much as any managed-care bureaucracy.

Another worry about restrictions is that many consumers equate freedom of choice with medical quality. They're not entirely wrong. If you receive poor treatment in a managed-care plan, it's hard to vote with your feet. However, they're not right, either. The quality of medical care varies considerably both in and out of managed care. In fact, the best managed-care plans offer quality advantages you won't get outside managed care, such as outreach for preventive services, heath-risk screening and coordination of care.

Whether you choose indemnity insurance or managed care, it's wise to check up on your providers in advance. One way is via state insurance department Websites. Florida, Maryland, Massachusetts, New York and Rhode Island, for instance, post lists of local doctors who have been disciplined for poor patient care or, in some cases, criminal conduct. New York and New Jersey rate local hospitals and doctors on how well they care for cardiac patients. Florida, New Jersey, New York, Maryland, Texas and Utah rate local managed-care plans. Nationally, the Joint Commission for the Accreditation of Health Organizations is the major rating group for hospitals, the National Committee for Quality Assurance rates managed-care plans and thehealthpages.com lists surveys and other data on selected health plans and health services. If the insurance plan you prefer seems unaffordable, check the money-saving strategies in the next section to see if there's a way to reduce your costs. And be sure to use our calculator to compare plans that you're considering.

Money-saving strategies

If you are young and healthy, saving on health-insurance premiums is tough enough. Older people not in the best of health will have great difficulty getting an affordable plan.

If you're buying your own insurance, you've got to shop around for the best price. As long as you're healthy and under 50, insurers want your business. To avoid attracting applicants they don't want, though, many keep a low profile, so you'll have to seek them out by phoning agents, checking with your state insurance department or going online. For instance, Quotesmith, a nationwide insurance broker, has a national online database of carriers you can search for policies that might be available to you.

Older people or those with health problems will have a tougher time finding insurance. Government protections offer some help (see "Your Legal Rights") but insurers are not always quick to advise you of your options, so you may have to take the initiative to get the coverage you're entitled to.

Make the most of spousal coverage. Working couples with insurance from two employers may be able to get more or pay less than one-income couples. Depending on the premiums and benefits of each available plan, the best deal may be separate coverage for each, double coverage for both, or forgoing one spouse's coverage in favor of the other's. If you have kids, you'll need to compare your options for family coverage. Be warned: The calculations can be mind-boggling and, even with double coverage, a couple can't collect more than 100% on the same claim.

Use available tax-breaks. If you're self-employed, you may be able to deduct 45% of your insurance premium from your gross income. If your employer offers a flexible spending account, sign up. You can pay your premium as well as expenses not covered by insurance with money that's not subject to income tax or Social Security taxes.

Take prudent risks. If you are generally healthy and use few medical services, you can cut premium costs substantially by buying "catastrophic" coverage. This is an indemnity policy with a very high deductible, perhaps as much as $2,500. Assuming this much financial risk can slash your premium by 50% or more, depending on your age. Don't try to trim your premium by reducing coverage on the other end, though. Make sure your insurance has a high maximum payout, at least $100,000, preferably $500,000.

Look for a subsidy. If your income is very low, if you're permanently disabled or if your medical expenses are extremely high, you may qualify for federal or state-subsidized insurance, such as Medicare or Medicaid (check your state Medicaid office). Regardless of your ability to pay, you may be qualified to receive free primary care through public health clinics. To find a site near you, check Bureau of Primary Healthcare web site.

If you lose your job or have health problems, federal and state laws give you certain rights to health insurance, which are described in the next section.

Your legal rights

If you work for a company with 20 or more employees and you lose your job, a federal law called COBRA (for Consolidated Omnibus Budget Reconciliation Act) requires your ex-employer to let you stay on the group policy for at least 18 months, at your own expense. If you have generous coverage paid mostly by your employer, the full premium (plus 2% for administrative costs) could be quite a shock. Still, it's wise to hang on to your old coverage until you're covered at a new job or find more affordable insurance elsewhere.

A more recent federal law called the Health Insurance Portability and Affordability Act (HIPAA) goes COBRA one better. It says that as long as you've been covered under a group policy within the previous 63 days, no insurer can turn you down for coverage, even if you're seriously ill. Unfortunately, HIPAA doesn't regulate premium costs so there's no guarantee that you can afford the insurance you're legally entitled to.

As the number of uninsured continues to rise, states have become increasingly active in helping individuals get insurance, though price continues to be a problem. Twenty-two states have so-called "high-risk pools," which guarantee insurance to applicants whose health histories make them undesirable to insurers. Some states have other ways of making coverage more accessible. New York, for instance, requires insurers to use a modified "community rating" when pricing coverage, so they can't charge disproportionately high premiums to applicants in poor health. For a state-by-state analysis of your rights to health insurance, check the Website run by Georgetown University's Institute for Health Care Research and Policy.

17. Buying a Car

Top things to know

1. Make sure you are getting the right vehicle.
This seems obvious, but you could wind up an unhappy car owner if you haven't thought carefully about how many people, and how much luggage or gear you need to carry.

2. Assess the worth of your old car.
Whether you plan to trade it in or sell it, your current car can be an important factor in your budget. Checking the right Web site and maybe your local newspaper will give you a realistic valuation.

3. Decide whether new or used is best for you.
Cars are built better now than in the past, so used cars make a lot of sense. But if you get a rebate or other cost break, the math may be on the side of a new vehicle.

4. Consider whether leasing or buying makes more sense.
Leasing provides lower monthly payments than buying with an auto loan. But it's not for everybody. If you don't have money for a down payment or if you trade your car every two or three years, you may be a good candidate for a lease.

5. Do your homework and set your target price.
The Internet has made it easier than ever to find out the dealer's cost for each vehicle and its options. That's the first step to getting the best possible deal.

6. Shop for money before you shop for the car.
If you plan to buy with a loan, check your credit union or local bank quotations (on websites) to find the lowest rate. Getting a pre-approved loan will give you added confidence in negotiating a good price.

7. Negotiating a lease.
In the complicated world of leasing, the dealer will have the upper hand unless you learn the jargon and how to negotiate the various segments of a lease deal.

8. Negotiate a purchase.
If you are doing it yourself, get bids from several dealers, keeping the focus on the dealer's invoice price, which you will know from your research. We suggest ways in which you may be able to get bids without going to showroom after showroom.

9.If you hate haggling, consider hiring help or using an Internet service.
Online auto-buying services make things easy with pretty good, no-haggle prices. But with most of them, you get quotations from only one dealer. Consumer services that shop several dealers near you may deliver even better prices.

10. Don't let the deal-closer close out your savings.
The finance manager isn't there just for the paperwork. He or she wants to sell you high-profit financial and mechanical add-ons. These are seldom worth the money.

The right vehicle

Before you shop, do your auto-biography.

Hey, wait. Don't go down to the car dealer and start shopping immediately. Are you sure that the car, pickup, sport utility, or van you have in mind is what you really need? If you rush into a deal without carefully considering how you will really use the vehicle, you could be making a $20,000 mistake, at the average new-car price.

Sure, you want a car that will make you smile. But consider the purpose of most of your driving. Is it commuting? Hauling kids? Weekends? Vacations?

If you drive more than half an hour to work every day, a combination of a comfortable ride and reasonable gas mileage become important. If you frequently drive clients or co-workers to lunch, a sleek coupe won't be welcoming for whoever has to crawl into the back seat; you need a four-door sedan. If you frequently haul your kids and their many friends or classmates, a minivan or sport utility with three rows of seats may be essential. If weekend errands involve hauling building materials or large bushes, that same utility or van will come in handy.

Be honest with yourself. What is the largest number of people you carry regularly? What is the biggest pile of gear, luggage or haul from Home Depot? Once you have made this practical matchup, however, you still have lots of choices. With careful planning, you can get a vehicle that you need AND that you really want. CNN/Money's New Car Matchmaker can help you find cars that are right for you.

Unless you are that lucky car shopper who has really made it and plans to let the world know it with a luxury car, you have to fit your automotive wants and needs into what you can afford.

That necessity leads to our next step -- budgeting carefully for your second-biggest purchase.

What can you afford?

Add up all the costs and alternatives before you decide which car best fits your image.

After your mortgage or rent, car loan or lease payments are likely to be the next-biggest item in your monthly budget. So calculate carefully what you can really afford. And don't forget to take into account such items as insurance costs. In pricing the car itself, don't forget state and possibly local sales tax -- which can run as high as 12 percent, but more typically 5 to 8 percent of the purchase price.

A new (or used) car calls for a new state registration, with fees typically running from $50 to $125. These items usually figure into the total amount you borrow with a loan or finance with a lease -- and therefore help determine your real-life monthly payments. Financial planners say a good rule of thumb is to plan on spending 10 to 15 percent of your total monthly budget on all automotive expenses. If you are buying a new car, your warranty will cover major repairs for at least the first three years. But remember that warranties do not cover routine maintenance such as oil changes or replacement for items such as batteries, windshield wipers or tires.

A new car means higher insurance costs. (Opting for a late-model used car can cut those costs.) Your premiums for liability coverage, required of all drivers, may not change much from your old car. What will increase is the so-called collision and comprehensive portions of your policy. Collision pays to repair accident damage to your car, while comprehensive covers theft, fire and natural disasters. Since you will want these coverages for a new car, your costs could shoot up sharply -- especially if you have been driving an older car or truck and have dropped collision and comprehensive coverage to save money.

Check the record. One way you can cut your insurance costs before you buy is to choose a model that has a good safety record and/or a low theft rate. Insurance costs vary not only by model but by metropolitan areas, and even from city to suburbs within those areas. So when you have narrowed the number of cars or trucks on your wish list to a handful, call your agent for a rate quote, or you can check theft and safety records on the Web. For federal crash test results, go to www.nhtsa.dot.gov. The site operated by the insurance-company sponsored Highway Loss Data Institute will give you rankings for injury and property losses for any vehicle, plus a list of the most- and least-stolen models. Both those factors affect insurance costs as well as your safety and peace of mind.

Those same rankings can be used for recent-model used cars. To help with that decision, the next section covers new versus used.

New or used?

With used cars more reliable than ever, the choice often boils down to money.

There's nothing like that new-car smell. Buying a new car has a lot of allure: It's brand new and it's all yours; nobody has abused it. You can get the vehicle equipped just the way you want, and you get the full factory warranty. But hold on. Your best deal could well be a late-model used car.

The used-car market has changed dramatically in the past few years. To start with, today's new cars -- and thus used cars -- are simply made better. Overall quality and durability has increased as U.S. manufacturers pushed hard to catch up to imports. A second factor is the rise of leasing. About one-third of all new cars now are leased -- up from 20 percent as recently as the early 1990s. Nowadays, the torrent of well-kept two- and three-year-old cars returning from leases is providing a supply of attractive, reliable used cars. And new used-car superstore chains are making it easier than ever to buy with huge inventories and no-dicker shopping. The kicker is that if you opt for a three-year-old model instead, you could save as much as 30 to 40 percent over new.

In response to the competition from superstores like CarMax and AutoNation USA, car dealers, backed by manufacturers, have introduced what they call "certified" used-car programs for newer used cars (usually up to three years old). Manufacturers insist that a used car must pass a series of inspections before it can become certified. And once a car passes, the manufacturer adds a fresh warranty of 12 months or more.

If you want a used car, start by checking prices of the vehicles that interest you. Among the best Websites are Edmunds.com, run by Edmund's, the publisher of paperback guides to automotive prices, and Carpoint.msn.com, Microsoft's automotive site. Both are free, and both will let you check the going prices for almost every make, model and year you can imagine. (The sites list new-car prices as well.)

These sites also offer classified ads for used cars, mostly from dealers. Enter your Zip code and you'll get a selection of cars within 100 miles or so of your home. While ads for these same vehicles undoubtedly also are running in your local paper, you get more detail on the net. Additional used-car classifieds are available at Cars.com.

Once you zero in on some possibilities, you need to double-check them. Unless you are buying a certified used vehicle, or a car that's still under the original warranty, spend a little extra to check any specific car, truck or van you are close to buying. The first step lets you make sure the odometer is honest and that the car has never been totaled (the used car business may have become less sleazy than it used to be, but problems still do occur). For $14.95 per vehicle on the Internet (Carfax.com) or $29.50 by fax (800-274-2277), the database firm Carfax will track down the history of your prospective vehicle by its Vehicle Identification Number (VIN), usually listed on a metal plate just inside the windshield. If, for instance, the car had 50,000 miles when its title last changed but now shows 30,000 miles, take a pass. If the car has ever been sent to a junkyard, a salvage title will show up on the report. About one in 10 cars in its database has some kind of problem, say Carfax officials.

Once a car has passed those big hurdles, you still need to get it checked by your own mechanic, if you have one. If you don't, many cities have specialized mechanic services that will make on-the-spot inspection of used cars, lemonbusters.net offers the service for $129. One such franchised inspection firm, CarCheckers of America, is in eight locations including Atlanta and Denver. If you are considering spending $15,000 for a used car, that $100 to double-check it may be well spent.

The most important thing to remember: Anything's negotiable except the right to inspect. If the seller won't let you and your mechanic inspect the car, walk away, no matter how nicely it runs.

Often, this rule of thumb means you'll be buying from an individual rather than a dealer, for many dealers don't allow inspections. Those who do typically won't let you take the car off the premises and won't let you use their lift.

Unless you have an unusually close relationship with your mechanic, he'll want you to bring the car to his shop. This isn't unreasonable, for a lift is essential for hunting nasties like rust, worn brake drums and deteriorating exhaust systems. However, a good mechanic can tell a lot from sliding underneath the car, inspecting the exterior paint for repaired body damage and checking the odometer reading against actual wear.

Confining your search to individuals usually means you'll get a lower price -- but it's more time-consuming because there's only one car at each location. Regardless of where you buy, there are some rules you can follow.

Jack Gillis, director of public affairs for the Consumer Federation of America, recommends what he calls the "touch and comment" technique often used by new-car dealers when they inspect trade-ins. "When you review the car, visibly point out the various problems that you note," he says. "An exaggerated touch of some loose parts or running your hand along body damage can put the seller in a defensive position."

This tactic can be used effectively when your mechanic is conducting an inspection within an earshot of the seller. Have your mechanic mention each problem, allowing you to comment grimly.

Having your expert on hand can make all the difference, because even if you know a lot about cars, you need an expert witness to present the damning evidence. Like any expert witness, however, mechanics must be paid. Some shops offer a pre-purchase checkout for a set amount that can vary widely depending on the shop and the procedures performed. Others offer on-premises inspections for their hourly labor rate, which can range from $40 to $70 an hour, depending on the region and the type of shop.

While indispensable, your mechanic is your consultant, not your agent. To get the best possible deal on a used car, you must do some work yourself. Some pointers:

- Before going to look at cars, visit your nadaguides.com and peruse the Official Used Car Guide of the National Automobile Dealers' Association. It lists recent prices fetched by specific year models in your region. The range between the trade-in value and retail value is your room to maneuver. If you can by a decent car from a dealer for less than its NADA book trade-in value, more power to you.

- If the seller touts the car as an immaculate jewel, be sure to negotiate an acceptable price before bringing in your mechanic. Failing to do so could leave you with no bargaining leverage if the car actually is in great shape. Make sure the seller understands that the agreed-on price is entirely contingent on the vehicle making Phi Beta Kappa. Once your technician determines the car's shortcomings -- and there are few used cars on the market without any -- it's your job to put a generous price on each repair needed. After all, you intone, the initial figure was based on perfection.

- Before buying, try to arrange a test drive at night and another on a rainy day. Nothing reveals a cheap windshield like oncoming headlights, and a replacement shield may mean the car's been wrecked and then given a convincing paint job. Also, it's impossible to know if trunk and door seals are leaking except when it's raining. Again, leaking seals may mean that the car's been wrecked, especially on a car only a few years old.

- There is a point at which too many glitches should eliminate the car from consideration. Says automotive author Mortz Schultz: "If you find a major problem, or if you rack up enough minor ones, forget the car."

In return for your rigors, do you get an absolute assurance that you won't regret the purchase? Of course not. But if your mechanic is competent, and you apply this counsel adroitly in negotiations, you can substantially lower the price.

If you decide, however, that you really want a new car, you have a different choice to make: Should you buy or lease?

Buy or lease?

Those low lease payments look great, but there's no such thing as a free lunch.

In those new-car ads on TV, lease payments look awfully low. And they are, compared with loan payments for buying the car. But leasing is not for everyone.

Leasing is the easiest way to get a new car every few years while letting the dealer or leasing company worry about disposing of the old one. But leases have some major disadvantages. One of the biggest drawbacks -- especially if you are not accustomed to leasing -- is that you are forced to make a major financial decision when your lease expires. You must either turn that car or truck back and buy or lease a new one, or decide to exercise your option to buy the vehicle at the lease-end price. (Typically, the value of your car or truck at the end of the lease is set in advance.)

On the other hand, if you buy a car or truck, you can postpone any decision about replacing it at least until mechanical trouble forces your hand. And some people just like knowing that they own the car once the final payment is made. If you don't mind driving an older car, the best decision on purely economic grounds usually is to buy a new car and keep on driving it long after your loan payments have stopped.

So which is right for you? If you typically trade for a new car every four years or less, want to avoid the loan down payment of 10 to 20 percent, drive close to but not more than the 15,000 miles a year allowed in most leases and typically keep your vehicle in good condition to avoid end-of-lease penalties, you might well be happy leasing.

Even so, before you opt for a lease, keep in mind that that there is a reason why those low payments look so attractive: Instead of paying for the entire car, you're only paying the estimated depreciation over the time you are leasing it. So to get a really good lease deal, you need to look further than just the payments. You need to understand how leasing works, do your homework and negotiate as hard as if you were buying the car. Here is a step-by-step guide:

Master the jargon. You can't successfully negotiate a lease without becoming fluent in the industry's terms. Here's what you need to know before you start to dicker. The capitalized cost is the equivalent of the selling price, which you want to get down as low as possible. The residual value is the estimated worth of the car at the end of your lease. Your monthly payments are determined by the difference between these two figures, plus an interest charge known as the money factor. Thus, raising the residual value or lowering either the capitalized cost or the money factor will lower your payments.

Look for a manufacturer-subsidized lease. These deals, often promoted in splashy ads in newspaper auto sections, are likely to be the cheapest available. To identify a generous subsidy, look in the ads' fine print for a residual value that's two percentage points or more above that published by Automotive Lease Guide, an independent research firm. To check the ALG value for a car, go to Carwizard.com, pick your model, and then select "Residuals and Factors."

Set a target and negotiate hard. You can find out the so-called dealer's invoice cost for any car or truck by checking CNN/Money's Car Finder. Set a target price about 2 percent above the dealer's cost ($400 on a $20,000 car, for instance). Start bidding below your actual target and plan to wind up near that figure.

Shopping for money

Having a loan approved in advance lets you focus on price negotiations.

When you go to a car dealership to negotiate for a new car, you're in a stronger position if you have a loan pre-approved. Unless your model has a special low-rate financing offer backed by the manufacturer, a local bank or credit union is likely to give you a better deal on a loan. And in most cases, you can take a rebate in place of any low-rate financing and use that to lower your purchase price.

Credit unions typically charge one-half to one percentage point lower interest than bank car loans. You may have access to a credit union where you work, or may be eligible through a professional organization (teachers, government employees).

If you don't have ready access to a credit union, check out your local bank offerings. Websites specializing in loan information will give you a quick rundown on average rates and the best rates in your area. HSH Associates gives you one car-loan rate per city -- among the best found for each location in their survey. Bank Rate Monitor gives five or more quotations for each major city, including the lowest rate available.

When you get a pre-approved loan, that commitment usually is good for a month or more. So you can shop for the car you want knowing your financing is ready to go.

In addition to getting financing before you go to a dealership, you also need to do your price homework. That's our next lesson -- setting your target price.

Setting your target price

It's easier than ever to learn just what the dealer's cost is on any vehicle.

Find this out before you start negotiations.

Having more information gives you more power. Not long ago, auto dealers had the upper hand because they had most of the information about price. The Internet has changed that -- with an estimated 25 percent of those who shop for new cars today checking for price information on the Web first.

Using CNN/Money's Car Finder, you can find out the dealer's cost for any vehicle. You can find out if price rebates, subsidized lease deals or other special breaks can cut your cost. And best of all, you can decide exactly what you intend to pay for the car or truck before you ever go near a showroom.

The number most often cited as the dealer's cost is the so-called invoice price -- the wholesale price that the manufacturer bills the dealer on shipment. But that is not the whole story. An additional amount -- called the holdback -- is paid by the manufacturer to the dealer later, in effect cutting the dealer's cost. When a car model is in oversupply, a dealer eager to get it off the lot may negotiate a price that will cut into his holdback -- typically around 3 percent of the Manufacturer's Suggested Retail Price (MSRP) -- and thus strike a selling price below the invoice price. But in normal circumstances most dealers are unlikely to sell below their invoice price unless there are special incentives.

The manufacturer may offer so-called "dealer incentives" for slow-moving models -- in effect, rebates paid to the dealer instead of the car buyer. Unlike heavily advertised consumer rebates, these dealer incentives are rarely publicized. But if you have done your homework and know such an incentive exists, you often can negotiate half or more of that amount for yourself.

To search for cars, minivans, sport utilities, and pickups with base prices and other data, use CNN/Money's Car Finder. We show you the base MSRP and dealer's invoice cost, as well as the same number with your choice of optional equipment.

A hot-selling new sport utility or sports car may sell for a while at full MSRP with no bargaining possible. But for more ordinary vehicles, a good starting point is to aim for a target price of 2 percent over the dealer invoice price.

For a slow-selling model, you may be able to go even lower (see the discussion above of the holdback and rebates). If you discover that the model you want carries a sizable consumer rebate or dealer incentive of $750 or more, let that alert you to bargain harder, since the dealer and the manufacturer want to move that model.

Negotiating the best deal

Know your target price and be ready for dealer maneuvers.

Before you head for the dealership you will have already done your homework, so you will know the dealer's invoice price, whether rebates or dealer incentives are available, and your target price, as well as where you plan to start bidding. You want to start the bidding as low as you reasonably can, but not so low that you will seem like an uninformed buyer just making a low-ball offer.

Pull together a folder showing your data and sources on these details where you can readily refer to them yourself or show them to the salesman.

At the showroom. Establish quickly that you are a serious buyer, not a browser. If you come across as just shopping, the salesperson will be eager to move on to a likelier sale. Don't say: "I'm looking at the Ford Taurus." Say instead: "I plan to buy a Ford Taurus LX within the next two weeks and I know pretty much how I want it equipped. I will buy where I get the best price. Let's talk about it."

That keeps you in control. The salesman wants to know as much about you as possible to start spotting potential profit points. Stay pleasant, but just turn away questions and say: "We can talk about me later. Let's talk about price."

Focus on the invoice price. As soon as you can, try to switch the discussion away from the MSRP, or list price to how much you intend to bid over the dealer's invoice cost. Bring out your Internet printout to show you have done your research on this. The salesman may well say: "That is not the right invoice price for the car." He or she may in fact know less than you do since traditional dealer training focuses on the MSRP and many dealers do not give salesmen the invoice prices. Say: "This is the invoice price for the car I want with the equipment I want." Show him your printout.

Start low. Though your target is $200 above invoice, you need to leave room for the dealership to budge you a little. So start out bidding at the invoice price on a car like the Taurus, where a rebate signals you to negotiate hard. You know you are entitled to the $500 consumer rebate that was offered recently, but don't bring that up yet. If that $500 had been a dealer instead of a consumer sales incentive payment, you would start out bidding to try to capture at least half that money. In that case, you would bid $300 below invoice and make it clear how you got that figure. "Since the dealership stands to get a $500 payment from Ford as a sales incentive, $300 below invoice seems fair."

He who hesitates loses. At this point, the salesman is likely to say something like: "I think this is way too low, but I will take your offer to my sales manager and see what I can do for you." He or she may not even intend to talk to the sales manager, but plans to keep you waiting in the glassed-in office to pressure you into a higher offer before even seeking approval. Tell him or her you do not intend to wait long. Then don't just sit there. Wander around the showroom or go outside to look at other cars. That usually brings the salesman back quickly. It's likely that he will bring the news that your initial offer was not good enough. At this point, if you started the bidding at the invoice price, agree to $100 over invoice.

If you get it, take it. If the dealership has a car in the color and equipment you want, and the salesman offers $200 over invoice, accept the offer. If not, get the best offer and take it to another dealer. If the second dealer beats the original offer, keep the competition going -- play it back to the first dealer. When you hit your target or come as close as you think you can, agree on the price. Now, and not before, is the time to talk about a trade-in. You already will know what your car is worth from checking local ads and looking up your model on Websites such as Edmunds.com and the Kelley Blue Book. If your car is a popular model in good condition and you are sticking with the same brand, you might match or slightly beat that price with your new-car dealer who sees potential profit in selling your used car. If the trade-in offer is a good one, say yes. If not, plan to sell it yourself or take it to the used-car lot of other dealer for a price quote.

Once your price and trade-in are set, you still have to finalize the deal. In our next section, we tell you how to close.

Closing the deal

Don't let your guard down at this crucial moment or you might close out your savings.

The salesman may call it "doing the paperwork" or some similarly innocuous description. But the finance manager you are about to meet hopes to boost dealer profits at your expense with attractive-sounding offers of mechanical and financial add-ons. In most cases, just say no. But there are some exceptions.

If you already have financing approved, just say so and you can avoid the financing pitch. The one exception: If you already know that the manufacturer is sponsoring a promotional deal with really low rates.

The next pitch you are likely to hear is for an extended warranty. Whether you want to consider this depends on how long you expect to keep the car. If it is the three years or less that matches the typical warranty, reject it immediately. If, however, you are almost sure you will keep your car for five years or more, you might consider an extended warranty contract. Ask when the extended-warranty coverage kicks in and what it covers. (So-called "power train only" warranties, for instance may exclude expensive electronic repairs common in today's cars.) And an extended warranty can cost $400 to $1,200. Also be sure you know how long the manufacturer's warranty runs. Volkswagen and Hyundai extend power train coverage for 10 years and luxury models Lexus and Infiniti for six to eight years.

The latest vogue in add-ons (replacing rustproofing now that almost all new cars are rustproof to start with) is security etching. Having your vehicle identification number etched into the glass on your windows may, as claimed, make your car somewhat less likely to be stolen. But it is certainly not worth the $1,100 some dealers are charging.

Buying on the Web

Web buying services can be a boon when buying a car, if you know a good deal when you see one.

For new car buyers, the real wonder of the Web is how easily you can get reliable price information that will give you a much stronger negotiating stance. But the Web is also powerful if convenience and low hassle matter a lot to you. Only some 5 percent or 6 percent of new-car buyers turn to the Internet, but surveys show most of are satisfied with the deals they got.

If you plan to buy from a dealer, know your target price before you start shopping. CNN/Money's Car Finder can tell you the Manufacturer's Suggested Retail Price (often called the "list price") and the Dealer's Invoice Price, or what the car cost the dealer.

Focus any negotiation on that dealer cost. For an average car, 2 percent above the Dealer's Invoice Price (that would be $400 on a $20,000 car) is a reasonably good deal. The Web site Edmunds.com gives you another useful figure -- the True Market Value, or average selling price, for a particular vehicle in your region. Knowing that price will tell you immediately if you are being offered a good deal by an Internet service.

If you have no taste for going head-to-head on Dealer Row, you can choose two kinds of Internet service:

Dealer Referral Autobytel.com, the major surviving service of this type, does not give you an immediate price quote. Fill in the Autobytel form detailing what vehicle you want and your color and options preferences. Then you will get a phone call or e-mail from a local dealership (sometimes almost immediately, sometimes a day or so later). At that point, you will get a price quote and some idea of whether the dealer has -- or can get -- the vehicle you want.

Since you will already know the True Market Value price from Edmunds, you can tell if the offer is a good one. Autobytel prices are supposed to be non-negotiable, but dealers actually will sometimes budge from their initial offer.

The major drawback of Autobytel, however, is that each dealership gets exclusive territory, so you will get a price from only that dealership designated for your area. That means you won't get the advantage of competitive bids.

Direct Internet Service. With CarsDirect.com, you can go onto the Web site, fill in the vehicle you want and get an immediate, non-negotiable price. These prices usually are competitive and may be a little above or below Edmunds True Market Value number depending on the vehicle.

CarsDirect.com, which gets its cars through dealers, doesn't guarantee it will be able to deliver exactly the color and options you want on your new car. But your chances are good if you are buying, say, a Honda Civic, a Chevy pickup or any other big-volume model in a popular color. When you find the price you want at CarsDirect, it really can't be any easier.

For another low-hassle option, consider hiring a car buying service. They do the hard part for you. For fees ranging from $190 to $450, depending on the level of service, they go out and get competitive bids from dealers and do all the negotiating for you. These services communicate with you via e-mail and telephone. Three of the best are AutoAdvisor (www.autoadvisor.com; 800-326-1976) CarQ (www.carq.com; 800-517-2277) and Car Bargains (www.carbargains.org; 800-475-7283).

18. Taxes

Top things to know

1. If you get a big refund each year, you're having too much withheld from your paycheck.
In effect, you're giving the government an interest-free loan.

2. If you have too little withheld, you may be charged an underpayment penalty.
You must have paid 90 percent of what you owe for the tax year by the end of that year or an amount equal to 100 percent of your tax liability for the previous tax year, whichever is smaller.

3. Not every dollar of your taxable income is taxed at the same rate.
That's because portions of your earned income fall into different brackets, which are assigned different tax rates. Generally speaking, the first dollar you make will be taxed at a lower rate than your last dollar. Your marginal tax rate is the tax bracket at which the highest (or last) portion of your income is taxed.

4. Your combined tax bracket determines how much tax you'll owe on income from investments such as CDs and money market funds.
Your combined bracket is the sum of your top (or marginal) federal tax rate and your top state income tax rate.

5. If you file your return by April 15, but don't pay the tax you owe, you may receive a late payment penalty.
The same goes if you file for an extension. An extension only allows you to file your return after the due date. But full payment is still required by April 15. If you make a partial payment by then, you may be charged interest on the amount outstanding.

6. You can reduce your chances of being audited.
One of the best ways is to fill out your return completely, correctly and on time every year.

7. You should pay estimated taxes if you're self-employed; expect hefty investment income or profits from a property sale; or if you don't have enough taxes withheld to cover the taxes you'll owe on non-wage-related income.
Retirees should also consider paying them if they haven't opted for voluntary withholding on their pension or IRA payments. Estimated taxes are due four times a year (April 15, June 15, Sept. 15, and Jan. 15).

8. Your adjusted gross income (AGI) is your total income minus certain adjustments such as IRA deductions, alimony payments or medical savings account payments.
Your AGI primarily determines whether or not you're eligible for tax breaks. Almost every break, be it a deduction, exemption or a credit, has its own AGI limit.

9. Your taxable income is your AGI minus exemptions and deductions.
The less your taxable income, the less in taxes you'll owe. That's why it's in your best interest to take advantage of tax breaks where you can.

10. A credit is better than a deduction.
A credit is a dollar-for-dollar reduction of the taxes you owe. A $100 credit means you pay $100 less in taxes. A deduction reduces the taxes you owe by a percent of every dollar you're allowed to deduct. You calculate the worth of your deduction by multiplying your marginal (or top) tax rate by the amount of the deduction. If you're in the 27 percent tax bracket, a $100 deduction means you'll pay $27 less in taxes (0.27 X $100).

Tax basics

Understanding tax fundamentals can save you money

Filing your tax return may seem daunting. But doing your taxes isn't always as hard as it seems. In fact, it actually can be a great opportunity to get your financial house in order.

But if that opportunity lacks appeal or your finances are just too complicated to handle on your own, there are plenty of tax professionals who can do the dirty work for you.

No matter which route you choose, however, you should understand tax basics for two reasons: You are legally responsible for your tax return; and being tax-savvy throughout the year can save you a great deal of money over time.

In this lesson, we'll go over some tax essentials, such as how much you should withhold; what those oft-heard but rarely defined phrases on your 1040 mean; what tax records you should keep; how you can avoid an audit; and some good tax-planning strategies. Unless we note otherwise, we're talking primarily about federal taxes. State and local governments impose a variety of income, sales and property taxes that are too complex and varied to address here.

So, what's your tax bracket?

Uncle Sam takes different-sized bites out of your paycheck

Not every dollar of your income is taxed at the same rate. That's because portions of your income fall into different brackets, which are assigned tax rates that increase on a graduated scale. Generally speaking, the first dollar you make will be taxed at a lower rate than the last dollar you make.

(Remember, your taxable income is not the salary your boss told you you'd make when you got your job, but the amount of income left over after you've made your pre-tax contributions to your 401(k) and after you've subtracted the tax breaks to which you're entitled. We'll talk about those breaks later, in the section "1040 Mysteries Revealed.")

The income ranges that define tax brackets are adjusted for inflation, change yearly and differ depending on your filing status (e.g., single, married filing jointly). And tax rates can change as well. In fact, under the Tax Relief Act of 2001, they have. They're set to decrease gradually between 2001 and 2010 (see table). What's more, a new 10 percent tax bracket was added, reducing the amount of income that used to fall in the 15 percent bracket.

Here's an example of how income is taxed: Say you are single and report $80,000 in taxable income in 2002. In accordance with the income ranges defining federal tax brackets for single filers in 2002, the first $6,000 of your income is taxed at 10 percent; dollars $6,001 through $27,950 is taxed at 15 percent; dollars $27,951 through $67,700 are taxed at 27 percent; and dollars $67,771 through $141,250 are taxed at 30 percent.

When people ask you what your tax bracket is, they're really asking for your marginal tax rate. That is, the percent at which the highest portion of your income is taxed. In the example above, if you report $80,000 of taxable income in 2002, your marginal tax rate is 30 percent -- the rate at which the last dollar of that $80,000 is taxed. But your effective rate is the overall percentage of your taxable income that was actually paid in income taxes at the end of the day. And that rate may be lower than your marginal tax rate.

You should also be aware of what's known as your combined tax bracket. That's the sum of your federal tax bracket and your state tax bracket. (If your top federal rate is 30 percent and your top state tax rate is 6 percent, your combined bracket is 36 percent.) That number will determine how much tax you'll owe on income from your investments. (If your combined bracket is 36 percent, then 36 percent of your investment income will go to Uncle Sam. Put another way, you'll be able to keep 64 percent of your investment income.)

TAX RATES DECLINE

Old rate	**2001***	**2002-2003**	**2004-2005**	**2006-2010**
39.6%	39.1%	38.6%	37.6%	35%
36%	35.5%	35%	34%	33%
31%	30.5%	30%	29%	28%
28%	27.5%	27%	26%	25%
15%	Same	Same	Same	Same
10%	New	Same	Same	Same

***Effective July 1, 2002**

How much you should withhold

Don't give the government an interest-free loan

If you're like most people, you probably pay Uncle Sam throughout the year by having your employer withhold tax from your paychecks.

Your employer, using tables supplied by the government, determines how much of your paycheck should be withheld based on information you provide.

Surprised? That's because you've probably forgotten about that Form W-4 you filled out, something most people do when they start a new job. The W-4, which can be amended at any time, lets you mark your tax filing status (single, married, etc.) and the number of allowances you want to take. An allowance essentially reduces the amount of taxes withheld, and increases the amount of your take-home pay. Each allowance represents an exemption, credit or some other tax benefit you plan to claim when you fill out your return. (For detailed instructions on adjusting your tax withholding, see IRS Publication 919.)

Your goal at the beginning of every tax year should be to withhold at least 90 percent of what you think you'll owe for that year -- but not much more. "If you use the worksheet that accompanies your W-4, you should definitely have that 90 percent covered," says Tony Bardi, an enrolled agent in Gresham, Ore.

Each January, your employer sends you and the IRS a Form W-2 that reports your earnings for the prior tax year and the total amount of tax you had withheld. You're then responsible for calculating how much more you owe (and paying the difference by April

15), or, figuring out how much the IRS should refund you if you overpaid.

Although a lot of people consider a refund found money, the truth is, getting a refund check just means you've given the government an interest-free loan. It's money you earned and should have had access to throughout the year. Say you get a $1,200 refund (the average is about $1,700). You could have pocketed more money if you had adjusted your withholding so that you got an extra $100 a month and invested that money in an interest-bearing account. Or, if you carried a credit card balance, the extra amount could have been used to pay off more of your high-interest debt.

What's FICA again?

Under the Federal Insurance Contributions Act (FICA), 12.4 percent of your earned income up to an annual limit must be paid into Social Security, and an additional 2.9 percent must be paid into Medicare. (There are no income limits on Medicare taxes - so even if your income is well above the cap for Social Security tax, you will still owe Medicare tax on the total.)

If you're a wage or salaried employee, you pay only half the FICA bill (6.2 percent for Social Security + 1.45 percent for Medicare), and the tax is automatically withheld. Your employer must contribute the other half. For most people that means 7.65 percent of their paycheck is withheld and their company pays another 7.65 percent on their behalf.

If you're self-employed, however, you're expected to cough up both the employee and the employer share of FICA. You are, however, permitted to deduct half of this self-employment tax as a business expense.

Who needs to pay estimated taxes

If you're self-employed, anticipate having a lot of investment income, are selling property in a given tax year, or don't have enough taxes withheld from your paycheck to cover an influx of non-wage related income (e.g., alimony or rental income), there's a good chance you will need to pay estimated taxes. They're due four times a year (April 15, June 15, Sept. 15, and Jan. 15) and are filed using IRS Form 1040-ES.

If you're a retiree, you might also consider paying estimated taxes if you make unexpected lump-sum withdrawals from your nest egg during the year or if your IRA custodian does not withhold tax on your regular withdrawals, says enrolled agent Tony Bardi.

On April 15, you have to file an annual return (Form 1040) for the previous year, and make your first estimated payment for the current year.

Figuring estimated payments can be tricky, so keep IRS Publication 505, "Tax Withholding and Estimated Tax," handy, and consult with a tax professional.

If, after taking all your deductions, exemptions and credits, you don't think you will owe any more than $1,000 on April 15 on top of what you've already paid in taxes for the year, then you're not required to pay estimated taxes, Bardi says.

As such, if you're expecting a substantial income boost from the sale of stock or property, you may be able to avoid the complication of estimated taxes by increasing the withholdings on your W-4. That should allow you to offset the remaining tax you'll owe at the end of the year. Likewise, if you're a shareholder in an S Corporation from which you receive wages and distributions, then you can boost your withholding to counterbalance any taxes you'll owe on the distributions.

A word about penalty and interest charges

If you balk at how much you pay the federal government, at least try to minimize your aggravation by doing all you can to avoid paying penalty and interest charges. There are plenty of circumstances in which such charges apply. Here are a few common ones:

Underpayment. Most of us look to April 15 as the day we must pay our taxes. Actually, it's the day we need to finish paying our taxes. Indeed, the Internal Revenue Service will charge you a penalty if you haven't paid 90 percent of what you owe for the tax year or an amount equal to 100 percent of your tax liability for the prior year, whichever is smaller. In other words, if you owed a total of $25,000 in taxes last year, and will owe $35,000 this year, you're in the clear as long as you have paid at least $25,000 by Dec. 31.

Late payments. There are three other key ways you'll get hit with extra charges if you don't give the IRS its fair share by the appropriate date:

If you file your taxes on time, but don't pay the full amount you owe, you may be charged:

- Interest on the unpaid tax from the due date of the return through the date of payment; and

- A late payment penalty.

If you file your taxes late and owe money, you may be charged:

- Interest on the unpaid tax from the due date of the return through the payment date;

- A late payment penalty; and

- A late filing penalty.

If you file for an extension but don't pay the tax you owe by April 15, you will avoid the late filing penalty. But you still may be charged:

- Interest on the unpaid tax from April 15 through the payment date; and

- A late payment penalty.

1040 mysteries revealed

The lowdown on 1099s, AGI, exemptions, deductions and credits

In January of every year, you will receive a host of tax forms that you'll need to use to fill out your return. Any forms you receive have also been sent to the IRS, so look them over carefully and be sure to report them accurately on your return.

- Your W-2 form reports how much money you made at your job, and how much tax you paid for the year.
- The 1099-G reports unemployment compensation or state tax refunds.
- The 1099-R reports retirement-plan income.
- The 1099-MISC reports income if you're an independent contractor, collected rent or received royalties.
- Other 1099s, such as the 1099-B, 1099-DIV or 1099-INT, report income from financial transactions (in this case, capital gains, dividends or interest income, respectively).

Many of your 1099 forms get reported on the schedules that round out your 1040. For instance, if you're self-employed, you may need to file Schedule C and Schedule SE. If you received rent or royalties, you may need to file Schedule E. Capital gains get reported on Schedule D. And interest and dividends, if they exceed a certain amount, get reported on Schedule B.

By simply going through the 1040 line by line you'll see what schedules you need.

The number at the bottom of the first page of the 1040 is your adjusted gross income (AGI) -- your total income minus certain adjustments, such as IRA deductions, alimony payments or medical savings account payments. Your AGI determines whether or not you're eligible for tax breaks and also determines whether you're eligible to make deductible IRA contributions or to open a Roth IRA.

Your AGI minus all exemptions and deductions equals your taxable income. Say your AGI is $70,000 and you can subtract $7,000 in deductions plus another $8,250 for personal exemptions. Your taxable income is $54,750.

The more exemptions and deductions you take, the lower your taxable income.

You're entitled to take a personal exemption for yourself, a spouse and each dependent. But if your AGI exceeds the limits set (in 2002, they were $137,300 for singles; $206,000 for married couples filing jointly; $103,000 for married couples filing separately and $171,650 for heads of household), your exemption will be reduced. (The 2001 Tax Relief Act reduces the phase-out limits gradually starting in 2006 and eliminates them completely by 2010.)

Everyone is also given a standard deduction, which is inflation-adjusted; in 2002 it is $4,700 for singles, $7,850 for married couples filing jointly, $3,925 for married couples filing separately, and $6,900 for heads of households. But you might be better off itemizing your deductions if you add up everything that you're permitted to deduct, such as mortgage interest, charitable contributions and state taxes -- and that amount exceeds the standard deduction. If that's the case, list all your deductions on Schedule A and attach it to your 1040.

Unlike deductions and exemptions, which lower your taxable income, tax credits are dollar-for-dollar reductions of the taxes you owe and are worth more than a deduction or exemption of the same amount. Say you're in the 27 percent bracket and owe $1,000 in taxes. If you can take a $100 tax credit, you'll only have to pay $900 in tax ($1,000-$900). A $100 deduction, by contrast, only reduces your tax liability by $27 ($100 x 0.27), which means you'll pay $973 in taxes.

There are lots of books to help you sort through your annual return and give you a basic understanding of taxes. Three favorites that you'll find in any bookstore: J.K. Lasser's Tax Guide, Ernst and Young Tax Guide and The Wall Street Journal Guide to Understanding Your Taxes. You also can find online sources of help by checking out our tax page. And if you need federal forms and instructions, go to the IRS Web site.

REDUCING YOUR TAXES

A deduction reduces your tax liability by a percent of every dollar deducted. If you're in the 27 percent tax bracket, a $100 deduction means you'll pay $27 less in taxes.

A credit offers a dollar-for-dollar reduction of the tax you owe. If you're in the 27 percent tax bracket, a $100 credit means you'll pay $100 less.

Alternative minimum tax: What you should know

There are few things more complicated in the tax code than the alternative minimum tax (AMT).

Often described as a "parallel" tax system, it was originally designed to prevent wealthy individuals from avoiding most or all federal taxes by taking an inordinate number of exemptions. Increasingly, however, it is beginning to hit middle-income Americans.

The AMT system eliminates many of the deductions and personal exemptions taxpayers are entitled to under the regular tax system. Among the tax breaks disallowed under AMT are deductions for state income and property tax.

If you're required to calculate the tax you owe using both the standard and AMT formulas, you must pay the higher amount.

The Tax Relief Act of 2001 increased the amount of income that is exempt from AMT for the years 2001 through 2004. The exemption amounts are: $49,000 if you are married filing jointly or are a qualifying widow or widower; $35,750 if you're single or a head of household; and $24,500 if you're married filing separately. (If you have a very high salary -six figures or more, generally speaking -- you may not qualify for the full AMT exemption.)

That doesn't necessarily mean if you're single and report taxable income of $50,750, that $15,000 will be subject to AMT. "It all depends on what you've taken as deductions," says Cindy Hockenberry of the National Association of Tax Practitioners. "If the deductions you've taken are allowed for regular tax and AMT purposes, then you won't be subject to AMT." Plus, if you're already paying a tax rate equal to or higher than the highest AMT rate (28 percent), then you won't be subject to AMT. "If you're not itemizing deductions, chances are you won't be subject to AMT because you're already paying tax at the highest rate anyway," Hockenberry says.

However, "the AMT continues to reach further and further down the economic ladder," says Blanche Lark Christerson, director of the Wealth Planning Strategies Group at Deutsche Bank Private Banking.

Here's why: First, the AMT exemptions have not been indexed for inflation, so they have not kept pace with today's salaries. Plus, the Tax Relief Act of 2001 lowered marginal tax rates under the regular tax system but not the AMT rates. As such, more people will find they owe more under the AMT system than they would under the regular tax system.

Middle-income taxpayers most vulnerable to AMT are those with large families who normally take several family-related deductions and exemptions; those who pay a great deal in state income and property taxes; and those who plan to exercise incentive stock options (ISOs) and hold the shares they buy for more than a year. (The difference between the price they pay for company stock and the fair market value is considered income subject to AMT. For more on ISOs and AMT, click here.)

If you or your accountant thinks you may be subject to AMT, fill out the worksheet associated with Line 41 on Form 1040. If you determine that you must calculate AMT on your return, fill out IRS Form 6251.

The dreaded audit: What are the chances?

Not high, but you should keep good records

Here's some good news if you hate being questioned by government authorities: Audit rates have declined drastically. There also have been declines in collection enforcement as well as IRS lawsuits against recalcitrant taxpayers and those alleged to have committed criminal tax violations.

The best way to minimize your chances of being questioned by the IRS is to file on time, attach all necessary schedules, fill out every form completely, and double-check your math before submitting your return, says Frederick W. Daily, author of Surviving an IRS Tax Audit.

Of course, you can't completely eliminate your chances. So to ensure that you're well prepared in the event that you are audited, maintain good records and receipt files. These include any forms and statements that show income or support deductions (W-2s, 1099s, canceled checks, receipts, etc.) as well as copies of your return.

Under the statute of limitations, the IRS has three years in which to audit a return, so keep your tax records for at least that long. The same goes if you filed a return but didn't pay the full balance owed. But many experts recommend keeping your records for up to six years since that's the time limit the IRS has to come after you if you underreport your gross income by more than 25 percent; and your state may have longer time limits for audits.

(It's worth noting, too, that if you don't file a return and you owe taxes or if you file a fraudulent return, the IRS can come after you at any time to claim what's due.)

There are some records you should keep indefinitely for tax purposes. These include:

- Statements documenting retirement-account activities, especially records of your after-tax contributions so you don't get taxed on them again when you withdraw them.

- Investment histories, home ownership papers, receipts documenting home improvements, and copies of old tax returns. Records of your investments (what you own, what you paid, when there were splits and distributions) are useful both in determining your tax basis if you choose to sell and allowing your heirs to trace the origins of an investment if you bequeath it to them after you die. Likewise, when you own a home, you need to document the value of your improvements when you go to sell it.

The best time for tax planning

It should be a year-round activity

Tax planning involves far more than scrambling in April to defer income and boost deductions. If you want to minimize what you pay in capital gains tax, reduce your year-end tax bill and give less of your estate to Uncle Sam, you should be aware of the short- and long-term tax consequences of all your financial moves.

One tax-savvy strategy is to contribute regularly to tax-deferred savings plans, which let you defer your tax payments until you make withdrawals. The benefits are two-fold: The more you contribute to a 401(k) or deductible IRA, for instance, the more you reduce your taxable income for that year. Plus, the money you invest grows at a much faster rate since it's not dragged down by taxes.

If you're looking to reduce your taxable estate, a quick way to do that is to make tax-free gifts up to $11,000 a year per person. (For more on estate planning strategies, including trusts that serve as tax shelters, visit the Money 101 lesson on estate planning.)

When you're investing outside of retirement plans, you have a number of tax-smart options. There are tax-managed mutual funds, which seek to minimize the turnover in holdings and hence limit the number of taxable gains distributions to shareholders. There are also tax-free CDs, bonds and money market funds. But a tax-free CD or money market fund may not always save you more than their taxable cousins. Here's how to tell which is best for you:

Compare your after-tax return on the taxable investment with the return on the tax-free investment. To figure out your after-tax return, you need to know your combined income tax bracket (federal + state), since that determines how much of your investment income you can keep. If you pay 27 percent in federal taxes and 6 percent in state taxes, your combined bracket is 33 percent, which means you keep 67 percent of the income the investment generates. So if a taxable investment guarantees a 7 percent return, you'll only pocket 67 percent of that, or about 4.7 percent. If a tax-exempt instrument offers less than that, you'll pocket more with the taxable option.

Generally speaking, if you're in a top tax bracket, you will benefit more from tax-free investments since the yield on a taxable investment would have to be very high to match your return in a tax-exempt instrument.

Another tax-friendly savings strategy: If you have a taxable account of stocks and funds, take advantage of your capital losses to reduce your tax bill. "Capital losses are allowed to the extent that you have capital gains plus an additional $3,000," said enrolled agent Cindy Hockenberry of the National Association of Tax Practitioners. In other words, if you have $10,000 in capital losses and no capital gains this year, then you can claim only $3,000 in losses. But if you have $5,000 in gains, then you can claim $8,000 ($5,000 + $3,000) in losses. Any unused losses may be carried over to future tax years.

Tax law changes and you

They can have a big effect on your wallet

Taxes may be one of the things you can be sure of in life, but the same can't be said of tax laws. They can change at any time.

In June 2001, for instance, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001. The Act significantly alters the tax treatment of several major financial issues, including income, retirement savings, educational savings and estate planning. It's a complex law that amounts to over $1 trillion in tax cuts, but most of those cuts are being phased in (and in some cases also phased out) over a 10-year period, and the entire act itself will sunset at the end of 2010. Between now and then, however, Congress may pass other measures that either extend provisions in the Act or eradicate them once the law sunsets.

In the short-term, however, you should know the Act lowers tax rates over a five-year period and introduces a new 10 percent tax bracket. That new bracket effectively reduces the amount of your income that previously had been taxed at 15 percent.

19. Home Insurance

Top things to know

1. You're a statistic. To an insurer, you're not a person; you're a set of risks. An insurer bases its premium (or its decision to insure you at all) on your "risk factors," including your occupation, who you are, what you own, and how you live.

2. Know your home's value. Before you choose a policy, it is essential to establish your home's replacement cost. A local builder can provide the best estimate.

3. Insurers differ. As with anything else you buy, what seems to be same product can have different prices from different companies. You can save money by comparison shopping.

4. Don't just look at price. A low price is no bargain if an insurer takes forever to service your claim. Research the insurer's record for claims service, as well as its financial stability.

5. Go beyond the basics. A basic homeowners policy may not promise to entirely replace your home.

6. Demand discounts. Insurers provide discounts to reward behavior that reduces risk. However, Americans waste some $300 billion a year because they forget to ask for them!

7. At claims time, your insurer isn't necessarily your friend. Your idea of fair compensation may not match that of your insurer. Your insurer's job is to restore you financially. Your job is to prove your losses so you get what you need.

8. Prepare before you have to file a claim. Keep your policy updated, and reread it before you file a claim, so there are no surprises.

Why insurance costs so much

Insurers will not only judge you on your record, but on your demographic as well.

It boils down to one word: risk.

To an insurance company, you are a collection of risks. Your sex, your age, your marital status, and what neighborhood you live in all contribute to an insurer's prediction of whether you'll file a claim.

If, for example, you are a homeowner who lives in a coastal area prone to storms, or a rural region far from fire stations, you are judged to be a higher risk because people in those situations have tended to file more, and more expensive, insurance claims.

The good news is that all insurers don't price the same risks identically. While insurers are highly regulated in many states, they still operate as competitive businesses, focusing on certain markets and avoiding others. What's more, some operate their businesses more efficiently than others, passing on the savings to consumers.

That means you may be able to save hundreds of dollars a year by shopping regularly, even if your insurer rewards long-time customers. A great quote from a new carrier may trump the loyalty card.

In the following sections, we'll look at some sensible ways to find the best coverage, whether you live in a mansion or studio apartment.

Value your home properly

Know how much insurance to buy.

First, you need to determine the cost of rebuilding your home.

Insure your home for its replacement cost -- that is, the amount it would cost to rebuild it if it were totally destroyed. That means determining the average local building cost in your region, and applying it to your home's size, style, and quality of construction.

Your best resource for this is a builder. For a flat fee, you may be able have a local contractor go through your home and provide an estimate. Try to find someone who builds individual, custom homes that don't benefit from the economies of scale that tract homes offer. If you want the same antique moldings, stone fireplace and plaster-and-lathe walls as before, make sure the builder takes that into account. Otherwise, the estimate may reflect less costly modern materials.

You could also invite an insurance or real estate agent to your home. An agent who visits your home can eyeball the construction quality, and point out any special features. If you deal with a direct marketer (a company with no local agents), you can better ensure proper coverage by accurately reporting your home's details -- built-ins, antique wood and glasswork, upscale kitchen appliances, marble bath tile, etc.

Getting the proper coverage

Here are some tips to help you make the right choices about homeowners' insurance.

Just as there are different home styles, insurers offer a menu of different policies. For the majority of single-family homeowners, the most appropriate policy is the HO-3, sometimes called the special policy (in Texas, for some reason, it's known as the HO-B). It insures all major perils, except flood, earthquake, war, and nuclear accident.

You'll need deep coverage, up to and including 100 percent of your home's replacement cost. By insuring at, say, 90 percent, you're making the reasonable bet that your home won't ever be a complete loss. That may be a reasonable bet. The basement usually remains intact almost regardless of what happens to the rest of the house. Still, victims of the devastating Oakland Hills, California fire in 1991 witnessed the destruction of even their basements. If you want to play it safe, insure at 100 percent.

Insurers generally cover a home's contents up to between 50 and 75 percent of the home's value. Make a list of your home's contents for a more exact estimate of your needs. That also provides written record that's useful when you file a claim. The industry-sponsored Insurance Information Institute provides a useful inventory.

You'll also have to pick a deductible, which is the amount you pay yourself before the insurance kicks in. The higher you go, the more you'll save.

Buy the guarantees.

Traditional guaranteed replacement cost coverage promises to pay whatever it takes to rebuild your home, even if it costs more than the original limits you purchased. That's crucial in the event that labor and building costs balloon after a major disaster. In many states, large insurers now cap the guarantee at 120 to 125 percent of purchased limits.

Your safest bet is to seek a company with no cap. However, if you've properly valued your home's replacement cost, the caps shouldn't scare you. It's unlikely that building and labor costs will go up to more 120 percent of your home's insured value.

If it's not built into your policy, ask for replacement cost coverage for your home's contents. Without it, you'll end up with just the depreciated value of any object that's damaged or stolen.

Get these important coverages, too.

Inflation guard. This option annually increases your premium at the rate of local building-cost inflation.

Ordinance-and-law coverage. This rider, which covers the costs of bringing your home into compliance with current building codes, is a must if your home is more than a few years old.

Limit your liability.

Your homeowner's policy protects against lawsuits for accidents that happen on your property. It also covers you if your dog bites someone.

You might also consider umbrella liability coverage, which is additional coverage over and above your regular homeowner's liability limits.

Consider these options:

Your homeowners policy also provides for living expenses if you're displaced; replacement of structures such as garages and sheds; and limited medical coverage for someone injured on your property. Don't buy more than the minimum offered. Depending on your situation, however, several other coverages may be worthwhile:

Floods Floods aren't covered by ordinary homeowner's insurance. Flood insurance is available through the Federal Emergency Management Agency. In California, you may need earthquake coverage; check with the California Earthquake Authority.

Home business coverage Business property worth more than $2,500 isn't covered by a homeowners policy, so buy a rider or separate policy to fill the gap. Business liability coverage must be purchased separately, too.

Riders for valuables A standard policy provides only minimal coverage for antiques, collectibles, furs, silver, jewels, cameras, computers, musical instruments, and firearms. For these, you need separate coverage, called a rider.

Picking an insurer

Here's how to find broad coverage without burning a hole in your pocket.

Cast a wide net.

First, check what's out there. Get quotes from at least four carriers.

Try a free database such as InsWeb, which offers quotes from up to 8 insurers, or Quicken InsureMarket, which provides up to 16 quotes. The larger the database, the better.

Try these options.

Companies like State Farm and USAA that deal directly with consumers without using independent agents are called "direct writers". In theory, they can pass on their savings by eliminating the middleman.

Read your junk mail. Direct marketers like Geico and Progressive Insurance Co. save on overhead-- and pass on the savings-- by marketing by phone, mail, or the Internet.

Let your state be your guide. Insurance departments in 23 states offer on-line shopping guides for homeowner's insurance. Your state's guide may identify little-known companies with competitive rates. Insure.com can link you to your state guide.

Look at service.

No discount in the world will make up for slow claims processing, so find out as much as you can about a company's service before you sign on. Consumer Reports periodically publishes service ratings for large insurers. You can also ask a representative about a company's claims turn-around time; a shorter turn-around is an indication of better service.

Focus on financials.

Nine insurers went belly-up following the unprecedented damage wrought by 1992's Hurricane Andrew. The 23,000 affected customers waited at least six months for a check from the state's insurance guaranty fund. For that reason, it's wise to look at the financial ratings of your home insurer. Ask the company for that information, or check out one of the financial ratings services on the Web. An A rating or higher from Standard & Poor's or an AA ranking or better from Moody's Investor Service is a good indicator of strength. Weiss Ratings, the most independent of the ratings services, and arguably the most stringent, publishes a list of the currently weakest companies.

As a last resort, there's your state.

Unfortunately, if your home's in a hurricane zone, you may be stuck with just one expensive option, your state-sponsored high-risk pool. But try shopping again a year from now. Private insurers are continually looking for new ways to cut up the market, and one company's black mark is another's business opportunity. Progressive Insurance Co., for instance, has thrived by insuring people and property that other carriers won't touch.

Some states provide assistance -- either shopping help or special coverage -- for homeowners who can't find insurance in urban or vulnerable coastal areas. Check with your insurance department for details.

Maximizing your savings

Lots of discounts are available, but you have to ask for them.

You can't change many of your risk factors. But you can save money by taking advantage of discounts that insurers offer for behavior that lowers your risk -- from driving less than the average number of miles per year to quitting smoking. Certain types of people--

senior citizens, for instance -- also are eligible for price cuts. You'll also save by installing certain safety or protective equipment in your car and home. There's one catch: You have to ask. By one estimate, consumers lose some $300 million a year by not taking advantage of discounts.

Here are some other money saving tactics:

Combine coverages. Because it's cheaper to service two policies from the same customer, insurers often cut premiums up to 15 percent if you link auto and homeowners policies.

Sweat the small stuff. Frequent claims are red flags for insurers; some won't renew policyholders with more than two claims in three years. So try to carry more of the risk by covering claims under $1000.

A few words about claims

Insurance is a product you buy, but hope never to need.

The company you've paid to protect you can become your adversary.

While it's the insurer's job to restore you financially, it's your job to prove your losses. And your perspective on what's fair compensation won't always jibe with your insurer's.

When to hire help

The more information you can provide on your claim, the more likely you'll get your due. If you've taken the steps outlined in this lesson, you shouldn't need outside help in filing your claim. The insurer will send an adjuster to assess what was lost, stolen or damaged, and offer a settlement to replace or rebuild. Independently, you should get three estimates from local contractors whose reputations you've researched.

But if you've faced a very big, traumatic loss and don't feel confident going it alone, consider hiring a public adjuster licensed by your state to walk you through the process.

Typically, they take between 5 and 15 percent of the settlement. Because the public adjuster works for you, he or she has no obligation to reduce costs for the insurer.

Twelve states -- Alabama, Alaska, Arkansas, Delaware, Idaho, Maine, Nebraska, New Mexico, North Carolina, South Carolina, Texas and Wyoming -- don't have licensing laws that apply to public adjusters. But you can obtain the names of public adjusters in every state who have passed the voluntary certification process sponsored by the National Association of Public Insurance Adjusters.

Information is the best protection

Whatever your claim, your best protection is good records. Record your version of the event; take photos, if possible. Get the police report. Call your insurer as soon as you're able, and keep notes of all related conversations. Track resulting medical, home-care, baby-sitting, or housekeeping bills, since some policies cover a portion of those costs. Keep track of living expenses if you're forced to live elsewhere temporarily.

Add this to your reading list...

Truth be told, you'll be most satisfied with your settlement if you know in advance what's covered. That means eyeballing your policy now. Pay particular attention to the exclusions section, which, as the name implies outlines what's not covered.

Why subject yourself to such torture? An insurer's definitions can make the difference between comfort and calamity. Check out the declarations page, which outlines the limits of your coverages. Coverage D of the homeowners policy, for instance, outlines how much an insurer will cover if you have to relocate temporarily. Does your insurer pay up to 10 percent of your home's insured value, or offer to pay "reasonable" expenses over 12 to 24 months?

Finally, update your policies regularly. Inform your insurer of improvements and additions to your home -- including redecoration -- of $5000 or more.

20. Life Insurance

Top things to know

1. All policies fall into one of two camps. There are term policies, or pure insurance coverage. And there are the many variants of whole life, which combine an investment product with pure term insurance and build cash value.

2. Insurance is sold, not bought. Agents sell the vast majority of life policies written in the U.S. because the life insurance industry has a vested interest in pushing high-commission (and high-profit) whole-life policies.

3. Whole life is expensive. Policies with an investment component cost many times more than term policies. As a result, people who buy whole life often can't afford an adequate face value, leaving themselves underinsured.

4. Whole life policies are built on assumptions. The returns quoted by the agent are simply guesses -- not reality. And some companies keep these guesses of future returns on the high side to attract more buyers.

5. Keep your investing and insurance strictly separate. There are better places to invest -- and without the high commissions of whole-life policies.

6. Buy enough term coverage to fill your needs. Life insurance is no place to skimp, especially with rates at historic lows. Use our calculator to get a rough idea of how much insurance you need.

7. Match the term of the policy to your needs. You want the policy to last as long as it takes for your dependents to leave the nest -- or for your retirement income to kick in.

8. Buy when you're healthy. Older people and those not in the best of health pay steeply higher rates for life insurance. So buy as early as you can, but don't buy until you have dependents.

9. Tell the truth. There's no sense in shading the facts on your application to get a lower rate. Be assured that if a large claim is made, the insurance company will investigate before paying.

10. Use the Web to shop. Buying life insurance has never been easier, thanks to the Internet. You can get tons of quotes, and no pushy salespeople.

Types of policies

There are two basic kinds of life insurance policies: whole-life and term insurance.

Whole-life policies (sometimes called permanent insurance) combine life coverage with an investment fund. Here, you're buying a policy that pays a stated, fixed amount on your death, and part of your premium goes toward building cash value from investments made by the insurance company. Cash value builds tax-free each year that you keep the policy, and you can borrow against the cash accumulation fund without being taxed. The amount you pay usually doesn't change throughout the life of the policy.

Universal life is a whole-life policy that combines term insurance with a money-market-type investment that pays a market rate of return. To get a higher return, these policies generally don't guarantee a certain rate. Because of their higher yield, sales of universal policies far outpace those of plain whole life,.

Variable life and variable universal life are whole-life policies with an investment fund tied to a stock or bond mutual-fund investment. Returns are not guaranteed.

The other type of coverage is term insurance, which has no investment component. You're buying life coverage that lasts for a set period of time provide you pay the monthly premium. Annual-renewable term is purchased year-by-year, although you don't have to requalify by showing evidence of good health each year. When you're young, premiums for ART are dirt cheap -- as low as a few hundred dollars per year for $250,000 worth of coverage. As you get older, premiums steadily increase. Level-premium term has somewhat higher but fixed premiums for longer periods -- anywhere from 5 to 30 years.

Buying strategies

Getting the right policy at the right price can be incredibly easy or very difficult. It all depends on how you proceed.

Life insurance is a highly competitive business, in which the sales force depends almost entirely on commissions. Insurance companies pay fat commissions to their agents for selling whole-life policies -- perhaps 80 percent of your first year's premium goes to paying the agent's commission -- and the premiums for these polices are often five times that of term. By contrast, the typical commission to the agent who sells a term policy is about 10 percent.

Small wonder then that agents push whole-life policies as if their livelihoods depend on it. If whole-life policies were beneficial to consumers, our story would end here. But the fact is, the vast majority of those who need insurance should buy term.

Today, the annual premium on a $500,000 term policy for a healthy, nonsmoking forty-year-old male might be about $500. The same policy for a healthy woman, aged 30, might cost about $260 annually.

Not long ago you couldn't buy term policies with level premiums for periods of more than 10 or 15 years. Today you can easily find 20- and 30-year term policies.

Agents will argue that whole-life policies are superior because you can keep them the rest of your life and build up cash in them tax-free, which can then be borrowed. That's true enough, but they don't tell you about the high fees and commissions built into whole life as well as surrender charges (if you want to cancel the policy) that often leave you with little or no cash value five and even 10 or 15 years after you took out the policy.

The tax-free buildup of cash just isn't that powerful anymore, given the proliferation of IRAs, 401(k)s and other tax-advantaged savings vehicles that have tiny commissions, much higher yields and complete portability.

So stick with term, and do your investing elsewhere.

How much coverage do you need?

This is no place to skimp. If you're going to buy life insurance, make sure

you've got enough.

There is no one answer to how much coverage is enough. Some financial planners say five to seven times your annual income is sufficient. Others argue that you need twice as much in face value. That would mean a person making $50,000 a year should have anywhere from $250,000 worth of coverage to $750,000 or more.

Our calculator is designed to give you a ballpark answer. It'll help you get closer to a reasonable figure by taking more of your family's needs into account. And remember, the sole purpose of life insurance is to replace your income in case you die, so that your dependents can maintain their current lifestyle.

Factors to consider include whether the surviving partner will have childcare expenses if one partner is out of the picture. Do you have other assets on which to draw? Will your children be out of the nest soon? These, and many other factors, influence the decision on how much coverage you need.

It's worth noting that many people who buy whole-life policies are underinsured. Because of the investment component of whole life, the policies are much more expensive than term. To make up for this, many people simply buy less coverage, defeating the purpose of buying insurance in the first place -- again, to cover dependents.

Next, you've got to figure out how long you need the policy.

A question of health

Insurance can be difficult and expensive to obtain if you are not in good health.

The cheapest rates, known in the business as select or preferred, go to those who are in good health and who have a family history of good health. If you take heart medication or are grossly overweight, you'll pay 50 percent more than preferred rates.

If you smoke, have a poor driving record or engage in risky sports like skydiving, you'll pay even more for life insurance. Rates can be four times more than the preferred rate.

If you fall into one of these more expensive categories, it pays to shop around. One company may charge much more than another, depending on how it estimates the risk of your condition (that's called underwriting). This is where a knowledgeable agent may come in very handy. Internet and phone quote services aren't set up to deal with nonstandard policies.

Why, some people might ask, should I tell the insurance company about negative information that will raise my rates? Well, even if you somehow get around the medical tests and other checks done before the policy is issued, you're just kidding yourself.

Insurers seldom pay out large claims without doing some checking. If the company finds out you've lied, the claim may be denied, or your heirs could be tied up in court for years.

So there's a good case to be made for getting a policy early in life while you are still in good health. However, it doesn't make much sense to buy one until you have dependents.

Web shopping

Many companies now sell life insurance on the Web, and give free quotes and advice. The key to buying on the Web is to shop by price and by the company's rating. Several agencies, including Standard & Poors and A.M. Best, rate insurers on their claims-paying ability. Stick with companies with low prices, the term you want, and a top rating.

Here are some links to sites that sell the policies of multiple companies:

- Quotesmith has quotes from over 300 companies and much detail on the policies available. Links to companies that sell low-load and agent-sold policies. Also supplies ratings for the insurers from the major rating agencies, such as AM Best.
- InsureMarket has some pretty good worksheets and advice. Lets you save quotes for later retrieval. Lists an 800 number. This site is run by the financial software powerhouse Quicken.
- Accuquote has over 1,000 policies in its database. But you need to fill out a harrowingly long form to get a quote. Site is an independent service.

21. Estate Planning

Top things to know

1. No matter your net worth, it's important to have a basic estate plan in place.
Such a plan ensures that your family and financial goals are met after you die.

2. An estate plan has several elements.
They include: a will, a living will, assignment of power of attorney and medical power of attorney (or health-care proxy). For some people, a trust may also make sense. When putting together a plan, you must be mindful of both federal and state laws governing estates.

3. Taking inventory of your assets is a good place to start.
Your assets include your investments, retirement savings, insurance policies, and real estate or business interests. Next, ask yourself three questions: Whom do you want to inherit your assets? Whom do you want handling your financial affairs if ever you're incapacitated? And whom do you want making medical decisions for you if you become unable to make them for yourself?

4. Everybody needs a will.
A will tells the world exactly where you want your assets distributed when you die. It's also the best way to name guardians for your children. Dying without a will - also known as dying "intestate" -- can be costly to your heirs and leaves you no say over who gets your assets. Even if you have a trust, you still need a will to take care of any holdings outside of that trust when you die.

5. Trusts aren't just for the wealthy.
Trusts are legal mechanisms that let you put conditions on how and when your assets will be distributed upon your death. They also allow you to reduce your estate and gift taxes and to distribute assets to your heirs without the cost, delay and publicity of probate court, which administers wills. Some also offer greater protection of your assets from creditors and lawsuits.

6. Discussing your estate plans with your heirs may prevent disputes or confusion.
Inheritance can be a loaded issue. By being clear about your intentions, you help dispel potential conflicts after you're gone.

7. The federal estate tax exemption -- the amount you may leave to heirs free of federal tax -- is rising gradually, from $1 million in 2002 to $3.5 million in 2009.
Meanwhile, the top estate tax rate is coming down. The estate tax is scheduled to phase out completely by 2010, but only for a year. Unless Congress passes new laws between now and then, the tax will be reinstated in 2011 and you will only be allowed to leave your heirs $1 million tax-free at that time.

8. You may leave an unlimited amount of money to your spouse tax-free, but this isn't always the best tactic.
By leaving all your assets to your spouse, you don't use your estate tax exemption and instead increase your surviving spouse's taxable estate. That means your children are likely to pay more in estate taxes if your spouse leaves them the money when he or she dies. Plus, it defers the tough decisions about the distribution of your assets until your spouse's death.

9. There are two easy ways to give gifts tax-free and reduce your estate.
You may give up to $11,000 a year to an individual (or $22,000 if you're married and giving the gift with your spouse). And you may pay an unlimited amount of medical and education bills for someone if you pay the expenses directly to the institutions where they were incurred.

10. There are ways to give charitable gifts that keep on giving.
If you donate to a charitable gift fund or community foundation, your investment grows tax-free and you can select the charities to which contributions are given both before and after you die.

Take stock

Assessing your assets and goals is groundwork for a good estate plan

Few people relish estate planning. After all, deciding how you want your assets distributed after you die can serve as an unnerving reminder that you're not immortal. But there are plenty of reasons to tackle the task with some enthusiasm:

- You get to name the people who you want to have your assets and know that your wishes carry the word of law.
- You can arrange it so that taxes siphon as little from your pot of gold as possible.
- And you have the satisfaction of knowing that your financial affairs are in order and that you're not bequeathing a costly administrative nightmare to your loved ones.

Your first step? Take stock of all your assets. These include your investments, retirement accounts, insurance policies, real estate or any business interests. Next, decide what you want to achieve with those assets and who you want to inherit them. This is also the time to think about people you would trust to handle your affairs and medical decisions in the event that you become incapacitated.

Once you decide what kinds of bequests you want to make, be sure to discuss your plans with your heirs. The sooner and more distinctly you outline your intentions to your family and friends, the less chance there will be for disagreements when you're gone. "If you treat your wealth as a hidden kingdom, a box that no one can open until you're gone, you're setting your family up for disaster," says Norman Ross, vice-president of Hirschfeld, Stern, Moyer and Ross, a New York estate-planning and benefits consulting firm.

In creating your estate plan, keep in mind that the laws governing estate planning are not set in stone. In fact, the Tax Relief Act of 2001 made several sweeping changes that are being phased in over a 10-year period. They include a gradual increase in the estate tax exemption (i.e., the amount of money you may leave heirs free from federal tax) and the eventual repeal of the estate tax; a reduction in the estate and gift-tax rates - the top rate falls from 50 percent in 2002 to 45 percent in 2009; the gradual repeal of the federal credit for estate taxes paid to a state government; and a revision in how the tax basis of inherited assets is calculated. It's a complex law made more complicated by the fact that it sunsets at the end of 2010. Between now and then, Congress may pass other measures that either extend provisions in the Act or eradicate them.

What that means is estate planning has become far more complicated for people with sizeable estates, and having a trusted and competent estate-planning lawyer is essential if you wish to protect as much of your assets from Uncle Sam as possible. Such a lawyer can create legal documents, offer advice, keep your estate plan current with new laws and help administer the disposition of assets.

ESTATE TAX EXEMPTIONS INCREASE

2002	$1 million
2003	$1 million
2004	$1.5 million
2005	$1.5 million
2006	$2 million
2007	$2 million
2008	$2 million
2009	$3.5 million
2010	Estate tax repealed*

*Unless a law is passed to extend the estate tax repeal beyond 2010, come 2011 you only will be allowed to leave $1 million to heirs free from federal estate taxes.

You should also keep handy an updated estate-planning reference guide.

ESTATE PLAN COSTS

Basic will plan*:	$300-$2,000
Basic trust plan:**	
For singles:	$1,600-$2,300
For couples:	$1,800-$3,000

*Includes a will, a living will, a health-care proxy and a power of attorney. More complex plans may include long-term tax planning as well as provisions for a bypass trust to take effect upon first spouse's death.

**Includes all the elements of a basic will plan plus the set-up of a trust. Prices are based on people with net worth up to $5 million. But you may pay more depending on the complexity of the trust.

Sources: American Academy of Estate Planning Attorneys fee survey; Roger Levine, Levine, Furman & Smeltzer; Mike Janko, National Association of Financial and Estate Planning; CPA P. Jeffrey Christakos of First Union Securities Financial Network.

Why do I need a will?

If you don't have one, a court decides who gets your assets

A will is a device that lets you tell the world who you want to get your assets. Die without one, and the state decides who gets what -- without regard to your wishes or your heirs' needs. If you're married with kids, typically that means your assets will be split between your surviving spouse and children. If you're single with no children, then the state is likely to decide who among your blood relatives will inherit your estate.

Making a will is especially important for people with young children, because wills are the best way to transfer guardianship of minors.

You may amend your will at any time. In fact, it's a good idea to review it periodically and especially when your marital status changes. At the same time, review your beneficiary designations for your 401(k), IRA, pension and life insurance policy since those accounts will be transferred automatically to your named beneficiaries when you die.

A will is also useful if you have a trust. A trust is a legal mechanism that lets you put conditions on how your assets are distributed after you die and it often lets you minimize gift and estate taxes. But you still need a will since most trusts deal only with specific assets such as life insurance or a piece of property, but not the sum total of your holdings.

Even if you have what's known as a revocable living trust in which you can put the bulk of your assets, you still need what's known as a pour-over will. In addition to letting you name a guardian for your children, such a will lets you ensure that all the assets you intended to put into trust are put there if you fail to retitle some of them before your death. Any assets that are not retitled in the name of the trust are considered subject to probate. As a result, if you haven't specified in a will who should get those assets, a court may decide to distribute them to heirs whom you may not have chosen.

Do I need a living will and health-care proxy?

Making known your medical wishes now can save a lot of heartache later

A living will -- also known as an advance medical directive -- is a statement of your wishes for the kind of life-sustaining medical intervention you want (and don't want) in the event that you become terminally ill and unable to communicate.

Most states have living will statutes that define when a living will goes into effect (for example, when a person has less than six months to live). And state law may restrict the medical interventions to which such directives apply.

Your condition and the terms of your directive also will be subject to interpretation. Different institutions and doctors may come to different conclusions. As a result, in some instances a living will may not be followed. But patients' wishes are taken very seriously, and an advance medical directive is one of the best ways to have a say in your medical care when you can't express yourself otherwise.

You increase your chances of enforcing your directive when you have a health-care agent advocating on your behalf.

You can name such an agent by way of a health-care proxy, or by assigning what's called a medical power of attorney. You sign a legal document in which you name someone you trust to make medical decisions on your behalf in the event that you can't do so for yourself.

A health-care proxy applies to all instances when you're incapacitated, not just if you're terminally ill.

Choose your health-care agent carefully. That person should be able to do three key things: understand important medical information regarding your treatment, handle the stress of making tough decisions, and keep your best interests and wishes in mind when making those decisions.

Why should I assign power of attorney?

When you can't control your financial life, make sure someone you trust will

No one is immune from aging or the loss of mental clarity that may come with it. And you're never immune to health crises that may leave you unable to handle the business of your life: paying bills, managing investments or making key financial decisions.

Granting someone you trust the power of attorney allows that person -- known as your "agent" or "attorney in fact" -- to manage your financial affairs if you are unable to do so. Your agent is empowered to sign your name and is obligated to be your fiduciary -- meaning they must act in your best financial interest at all times and in accordance with your wishes.

There are different kinds of powers of attorney, but in estate planning there are two essential types you should know. The first is the "springing power of attorney," which only goes into effect under circumstances that you specify, the most typical being when you become incapacitated. Often that means your agent cannot act until he or she provides doctors' letters and sometimes court orders to prove you are incapable of making decisions for yourself.

There is also the "durable power of attorney." It is effective immediately, and your agent does not need to prove your incapacity in order to sign your name.

An attorney can help you decide which form makes the best sense for your circumstance. In any case, take care in choosing your agent. That person should be competent, trustworthy, willing to take on the burden of your affairs and financially secure.

If you choose a relative or friend as your agent, you probably won't have to pay them. But if you name a bank, lawyer or another outside party, you will have to negotiate compensation, which can range from hourly fees to a percentage of your assets paid annually.

If you do become incapacitated without having assigned power of attorney, the court will step in to appoint a guardian - a process that might cost your family well over $1,000, not including the cost of the guardian's annual visits to court to report on your situation. Plus, the person chosen may not be someone you would have picked.

Does a trust make sense?

It's not just for Rockefellers.

The notion of a legal trust may conjure up images of country clubbers cradling gin-and-tonics.

But the truth is a trust may be a useful estate-planning tool for your family if you have a net worth of at least $100,000 and meet one of the following conditions, says Mike Janko, executive director of the National Association of Financial and Estate Planning (NAFEP):

- A sizeable amount of your assets is in real estate, a business or an art collection;
- You want to leave your estate to your heirs in a way that is not directly and immediately payable to them upon your death - for example, you want to stipulate that they receive their inheritance in three parts, or upon certain conditions being met, such as graduating from college;
- You want to support your surviving spouse, but also want to ensure that the principal or remainder of your estate goes to your chosen heirs (e.g., your children from a first marriage) after your spouse dies;
- You and your spouse want to maximize your estate-tax exemptions;
- You have a disabled relative whom you would like to provide for without disqualifying him or her from Medicaid or other government assistance.

Among the chief advantages of trusts, they let you:

- Put conditions on how and when your assets are distributed after you die;
- Reduce estate and gift taxes;
- Distribute assets to heirs efficiently without the cost, delay and publicity of probate court. Probate can cost between 5 percent to 7 percent of your estate;
- Better protect your assets from creditors and lawsuits;
- Name a successor trustee, who not only manages your trust after you die, but is empowered to manage the trust assets if you become unable to do so.

Trusts are flexible, varied and complex. Each type has advantages and disadvantages, which you should discuss thoroughly with your estate-planning attorney before setting one up.

When it comes to cost, a basic trust plan may run anywhere from $1,600 to $3,000, possibly more depending on the complexity of the trust. Such a plan should include the trust set-up, a will, a living will and a health-care proxy. You will also pay fees to amend the trust if it's revocable and to administer the trust after you die.

One caveat: Assets you want protected by the trust must be retitled in the name of the trust. Anything that is not so titled when you die will have to be probated and may not go to the heir you intended but one the probate court chooses. For a trust in which you want to put the majority of your assets - known as a revocable living trust -- you also have to have what's known as a "pour-over will" to cover any of your holdings that might be outside of your trust if you die unexpectedly. It essentially directs that any assets outside of the trust at the time of your death be put into it so they can go to the heirs you intended.

22. Auto Insurance

Top things to know

1. You're a statistic. To an insurer, you're not a person, you're a set of risks. An insurer bases its premium (or its decision to insure you at all) on your "risk factors," including some things that may seem unrelated to driving a car, including your occupation, who you are, and how you live.

2. Insurers differ. As with anything else you buy, what seems to be same product can have different prices from different companies. You can save money by comparison shopping.

3. Don't just look at price. A low price is no bargain if an insurer takes forever to service your claim. Research the insurer's record for claims service, as well as its financial stability.

4. Go beyond the basics. Most states require only a minimum of auto-insurance liability coverage, but you should look for more coverage than that.

5. Demand discounts. Insurers provide discounts to reward behavior that reduces risk. However, Americans waste some $300 billion a year because they forget to ask for them!

6. Ask for the real thing. Insurers cut costs by paying only for car parts made by companies other than the car's manufacturer. These parts can be inferior. Demand parts by the original equipment manufacturers (OEMs).

7. At claims time, your insurer isn't necessarily your friend. Your idea of fair compensation may not match that of your insurer. Your insurer's job is to restore you financially. Your job is to prove your losses so that you get what you need.

8. Prepare before you have to file a claim. Keep your policy updated, and reread it before you file a claim, so there are no surprises.

Why insurance costs so much

Insurers will not only judge you on your record, but on the records of people like you.

Your 16-year-old son has passed his driver's education course, and scraped together enough cash for his own car. You take a deep breath and given your blessing, until your agent tells you the rather large amount added to your premium -- just to insure a lousy used sports car.

Why can insurance sometimes cost as much as the car? Why are insurers so tough on kids, or Corvettes?

It boils down to one word: risk.

To an auto insurance company, you are a collection of risks. Your sex, your age, your marital status, driving record, type of car, and place of residence all contribute to an insurer's prediction of whether you'll file a claim. An insurance company can't know, for certain, what kind of driver you are. They can only guess, based on the accumulated statistics for drivers like you. Even if you're a stellar driver who just happens to be young, single, male, and own a sports car, the insurer is probably going to place you in a category with a high premium -- or it may reject you entirely.

The good news is that all insurers don't price risks identically. While insurers are highly regulated in many states, they still operate as competitive businesses, focusing on certain markets and avoiding others. What's more, some operate their businesses more efficiently than others, passing on the savings to consumers.

That means you may be able to save hundreds of dollars a year by shopping regularly, even if your insurer rewards long-time customers. A great quote from a new carrier may trump the loyalty card.

In the following sections, we'll look at some sensible ways to find the best coverage, whether you're age 16 or 86.

Understand your coverages

Some auto coverages are crucial; others are desirable; still others are just unnecessary.

Cover your assets and your family first.

Most states require bodily injury liability insurance to cover medical treatment, rehabilitation and funeral costs incurred by your own passengers, the other drivers, their passengers, and even injured pedestrians. This also covers lawyers' fees, and non-monetary losses related to pain and suffering. State minimum coverage limits are too low to protect the assets of most motorists. Unless your income and assets are minimal, buy at least $100,000 per person, $300,000 per accident.

Property-damage liability covers repair or replacement of other people's cars and property. State minimum limits average about $15,000. With the average cost of a new car at $22,000, however, buy at least $25,000 in coverage.

When a hit-and-run driver, or someone who's inadequately insured, strikes your car, uninsured-motorist and underinsured-motorist coverage pays for the medical, rehabilitation, funeral, and pain-and-suffering costs of the victims in your car. This crucial coverage also insures your household members as pedestrians. Buy this coverage at the same limits as your bodily injury liability coverage.

Personal-injury protection (PIP), often known as "no-fault," covers medical, rehabilitation and funeral costs for household members, as well as some lost wages and in-home care. Unless your health and disability coverages are slight, buy the minimum required.

If your budget permits, consider these options.

Collision pays to repair or replace your car after an accident. If you have a new car with a loan, you'll be required to buy this coverage.

Comprehensive pays if your car or its contents are stolen, or if your car is damaged by fire, water, or other perils. Lenders will also require this coverage.

For both, you'll have to choose a deductible: a dollar amount you fork over to the repair shop before the insurer antes up. The higher the deductible you carry, the more you'll save. Try to carry a deductible of at least $500 on each coverage.

For cars worth less than $3000, comprehensive and collision probably aren't worthwhile. Over time, the premiums you'll fork over will probably exceed the payout, even if your car is totaled. Plus, in an accident that isn't your fault, you can figure that the other driver's insurance will cover your car. (To estimate your car's market value, consult the Kelley Blue Book.)

You can probably do without these:

Medical-payments pays the deductibles and co-payments not covered by your health insurer, or the insurer of any of your passengers. It also covers some funeral and rehabilitation costs. It's not useful unless you face very high health-insurance deductibles. If your state requires it, buy the minimum.

Towing and labor only pays if you can't drive your car away from an accident. Members of auto clubs with such privileges don't need this coverage.

Rental insurance costs only a few dollars per year. But if you can depend on another car in a pinch, spare the expense.

Glass breakage coverage can add up to 20 percent to your comprehensive premium. When it's not built into the premium, avoid it.

Picking an insurer

Here's how to find broad coverage without burning a hole in your pocket.

Cast a wide net.

First, check what's out there. Get quotes from at least four carriers.

Try a free database such as InsWeb, which offers quotes from up to 8 insurers, or Quicken InsureMarket, which provides up to 16 quotes. The larger the database, the better off you are.

Try these options.

Companies like State Farm and USAA that deal directly with consumers without using independent agents are called "direct writers". In theory, they can pass on their savings by eliminating the middleman.

Read your junk mail. Direct marketers like Geico and Progressive Insurance Co. save on overhead -- and pass on the savings -- by marketing by phone, mail, or the Internet.

Let your state be your guide. Insurance departments in 33 states and the District of Columbia offer on-line shopping guides for auto insurance. Your state's guide may identify little-known companies with competitive rates.

Look at service.

No discount in the world will make up for slow claims processing or shoddy repairs, so find out as much as you can about a company's service before you sign on. Consumer Reports periodically publishes service ratings for large insurers. You can also ask a representative about a company's claims turn-around time; a shorter turn-around is an indication of better service.

Focus on financials.

It's wise to look at the financial ratings of your auto insurer. Ask the company for that information, or check out one of the financial ratings services on the Web. An A rating or higher from Standard & Poor's or an AA ranking or better from Moody's Investor Service is a good indicator of financial strength. Weiss Ratings, the most independent of the ratings services, and arguably the most stringent, posts a list of the currently weakest companies.

As a last resort, there's your state.

If your driving record is bad, you may initially have only one option other than taking public transportation. That's your state-sponsored high-risk pool and it's expensive. But try shopping again a year from now. Private insurers are always looking for new ways to serve more customers, and one company's black mark is another's business opportunity. Progressive Insurance Co., for instance, has thrived by insuring people and property that other carriers won't touch.

Maximizing your savings

Lots of discounts are available, but you have to ask for them.

You can't change many of your risk factors. But you can save money by taking advantage of discounts that insurers offer for behavior that lowers your risk -- from driving less than the average number of miles per year to taking a defensive driving class. Certain types of people -- senior citizens, for instance -- also are eligible for lower rates. You'll also save by if you have certain safety or protective equipment installed in your car, like anti-lock brakes or a security system. Make sure you ask about these discounts. Your agent may not tell you about them.

Here are some other money saving tactics:

Combine coverages. As with any product, it's cheaper for insurance companies to sell more to one customer, so insurers often cut premiums up to 15 percent if you link auto and homeowners policies.

Sweat the small stuff. Frequent claims are red flags for insurers; some won't renew policyholders with more than two claims in three years. So try to carry more of the risk yourself by paying for repairs costing under $1000 out of your own pocket. Or, if the damage is purely cosmetic, you could just ignore it.

Raise your deductible. The average driver files a collision claim once every 3 years, and a comprehensive claim once every 10 years. Increasing a collision deductible on your auto policy from $200 to $500 can save up to 30 percent annually. Given the likelihood of filing a claim, you might come out ahead with the higher deductible.

Drive safely. A clean driving record -- for at least 36 months -- keeps your premiums low. Completing a defensive driving course can qualify you for a discount.

Pick the car carefully. Cars that cost a lot to repair, or that are popular with thieves, can cost more to insure. The National Insurance Crime Bureau has a list of the most frequently stolen cars.

Park your teens in one car. Name teenagers as the occasional drivers of your least expensive car, and make sure they only drive that car.

Get your records straight. Insurers have access to all sorts of personal information, including your motor vehicle record, credit record, and your history of claims with other insurers. It makes no sense to lie about your background. Mistakes can happen, however, and a glitch on your report could make you look like a worse risk than you are. If you haven't done so in a few years, consider obtaining your credit reports from all three credit reporting services, Equifax, Experian, and TransUnion. For a combined report, check out Qspace.

23. 401(k)s

Top things to know

A 401(k) offers three compelling benefits: a way to reduce your taxable income since 401(k) contributions come out of your pay before taxes are withheld; often a matching contribution from your employer; and tax-deferred growth, which lets your money compound more quickly than it would if it were taxed yearly.

The federal limit on annual pre-tax 401(k) contributions is on the rise. It rose to $11,000 in 2002, and will increase gradually to $15,000 by 2006. Workers 50 and older will be allowed to contribute an additional "catch-up" amount that increases from $1,000 in 2002 to $5,000 in 2006.

If you can't afford to max out your 401(k), contribute at least enough to get the matching contribution, a.k.a. free money. The typical match is 50 cents on the dollar up to 6 percent of your salary. To help you do the math on your match, click here.

Taking money out of a 401(k) before retirement is expensive. Loans must be repaid with after-tax money plus interest. And, with few exceptions, if you withdraw money before age 59-1/2 you must pay income taxes plus a 10 percent penalty. What's more, lost time for compounding will substantially shrink your nest egg.

When setting up your 401(k) investments, figure out what your mix of stocks and bonds should be. Two factors influence this decision: your time horizon until retirement and your risk tolerance.

You're limited to the investments your employer chooses for your 401(k) plan. If you don't like many of the selections, keep your choices simple by investing, for example, in a broad-based index fund. But don't boycott the plan altogether. If you do, you lose out on tax-advantaged compounding and a matching contribution.

When you change jobs, you'll often have three choices: leave your 401(k) money where it is, roll it into an IRA or another 401(k), or cash out. If your account balance is less than $5,000, your employer may insist you take it out of the plan, but cashing out is like shooting yourself in the foot financially. Even small amounts can grow large with time and tax-deferred compounding. You'd be better off rolling the money into another retirement account.

When you do roll money into an IRA or 401(k), make it a "trustee-to-trustee" transfer. That is, have the check made out to the custodian of your new account, not you. Otherwise, you risk possible penalties if you fail to execute the rollover properly.

IRS rule 72(t) provides one way to take early 401(k) withdrawals without penalty. You must take a fixed amount of money out for five years or until you reach 59-1/2, whichever is longer. The annual withdrawal amount is based on your life expectancy.

Some employers let you leave money in your 401(k) account when you retire. Find out what rules, if any, the employer imposes on when and how you must start taking distributions. If there are none, you may leave the money untouched until you're 70-1/2. That's the age when Uncle Sam insists all retirees begin withdrawing money from traditional IRAs and 401(k)s.

The virtues of a 401(k)

Uncle Sam doesn't offer many gifts. This is one.

If someone offered you free money, would you refuse it? Probably not. But that's just what you're doing if you don't contribute to your 401(k). The more you contribute, the more free money you get. Here's why.

Contributing part of your salary to a 401(k) gives you three compelling benefits:
- You get an immediate tax break, because contributions come out of your paycheck before taxes are withheld.
- The possibility of a matching contribution from your employer -- most commonly 50 cents on the dollar for the first 6 percent you save.
- You get tax-deferred growth -- meaning you don't pay taxes each year on capital gains, dividends and other distributions.

Thanks to the Tax Relief Reconciliation Act of 2001, there are a few changes to 401(k)s that will be of greater benefit to you.

For starters, the federal limit on annual contributions is increasing gradually from $10,500 in 2001 to $15,000 in 2006. The Tax Relief Act also offers catch-up provisions for workers 50 and older. Starting in 2002, if you're 50 or older, you may contribute an additional $1,000 above your maximum allowable 401(k) contribution, a catch-up amount that will increase gradually to $5,000 by 2006. (See table.)

Keep in mind; however, while federal law sets the guidelines for what's permissible in 401(k) plans, your employer may set tighter restrictions. Plus, it will take time for the administrators of your plan to implement the changes.

What's more, there are other federal non-discrimination tests a 401(k) plan must meet, one of which applies to "highly compensated" employees. So if you make more than $90,000 a year (the limit in effect in 2002), you may not be permitted to contribute as high a percentage of your salary as some of your lower paid colleagues.

For all its tax advantages, the 401(k) is not a penalty-free ride. Pull out money from your account before age 59-1/2, and with few exceptions, you'll owe income taxes on the amount withdrawn plus an additional 10 percent penalty.

Also, be aware of your plan's vesting schedule -- the time you're required to be at the company before you're allowed to walk away with 100 percent of your employer matches. Of course, any money you contribute to a 401(k) is yours.

WHY A 401(k) PAYS
Your contribution:
$3,000 (6% of $50,000 salary)
Employer match:
$1,500 (50% match on first 6 percent)
Total investment:
$4,500

Taxes you save:	
$930	(assuming 31% combined federal and state tax bracket)
Free Money:	
$2,430	(Employer match plus tax saving)

FEDERAL LIMITS ON 401(k) CONTRIBUTIONS*		
In 2001:		
	$10,500	
In 2002:		
	$11,000	($12,000 if you're 50+)
In 2003:		
	$12,000	($14,000 if you're 50+)
In 2004:		
	$13,000	($16,000 if you're 50+)
In 2005:		
	$14,000	($18,000 if you're 50+)
In 2006:		
	$15,000	($20,000 if you're 50+)
* From 2002 on, the limits also apply to 403(b)s for nonprofit workers; 457s for state and local government workers and salary-reduction SEPs, also known as SAR-SEPs.		

How to invest in a 401(k)

So, great, you've got a 401(k). Now all you need to know is how to use it. Making 401(k) investments, like having a car, is useful but only if you can avoid crashing.

Here's how to set up a collision-free course for your retirement savings at work.

For starters, figure out how much you're allowed to save each year. Although Uncle Sam lets you put away as much as $11,000 on a pre-tax basis in 2002 ($12,000 if you're 50 or older), the plan offered by your employer may restrict you to a lesser contribution.

Within that limit, you've got to calculate how much you need to save. If you're just starting to plan for retirement at age 40, you'll need to put away more than if you were 25. Typically, however, financial planners recommend you save at least 10 percent of your income if possible. For help figuring out how much you need to save, play Moneyville.

Next, find out if your employer offers matching contributions, otherwise known as free money. A typical employer offers 50 cents for every dollar you contribute up to 6 percent of your salary. If you can't afford to sock away 10 percent, contribute at least enough to get the full match. (And be sure to ask about the vesting schedule, which is the amount of time your employer requires you to be at the company in order to walk away with 100 percent of your matching contributions.)

Your next task is to determine how you should be invested for the long haul. For starters, figure out what your mix of stocks, bonds and cash should be. This is also known as asset allocation. There are two key factors to consider when picking your asset allocation: your risk tolerance and how many years you have left before retirement. If you have 20-plus years, you can afford to have a higher percentage of stocks in your portfolio than if you were three years from retiring. Stocks, remember, offer greater chances than bonds for long-term growth, although they can pose greater risks in the near-term. (For help in figuring out the best allocation for you, try our Fix Your Mix Asset Allocator.)

Once you've got that settled, you're ready to review the mutual fund offerings in your 401(k) plan. There are four things to look for in picking a good fund:

- **Better-than-average returns:** A fund, if it's worth your while, should have performed in the top half, and ideally the top 25 percent, of its peer group over a three-, five-, and 10-year time span.
- **Low price:** A fund's expense ratio - what you are charged annually and what will lower your overall return - should not exceed the average among the fund's peers.
- **Solid management:** If you're opting for an actively managed fund (as opposed to an index fund), the manager should have a solid track record of experience.
- **Reasonable size:** Sometimes when a fund becomes too popular, its asset base -- the dollars invested in the fund -- gets bloated. That means the manager can't move in and out of a stock too quickly without moving the market. John Rekenthaler of Morningstar offers this rule of thumb: A fund's asset size should be smaller than the median market capitalization of the stocks it invests in. (To find that median market cap, get Morningstar's Snapshot Report on the fund in question by using our mutual fund look-up tool and click on the "Portfolio" option once the fund is called up.)

In picking the right funds for your portfolio, make sure you diversify your investments. That means don't over-invest in any one sector such as technology or in any one investment style such as growth stocks or value stocks. It also means you don't want to invest in funds that share many of the same top 10 holdings, which traditionally are the most heavily weighted part of a fund's portfolio. And, as the Enron debacle taught investors, you don't want to overload on your employer's stock either. (For tips on diversifying away from company stock, especially if you receive your matching contribution in stock, click here.)

The main advantage to spreading your bets is that you lower your investment risk because even if some of your holdings go down, others go up. (For more on the basics of investing, click here.)

Of course, not all 401(k)s are created equal. Some are better than others, particularly when it comes to the breadth of investment choices. But even if your plan isn't a plum and you're less than enchanted with the funds offered, you should still consider investing some money in it. Here's why: Saving for retirement while getting a tax break and free money from an employer match is not a bad deal. "Even a mediocre 401(k) plan is better than none," said Dee Lee, coauthor of *The Complete Idiot's Guide to 401(k) Plans*.

In such a case, however, the key is to keep your 401(k) investments simple. "Pick something that probably won't go wrong, like an S&P index fund," said certified financial planner Mari Adam. "The lousier your plan gets, the simpler you get."

Early withdrawals and loans

When faced with a sudden cash crunch, it can be tempting to tap your 401(k). Indeed, more than a few individuals have raided their retirement account for everything from medical emergencies to a week-long vacation.

But if you're under 59-½, keep in mind that an early withdrawal from your 401(k) will cost you dearly. You're robbing your future piggy bank to solve problems in the present. You'll miss the compounded earnings you'd otherwise receive, you'll likely get stuck with early withdrawal penalties and you'll certainly have to pay income tax on the amount withdrawn to Uncle Sam.

If you'd like to learn more about the long-term consequences of withdrawals from your 401(k) plan, take a look at some advice and alternatives we've given to our readers in the past.

"When you put money into a 401(k) plan, it really is with the understanding that the money is for your retirement future," said Ann-Marja Lander, a certified financial planner in Long Beach, Calif. "It's not a place for your short-term cash."

If you absolutely must draw from your 401(k) before 59-½, and emergencies do crop up, there are a few ways it can be done.

Hardship withdrawals

You are allowed to make withdrawals, for example, for certain qualified hardships - though you'll probably still face a 10 percent early withdrawal penalty if you're under 59-½, plus owe ordinary income taxes. Comb the fine print in your 401(k) plan prospectus. It will spell out what qualifies as a hardship.

Although every plan varies, that may include withdrawals after the onset of sudden disability, money for the purchase of a first home, money for payment of higher education expenses, money for payments necessary to prevent eviction or foreclosure, and money for certain medical expenses that aren't reimbursed by your insurer.

Loans

Most major companies also offer a loan provision on their 401(k) plans that allow you to borrow against your account and repay yourself with interest. Restrictions will vary by company but most let you withdraw no more than 50 percent of your vested account value as a loan. You can use 401(k) loan money for anything at all - tuition for graduate school, tickets to see Britney Spears. You then repay the loan with interest, through deductions taken directly from your paychecks.

Borrowing from your 401(k), if you absolutely must, is a cost-effective way to obtain a loan, since you're borrowing your own money and paying it back with low interest. Because it's your money, you won't have to undergo extensive credit checks, either.

But there are disadvantages, too. First and foremost, you're robbing your future. Though you may repay the money you withdraw, you lose the compounded interest you would have received had the money just sat in your account. And some companies restrict you from continuing to contribute to your 401(k) while you're paying back a loan, which could force you to miss out on even more money.

The whole situation becomes more precarious if you leave the company. Whether you quit, get fired or are laid off, the loan becomes immediately due. Before you take out a 401(k) loan, you need to consider what would happen if you found yourself out of a job and with an imminent loan on your hands at the same time.

72(t) withdrawals

Finally, you may be able to withdraw without penalty under IRS rule 72(t), which allows you to withdraw a fixed amount based on your life expectancy.

Under the 72(t) rule, you must take withdrawals for at least 5 years or until you reach age 59-½, whichever is longer. If you're 56 and poised to retire, for example, you'll get a specified amount every year for 5 years, until you're 61. But if you're 52, you'll get your specified amount every year for 7-½ years, until you're 59-½.

It isn't an entirely free ride, though. Although you do avoid the 10 percent early withdrawal penalty, you still pay taxes on the amount you tapped. You still lose compounded earnings you'd otherwise have if you let the money grow. And if you choose 72(t) payments when you're much younger than 59-½, the deal you get isn't as good. Someone who began 72(t) withdrawals at age 40, for example, would only get a small amount (because her life expectancy is long) every year, and pay income taxes on it for the next 19-½ years.

Rollovers

New tax laws are making it easier for people to change jobs and take their retirement money with them.

They can move their 401(k) into an IRA. They can take money from their old 401(k) and drop it into a new one. And they can take money from a different type of plan - say, a 403(b) - and put it directly into a new 401(k).

They can also, of course, co-mingle the money in their 401(k) and IRA, and then move the whole pile of dough into a new 401(k) - a big No-No under the old retirement system rules.

"With the new portability provisions, you can pretty much move anything anywhere," said Ed Slott, anIRA expert and editor of the newsletter *Ed Slott's IRA Advisor*.

The 401(k) switcheroo

When you change jobs, your choices are to leave your 401(k) money where it is, move it to your new 401(k) or move it into an IRA. (You could cash out the plan, but that's the financial equivalent of shooting yourself in the foot, because you'll pay income taxes plus a 10 percent penalty if you're under age 59-½. You'll also lose out on tax-deferred saving.)

If you've built up a hefty balance in your old plan, and you have access to funds you love that are otherwise closed to investors, you might want to leave the money in the plan. That's especially true if your new plan isn't so hot.

Still, there are good reasons to take your 401(k) money with you. Some planners argue it's good to have all your money in one pot, working for you as a single asset. You'll have access that way to a loan you can tap in case of emergencies.

If you're moving to another job that does not offer a 401(k), it makes sense in most cases to move the cash into an IRA, because you'll have greater control. Instead of 10 or 20 investing choices, you'll have access to thousands of mutual funds. At the same time, however, it's important to remember that 401(k) accounts are a bit more protected from creditors than IRAs - something that could become important if you are ever sued or file for bankruptcy.

New portability rules

In the old days, investors were required to put 401(k) money into something called a rollover IRA or a "conduit IRA," if they thought they might move the cash back into another 401(k) down the road. You had to be careful not to mix that money with any other retirement dollars. And you couldn't make new contributions to the account, either.

But starting in 2002, you're free to blend those dollars. You can now put 401(k) money into an existing traditional IRA and continue making contributions. Or, you can move your 401(k) account to a new IRA and then transfer that into a Roth IRA. (You just can't go directly from a 401(k) to a Roth, Slott said.)

The new legislation also, of course, allows you to transfer an old 401(k) directly to a new one, without the middle step of opening an IRA. And generally speaking, you can even transfer a different type of plan, like a 403(b), which is a tax-deferred retirement tool for those who work at schools and non-profit groups. You'll just have to be sure that your new plan accepts transfers from other types of plans. In most cases, they do.

In all cases, however, just be sure you perform what's called a "trustee-to-trustee transfer," when you move the money. That means you direct the company housing your new account to arrange the transfer with your old employer.

A trustee-to-trustee transfer will avoid the costly trap when your old employer writes a check to you for your balance and you have 60 days to deposit it in a new account. If you choose this method, your old employer will automatically withhold 20 percent of your balance for income taxes. You'll get the 20 percent back the next time you file your income taxes, but in the meantime you'll be required to make up the difference within the 60-day period.

If you fail to roll over the full amount in 60 days, the IRS deems the shortfall a taxable withdrawal and imposes ordinary income taxes plus a 10 percent penalty.

Taking distributions in retirement

When you retire, you have to decide what to do with your 401(k) money. Generally speaking, you will have some, if not all, of the following five choices: leave your money parked in the plan; take a lump-sum distribution; roll the money into an IRA; take periodic distributions; or purchase an annuity through an insurer recommended by the plan sponsor (i.e., your employer).

Keep in mind, not all employers allow retired workers to remain participants in their 401(k) plan, but if yours does, here's a quick look at the pros and cons of the various distribution options:

Lump-sum distribution: If you need a wad of cash right away, this option will serve that purpose. But there are two key downsides: you forfeit the benefits of tax-deferred compounding by cashing out all at once; and you'll have to pay income taxes on your distribution for the tax year in which you take it, which can be a big bite out of your nest egg all at once. (If you were born before 1936 and have been a plan participant for five years, however, you can lower your tax bill by using what's known as a 10-year averaging basis - meaning what you owe is calculated as if you were taking distributions over 10 years. But you still must take the money all at once and your total tax bill is due the year of distribution.)

Leave the money as is: Financial advisers often recommend retirees tap taxable accounts first in order to keep as much money growing tax-deferred as possible. So if you're retiring and have money outside of your 401(k) that you plan to live on, you may leave your account untouched until you're 70-½. That's when Uncle Sam requires all retirees to begin taking mandatory annual distributions from their 401(k)s and traditional IRAs. Of course, if your plan's investment choices are very limited or have performed poorly relative to their peers, you might be better off rolling the money into an IRA.

Rolling money into an IRA: This is the option often recommended by financial advisers since an IRA offers greater investment choice and control, and is especially recommended if your plan has few investment options and not very good ones at that. But if you're satisfied with your 401(k)'s investment menu, it has served you well and it provides enough diversity for you to reallocate your portfolio as needed in years to come, staying put may be a viable option. The same is true if your plan offers a brokerage window, which lets you invest through a brokerage in funds and stocks that are not part of the plan's core investment options.

There are two advantages your 401(k) has over an IRA. The first is protection from creditors. Money in a 401(k) cannot be touched in the event of personal bankruptcy or lawsuits. That's not necessarily the case with an IRA. It depends where you live since some states offer partial protection of your IRA assets. The second advantage is cost. Often with investments in a 401(k) plan, transactions fees and loads are waived. What's more, you may have access to mutual funds' institutional share classes, which charge lower annual expenses than the retail share classes you would buy through a broker for your IRA. However, if you have a financial adviser helping you with your IRA, you may be able to gain access to institutional shares that way.

Among the potential disadvantages of a 401(k): If you have a string of retirement accounts when you leave the work force, you might be better served by consolidating your accounts into an IRA for two reasons: a consolidated account may be easier to manage in terms of administration and efficiency; and the larger your IRA account balance, the better your chances of qualifying for discounts on sales charges (a.k.a. break points) in mutual funds. Also, in a 401(k) you have less control over the governance of your account, since you are subject to rule changes made by the plan sponsor within the confines of federal law.

Periodic distributions: If you're satisfied with your 401(k) plan and don't want to enter the wide world of investing through an IRA or simply want to avoid the hassle of changing accounts, you may be able to receive a regular stream of income from your 401(k). Typically, plans let you select an amount to receive monthly or quarterly, and you're allowed to change that amount once a year, although some plans allow you to do so far more frequently, said David Wray, president of the 401(k)/Profit Sharing Council of America. If these payments are your main source of income, however, you have to be careful to manage your distributions so you don't outlive your dollars.

Annuities: Another way to receive regular payments is to buy an annuity based on some or all of your 401(k) account. Among the advantages, you receive guaranteed income for the rest of your life; you don't have to worry about how the source of that income is invested; and if you buy an annuity with survivor benefits, your spouse can receive a portion of your payments after you die. The key drawbacks are that annuities are not inflation-adjusted; you may be able to generate a higher return investing on your own or with an adviser; and if you die soon after retiring, the insurance company, not your heirs, is more likely to benefit from the bulk of your savings.