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Investment Income

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the sources and characteristics of unearned income. You will also examine how agility can help you save enough for the future. Specifically, this lesson will cover:

1. Earned Income Versus Unearned Income

You need sources of income – from wages, tips, salaries, commissions, and bonuses – to pay your daily living expenses and to save for the future. These income sources are called earned income because you need to work or perform an activity to receive payment. Your human capital is used to produce earned income.

There are also other types of income that can help fuel your financial journey: unearned income, which is money you receive from financial capital like investments. The great thing about unearned income is that you don't have to work for it. Instead, your money works for you.

1a. Earned Income

As the name implies, **earned income** is money that you receive from work (payment for effort) whether in the form of salaries, wages, commissions, bonuses, or self-employment. That is, sources of earned income come primarily through the labor market.

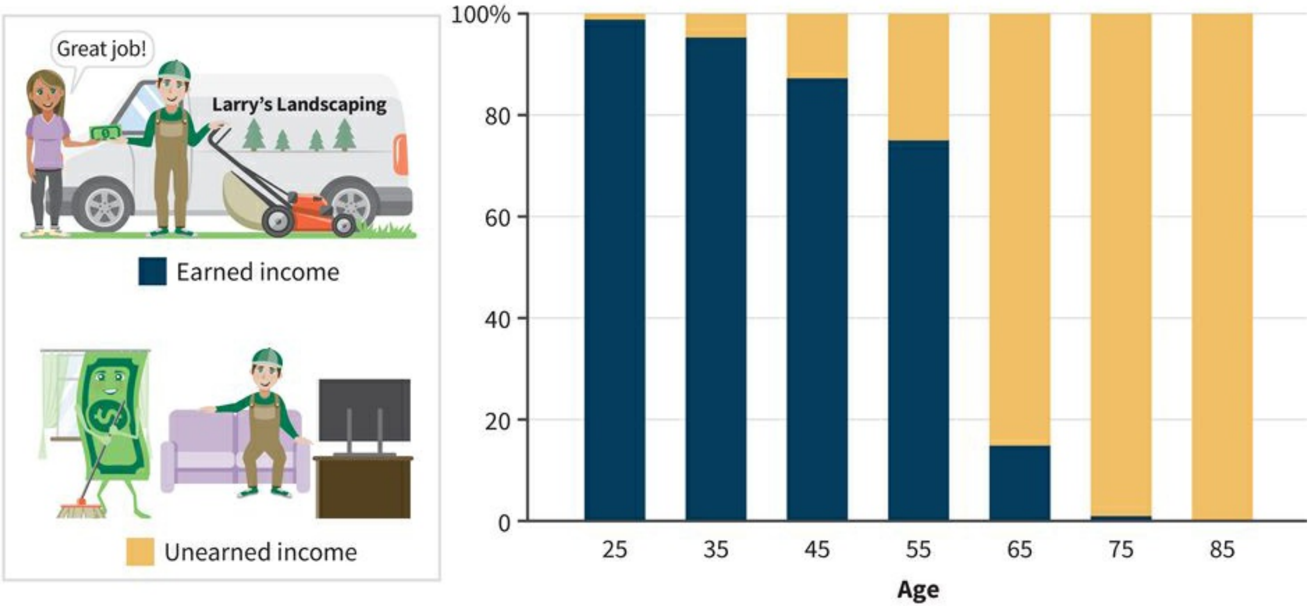
TERM TO KNOW

Earned Income
Money that you receive from work whether in the form of salaries, wages, commissions, or bonuses, or for operating your own business.

1b. Unearned Income

The following illustration shows that your **total income** is the combination of earned and **unearned income**. If earned income is what you make from your job or through self-employment, what is unearned income? Unearned income is money received from sources other than wages, salaries, commissions, bonuses, or self-employment. It is typically derived from investments.

- During your working life, the bulk of your total income comes from earned income.
- Over time, however, the size of the contribution of earned and unearned income in shaping your total income changes.
- When you stop working and retire, your total income will consist primarily of unearned income sources.



Sources of unearned income, according to the Social Security Administration, include but are not limited to:

- Interest from savings accounts
- Dividends
- Capital gains
- Monetary gifts you receive
- Government benefits
- Unemployment insurance
- Social Security benefits
- Money received by inheritance
- Proceeds from savings bonds
- Child support
- Alimony

TERM TO KNOW

Total Income
The combination of earned and unearned income.

Unearned Income
Money you receive from sources other than work or labor; also from financial capital, such as investments.

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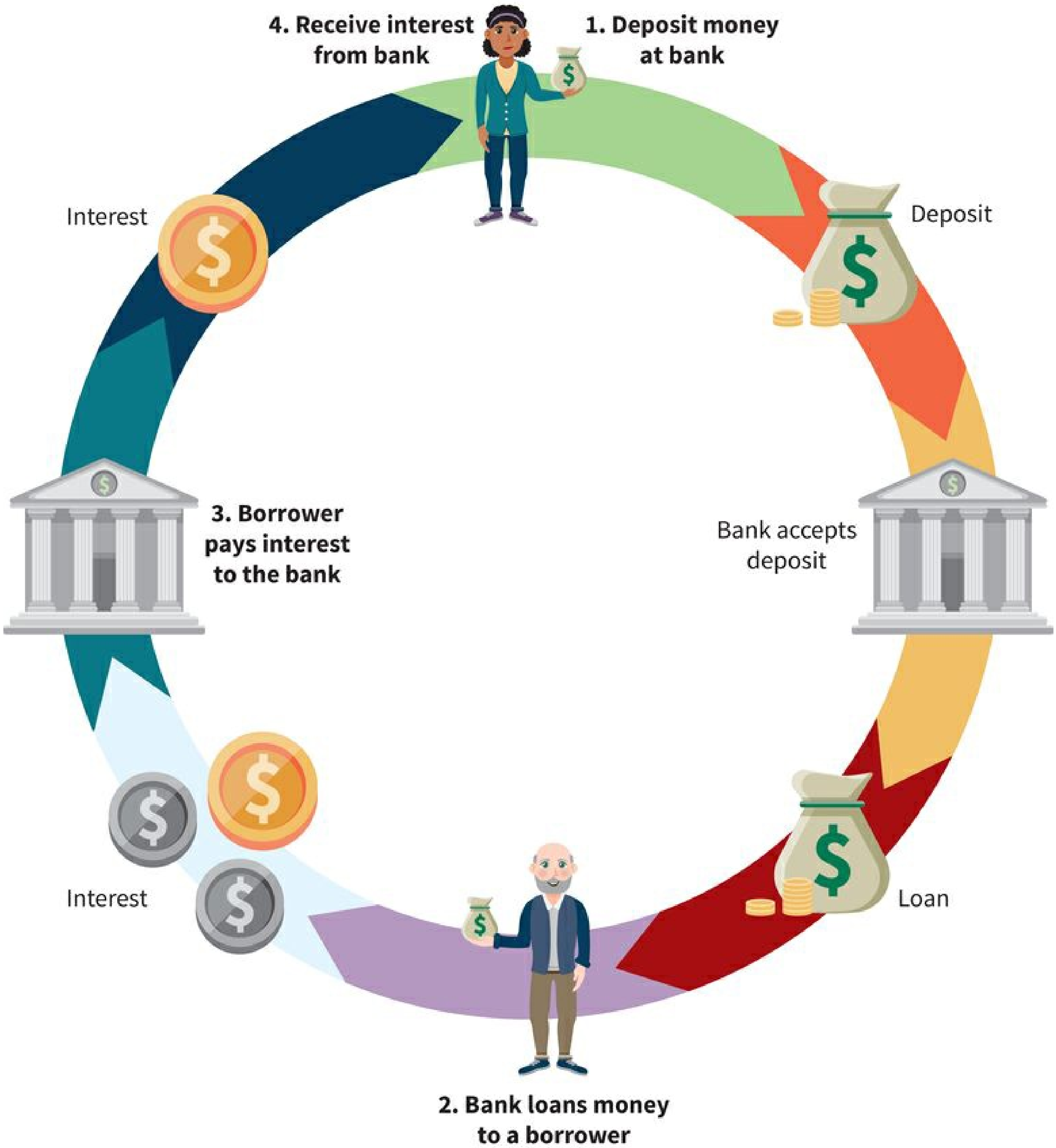
2. Interest and Dividends

As opposed to many of the unearned income sources listed above, which are often one-time occurrences or related to an unfortunate event, you can plan and control earnings from interest and dividends with greater certainty. Interest and dividends are particularly good tools for putting your money to work.

2a. Interest as Income

Think of a bank or credit union as a piggy bank, except that your piggy bank in this case pays you every time you drop a coin into the bank. As the following illustration shows, when you put money into your account, so does a banker.



Here's how the process of earning income at a bank or credit union (a credit union is an organization that is owned by account owners) works.

STEP BY STEP

1. You deposit money at the bank in an account.
2. The bank uses this money and lends it to others.
3. The bank then makes money by charging interest on what it lends out (this is the money the bank borrowed from you).
4. The bank pays you interest in return for borrowing your money. Interest is a payment that you receive for allowing the bank to use your money.

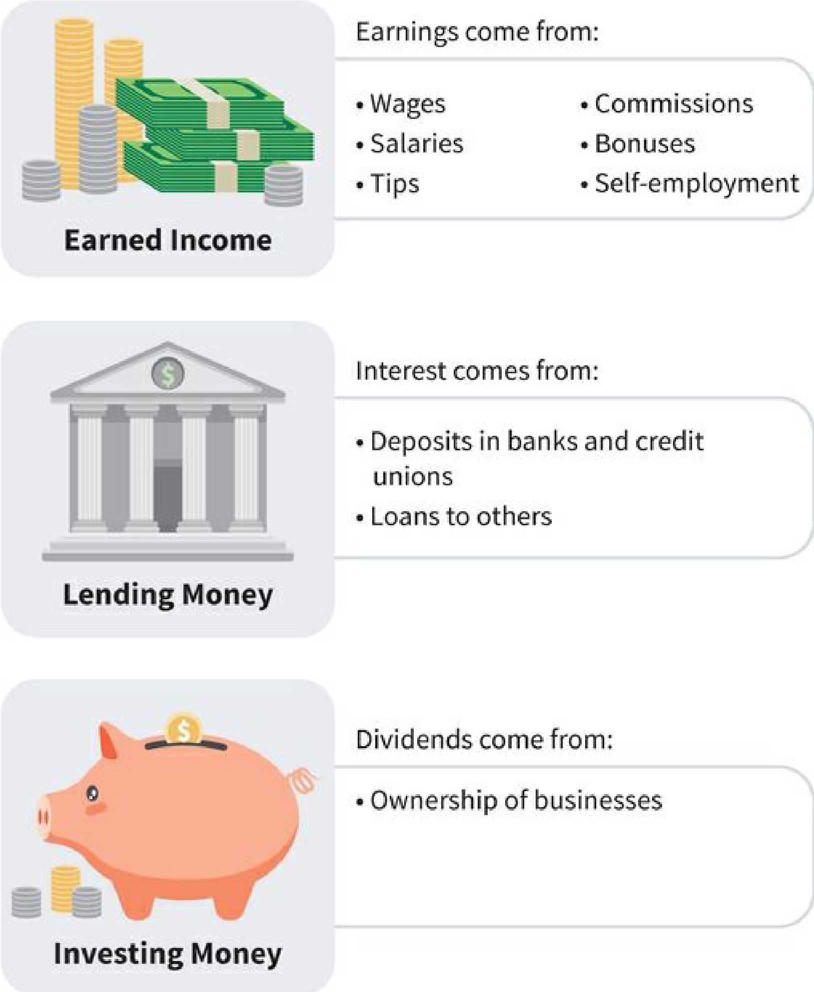
When your money and interest begin to compound over time, your savings account balance can grow quickly, which will enhance your wealth situation.

2b. Dividends as Income

During your lifetime financial journey, you can make money in these three ways:

1. Through employment (your job)
2. As a lender
3. As an **investor**

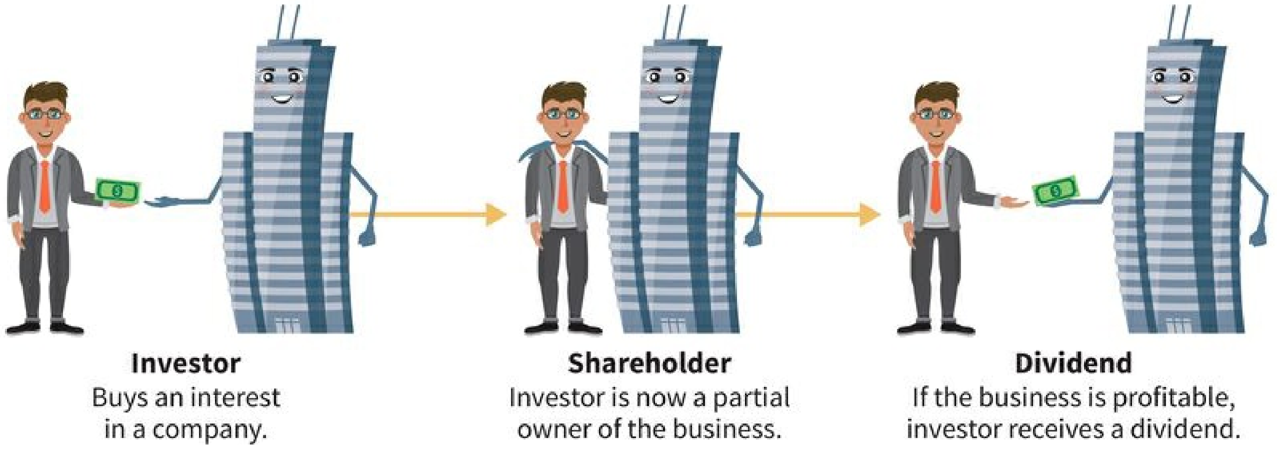
As shown in the following illustration, you generate earned income from your job. Lenders – you are a lender when you deposit money in a bank or credit union account – produce unearned income in the form of interest. Investors receive unearned income as **dividends** as well as capital gains.



Investors are people who put their money at risk through the partial ownership of businesses.

- If the company is profitable, investors get to share in the profits of the firm.
- An investor's share of the profits is known as a dividend.

If you want to become an investor, you will need to open a brokerage account or purchase shares in a mutual fund or similar product. Once you have an account, you can begin investing. The illustration below summarizes the process an investor takes to generate unearned income.



It's possible for an investor to buy into a company and receive nothing in return. This risk is why investors tend to demand a higher rate of return than savers and lenders.

- If you lend money by making a deposit into an insured bank or credit union account, you will not earn much interest because you are completely protected in case of a loss.
- When you make an investment, that protection does not exist. Further, if a company loses money, you may lose your original investment.

TRY IT

Alex has managed to save $10,000 over the past few years. After visiting several banks and doing online research, Alex has narrowed his options to two choices: (1) a savings account that will pay $600 total for the use of the money for 3 years (guaranteed), or (2) an investment that pays a 2% dividend.

What is truly remarkable is that the dividend has been increasing by 10% each year. For example, if Alex were to invest today, he would receive $200 in dividends. The next year, he would receive $220 in dividends. Here is how much Alex estimates he might receive in dividends over the next few years if he invests today:

Year	Dividend
1	$200
2	$220
3	$242
4	$266
5	$293
6	$322
7	$354
8	$390
9	$429
10	$472

Assume that Alex has a long time horizon and is willing to accept some ups and downs in the value of his savings and investments over time.

Given the information provided here, what option should Alex choose if his primary goal is to accumulate wealth? +

Alex should choose the investment. Even though the savings account will generate a 6% return ($600 ÷ $10,000) over 3 years, the investment will generate a higher long-term return. During the first 3 years, Alex will receive $662 in dividends. The fact that the dividend will grow by 10% each year means that the level of his unearned income will quickly be larger than the fixed 6% rate of earnings he can achieve through the savings account. Keep in mind, though, that Alex is taking more risk buying the investment. If the company were to lose money or if something else happened, the dividend could be cut.

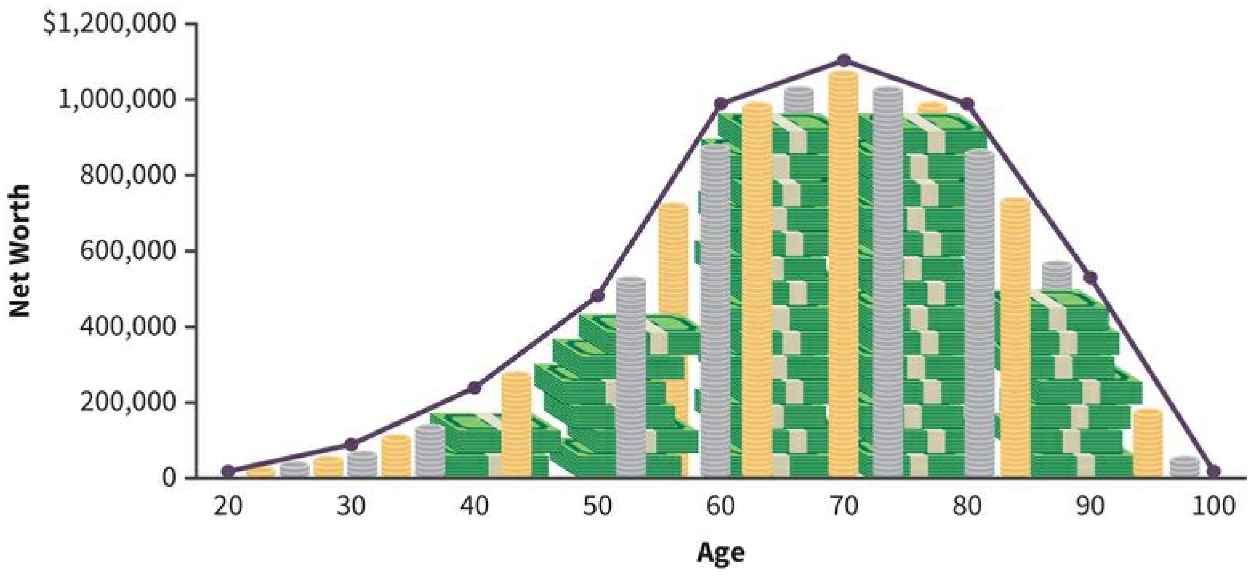
TERMS TO KNOW

Investor
Someone who allocates resources to assets in the hope of making money.

Dividend
An investor's share of the profits that is distributed directly to the shareholder.

3. Wealth Over the Life Span

If you manage your earned and unearned income effectively, your financial life might look like the one shown in the illustration below. This mountain-shaped curve shows how you might expect to see your wealth rise and then diminish over time.



The previous line chart represents what economists call the **economic life span**.

- When you are young, you have lots of time, energy, and skills; the present value of your future earnings (human capital) is high. However, your net worth situation has been, or may actually be, negative.
- As you save and invest as you grow older, you should find that your wealth begins to increase. At first, the growth will be slow because you will be paying off debts, buying new things, and possibly raising a family.

- Sometime near age 50 and extending through age 70, many of your expenses will begin to flatten out. This means that you can start to redirect more of your earned income into savings. It is at this point that you will experience the greatest increase in wealth. Although your earnings will likely be near their highest for your career, you will have fewer work years remaining. Thus, the present value of fewer work years is decreasing.

Your ultimate goal is to accumulate enough wealth and sources of unearned income during your younger years to retire in comfort during later life. At times, this will require you to pivot and make changes. Throughout your professional career, you will often need to adjust your working habits in order to convert economic challenges like inflation into financial opportunities. Remember, agility isn't just moving quickly. It's the ability to be flexible: to respond to change and to be able to proactively choose the best scenario in a situation, not just reactively make a quick choice to keep things moving along. It is a skill that is applicable in any type of career, academic pursuit, or daily life.

BIG IDEA

How much you need to ultimately accumulate will be based on your dreams, desires, and goals. Remember that no two lifetime financial paths are the same.

TERM TO KNOW

Economic Life Span
How wealth rises and diminishes over time.

SUMMARY

In this lesson, you learned that **earned income** arises from salaries, wages, commissions, bonuses, and self-employment. You also learned that **unearned income** is derived from investments. **Interest and dividends** are financial tools that you can plan and control to generate unearned income and put your money to work. If you are agile and manage these tools effectively, you should see a gradual rise in economic **wealth over your life span** between ages 20 and 70.

TERMS TO KNOW

Dividend
An investor's share of the profits that is distributed directly to the shareholder.

Earned Income
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Economic Life Span

How wealth rises and diminishes over time.

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Total Income
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