Ten Financial Terms Everyone Should Know

Understanding financial matters can be difficult because of the jargon used. Becoming familiar with these ten financial terms may help make your financial picture clearer.

1. Time value of money

The time value of money is the concept that money on hand today is worth more than the same amount of money in the future because the money today can be invested to earn interest. Why is it important? Understanding that money today is worth more than the same amount in the future can help you evaluate and compare investments that offer returns at different times.

2. Market volatility

Market volatility measures the rate at which the price of a security moves up and down. If the price of a security historically changes rapidly over a short period of time, its volatility is high. Conversely, if the price of a security rarely changes, its volatility is low. Why is it important? Understanding volatility can help you evaluate whether a particular investment is suited to your investing style and risk tolerance.

3. Inflation

Inflation reflects any overall upward movement in the price of goods and services in the economy. Why is it important? Because inflation generally pushes the cost of goods and services higher, any estimate of how much you'll need in the future--for example, how much you'll need to save for retirement-- should take into account the potential impact of inflation.

4. Asset allocation

This strategy means spreading investments over a variety of asset categories, such as equities, cash, bonds, etc. Why is it important? How you allocate your assets depends on a number of factors, including your risk tolerance and your desired return. Diversifying your investments over asset classes can potentially help you manage risk and volatility.

5. Net worth

Net worth is what your total holdings are worth after subtracting all of your financial obligations. Why is it important? Your net worth will probably fund most of your retirement years. Therefore, the faster and bigger your net worth grows, the earlier and more comfortably you will be able to retire. Once retired, preserving your net worth to last through your retirement years is your goal.

6. Five C's of credit

These are character, capacity, capital, collateral, and conditions. They're the primary elements lenders evaluate to determine whether to make you a loan. Why is it important? With a better understanding of how your banker is going to view and assess your creditworthiness, you will be better prepared to deliver appropriate information to obtain the loan you want or get a better interest rate.

7. Sustainable withdrawal rate

Sustainable withdrawal rate is the maximum percentage that you can withdraw from an investment portfolio each year to provide income that will last, with reasonable certainty, as long as you need it. Why is it important? Your retirement lifestyle will depend not only on your assets and investment choices, but also on how quickly you draw down your retirement portfolio.

8. Tax deferral

Tax deferral refers to the opportunity to pay income taxes in the future for investment interest and appreciation earned in the current year. Why is it important? Tax-deferred vehicles like IRAs and

annuities produce earnings that are not taxed until withdrawn. This allows those earnings to compound further adding to potential investment growth.

9. Risk/return trade-off

This concept holds that, in order to achieve a higher personal investment return, you must be willing to accept greater risk. Why is it important? When considering your investments, the goal is investing to get the greatest return for the level of risk you're willing to take, or to minimize the risk involved in trying for a given return.

10. Annuity

An annuity is a contract where you pay money to an insurance company in return for the insurer's promise to pay it back, with interest, in the future. Why is it important? You can supplement other retirement savings with tax-deferred annuity funds, and you can add to your retirement income with payments from your annuity for a fixed period of time or for the rest of your life.

Ask the Experts: How do I unwind my QPRT?

Given the state of the economy, it's not uncommon for real estate that has been transferred to a *qualified personal residence trust* (QPRT) to have experienced less than anticipated appreciation or even depreciation. Consequently, one of the purposes of the QPRT--removing future appreciation from an estate--may go unachieved. Some grantors in this position may be inclined to "unwind" (undo) the QPRT. That, however, may not be the best option.

If you unwind the QPRT, you will have wasted any payment of federal gift tax or gift tax exemption that you may have used on the original transaction.

For example, say you transferred your primary residence valued at $500,000 to a QPRT with a 20-year term when you were 40 years old and the Section 7520 rate was 4%. You made a gift of approximately $205,000, and you either paid gift tax on that amount or you used up $205,000 of your $1 million gift tax exemption. Either way, you will have squandered that amount because you won't get that back when you unwind the QPRT.

You may be better off keeping the QPRT. Even if there will be zero appreciation in the property, you might still enjoy some tax savings if you let the QPRT continue. That's because when the IRS values the gift, it assumes there will be no appreciation in the property; plus, it gives you a discount because there's a chance you may die during the trust term. So, if you outlive the trust term, you will still enjoy the benefit of that discount.

Not only that, but when the QPRT terminates, you will have to pay the remainder beneficiaries fair market rent. These payments will reduce your estate even further.
That said, if you still want to unwind the QPRT, your best option may be to invalidate the QPRT by ceasing to use your home as a primary residence (a requirement for a valid QPRT). How? Sell the home or rent it out.

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