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Making S.M.A.R.T. Financial Decisions

Prioritizing Saving

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In other videos I've recommended that you save 20% of your after-tax income. But how should you prioritize that savings? Number one is that if your employer makes matching contributions to your 401(k) plan, always contribute enough to get the entire match. Not doing so is like not cashing your paycheck. Money that your company contributes to your 401(k) plan counts as part of your goal of saving 20% of after-tax income. Start saving for your retirement and your other goals. 20% of your after-tax income should be earmarked for savings. This is you paying you. Put 10% of after-tax income into an IRA, a 401(k), or another retirement account. Elsewhere in the course we'll talk about different types of retirement accounts.

If you're over 35 years old and you haven't started saving for retirement, you should put more than 10% into your retirement savings. If you work for a company that makes matching contributions to your retirement account, that matching contribution counts towards your 10% Use the next 5% to build up a security fund, and then to save for a down payment on a home or to pay off principal on the mortgage of the home you own. If you aren't renting and don't intend to buy a home, put that 5% into retirement savings. If you don't own a home when you retire, you're going to need more in retirement savings.

Let's talk for a moment about a security fund, also referred to as an emergency fund or a rainy day fund. In their book All Your Worth, Elizabeth Warren and Ann Tyagi recommend keeping 6 months of your must-have expenses in this fund. This is a good rule of thumb, but how much you need is going to vary from person to person. If you have a high income, a secure job, and other savings, you may not need a 6-month cushion. However, if your income is unstable or your chance of losing your job greater than average, you may need a bigger security fund. If your health is bad or you have a job that has a high risk of injury, you may also need a bigger security fund. A security fund is not a substitute for health or disability insurance, but even with health and disability insurance, you are likely to lose income if you have a bad injury or a severe illness. That's what a security fund is for. This money is for when your car breaks down or you get sick and you miss work. It's not for vacations or a new iPhone. You'll save for these, but not in your security fund.

Where should you keep your security fund? Not in your checking account. That just makes it too easy to spend. But you don't want to put it in an illiquid or volatile investment, so don't put it in a certificate of deposit because early withdrawals are subject to penalties, and don't put it in the stock market. Too many ups and downs. Either keep your security fund in a standard savings account or in a money market account. You need to be able to access your security fund quickly when things go wrong, but you don't want to use it for non-emergency expenses. If you do have an emergency such as an unexpected car repair, pay for it out of your security fund and then start rebuilding the fund when you get your next paycheck.

So why keep 6 months of expenses in a savings account or a money market account that's paying very little interest? Wouldn't it be better to put this money into an individual retirement account and invest it in the stock market? No. The purpose of the security fund is to help you cope with the unexpected without going back into debt. This is like an insurance policy. It costs you something, but it's worth it. In the long run, you're better off giving up some of the investment return and avoiding crushing credit card debt. Saving 20% of after-tax income is a good goal, but for most people it's going to take a while to work up to saving this much. I've suggested saving 10% of this 20% in a retirement account, using the next 5% to create a security fund, and once that's done, either saving for a down payment on a house or increasing your contributions to your retirement account.

What about the final 5%? Use the final 5% to save for something that's important to you-- your daughter's education or a special trip you hope to take some day. You decide. But if you got off to a late start with your retirement savings, you should keep your focus there for a while. What about things in the wants category? Money for Christmas, money for a new couch or a new personal computer or a week in Hawaii? Things that are a bit too big to pay for out of your monthly check but definitely fall into the wants category. Pay for your wants in advance. Save up for them and buy them once you have the money. Don't let things you want drive you back into debt. You're going to enjoy a vacation more if you pay for it in advance, and it will cost you far less in the long run. How much you save for your short-term goals really depends on what you want and what you can afford. This isn't part of your 20% long-term savings, this is simply the sound practice of saving money first and then buying, rather than buying now and going into debt.

Finally, parents of young children often ask themselves whether they should first save for their children's education or for their own retirement. You should first save for your retirement and then for your children's education. There are other ways, such as loans and scholarships, to pay for tuition. There are no retirement scholarships.