Budgeting for Beginners

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Getting that first job out of school is exciting—you're finally a real adult. With that comes responsibility for your own money. How much are you supposed to spend on what, how can you even think about saving anything, never mind about retirement, and what about those looming student debts?

One oft-seen formula is the 50-15-5 guideline: limit essential expenses to 50 percent of after-tax income; save 15 percent of pre-tax income for retirement; set aside five percent of after-tax income for emergencies and short-term savings. Beyond defining what falls into each category, note the mash-up of pre- and post-tax dollars. How does all this work in real life?

Let's invent Julia, a recent college graduate with a nice job—she'll be making $45,000 annually in a major city near the suburb in which she grew up. Julia has $20,000 in student loans. She plans to live with some sorority sisters and has hopes of buying a car. Julia's employer will match as much as three percent of her salary in 401k contributions and will subsidize her medical insurance.

Budgeting for Essential Expenses. Essential expenses are those that don't go away, even if the job does. That's why a new graduate should keep them under control. To calculate that five percent in a perfect world, Julia would back her projected 401k contribution out of her salary, determine what (if anything) she can contribute to a flexible spending account, calculate Social Security and Medicare taxes, and then pull out the income tax tables. Even with an accounting degree, our hypothetical college graduate isn't going to do that. Instead, ballpark 50 percent of after-tax salary as one-third of pre-tax salary.

Reality comes crashing down: this gives Julia $15,000 annually, or $1,250 monthly, to spend on: housing, commuting, groceries, medical costs, and student loans. Her student loan will run $230 per month, leaving her just over $1,000 to cover other necessities. She may need more roommates than she anticipated, to live in a less hip neighborhood, or even to move back home for a bit. Julia should compare public transportation versus owning a car. She likely won't need the most expensive medical plan out there. Julia, like most recent graduates, can expect to scrimp for a while.

Saving for Retirement. Julia should know the benefits of early retirement savings. Assume she saves $5,000 per year starting at age 25 for ten years. She doesn't save a dime after that, but her investments grow at seven percent, compounded annually. At age 65, Julia would have \$602,070. To compare, assume Julia doesn't begin saving for retirement until age 35. She saves that same \$5,000 annually, earning that same seven percent, up until age 65. Even though Julia has set aside more nominal dollars, she has only \$546,091 in retirement savings. Julia needs to begin investing in her 401k plan as soon as she is eligible to do so.

Julia should contribute 15 percent of her pre-tax earnings annually. Luckily, that doesn't all come from Julia. Her employer will match 50 percent of Julia's contributions, up to six percent of salary—three percent. That leaves 12 percent for Julia to contribute, or \$5,400 annually. Because Julia is young, she should invest for long-term growth, with most (if not all) of her 401k in low-cost equity mutual funds. If Julia's 401k plan allows, some of her contribution should be to a Roth 401k. She won't get an immediate tax deduction, but all earnings and growth will stay off the income tax grid forever.

<u>Emergency Fund and Short-Term Savings</u>. Finally, Julia should establish an emergency fund to cover three to six months of essential expenses, followed by saving up—for a car, a home, a wedding. Given Julia's monthly budget of \$1,250 for essential expenses, she should aim for an emergency fund of about \$7,500—that can cover job loss, medical emergencies, or other unexpected expenses. A five percent pre-tax savings target translates to about 3.3 percent after tax—or \$125 per month. Even at that rate, it will take Julia awhile to build up an emergency stash.