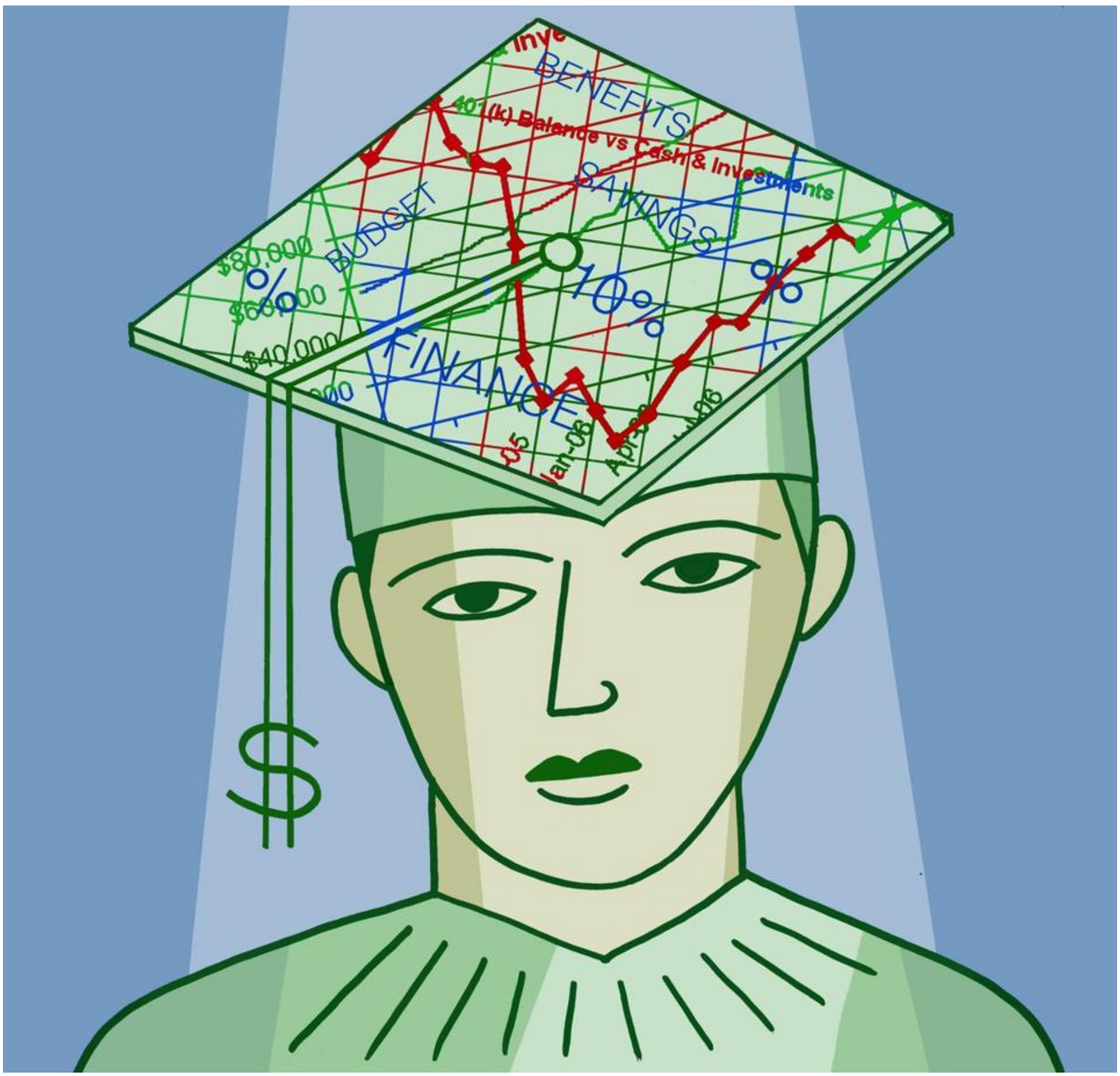
Post-graduation course: budgeting

The joy of a paycheck may be tempered by the decisions and challenges that come along with it

By Lynn Asinof | GLOBE CORRESPONDENT JUNE 01, 2014



ANTHONY RUSSO FOR THE BOSTON GLOBE

Just because they've earned college degrees doesn't mean recent graduates have any idea how to tackle the myriad financial decisions now facing them.

All those classes in American lit and chemistry don't provide students with the skills needed to create a budget, establish an emergency fund, or pay off school loans. Moreover, many graduates may have a tough time finding work or end up in jobs that pay far less than what they expected, making these decisions even tougher.

So here's a primer for the newly independent as they tackle financial decisions that include choosing workplace benefits, creating a budget, and planning for the future.

New workers are usually handed a packet on their first day on the job and they will be asked to make choices about everything from health insurance and tax withholding to how they want to invest their retirement plan assets. "It is just so overwhelming to have so many decisions to make at one time," said Jennifer Lane, a fee-only financial planner with Compass Planning Associates in Boston.

Some choices are relatively straightforward. Thanks to the new health care law, for example, young adults can stay on their parents' health insurance plan until age 26. That means new graduates may be able to save money by opting out of their employer's health care coverage.

They'll also be asked to fill out a W-4 form to determine their income tax withholding. Checking the "single" box and claiming zero allowances is a good starting place for new grads and other young employees —it should mean enough will be withheld from their paychecks to avoid an unexpected tax bill come April 15. The allowances can be adjusted later if it turns out too much is being withheld.

One common financial planning question 20-somethings ask at this point: Do I have to put money aside in my retirement plan right now? "The answer is always yes, absolutely, you have to start right now," said Mary Hoey, a fee-only financial planner with Braver Wealth Management in Needham.

Compound interest makes these early years particularly powerful. A person who puts $1,000 a year into a retirement plan starting at age 22 would end up at age 65 with more than $283,000, assuming a 7 percent annual return. If that same individual waits 10 years to start making contributions, however, he or she would end up with less than half that amount.

How much should you contribute? Start by making sure you take full advantage of any employer match. The most common employer match is 50 cents on the dollar on contributions up to 6 percent of salary. That's free money, so always contribute enough to get the maximum match.

But don't stop there. Even those who are just starting out should be saving a full 10 percent of their income. "Pay yourself first," said Hoey. Once you capture the employer match, use the rest of that 10 percent to both build an emergency fund and start a Roth Individual Retirement Account, she said.

The Roth offers greater flexibility than other IRAs. Unlike traditional IRAs, Roth contributions are made with money that has already been taxed, but young adults are typically in relatively low tax brackets. The benefit of this after-tax funding: Withdrawals typically aren't subject to income tax, and contributions can be taken out at any time without penalty.

The rule of thumb is that an emergency fund should be able to cover three to six months of living expenses. It may take a couple of years to build up the fund to that level. Since money contributed to a Roth IRA can be withdrawn at any time without penalty, you may want to keep some of your Roth dollars in cash as you build your emergency fund.

When it comes to investing, consider putting retirement account dollars into a "target-date" mutual fund pegged to the anticipated year of retirement. These funds invest in a mix of stocks and bonds — more aggressively when employees are young, more conservatively as they approach retirement. Employer plans commonly offer this choice.

"This is probably your best option when you are just starting out," said Dana Levit, a fee-only planner with Paragon Financial Advisors in Newton, noting that these mutual funds provide new investors with easy access to a portfolio that includes a range of different investments.

Once all those pieces are in place, it's time to put together a budget using what is left after deductions and savings. Start with essential expenses such as housing, food, transportation, and utilities. Student loan repayments usually kick in six months after graduation, so it's important to review the options early and build those monthly loan payments into the budget.

Then consider discretionary spending, tracking every dollar spent, whether it is for lunch, a morning coffee, new shoes, or a movie with friends.

"You really need to differentiate between needs and wants," said Michelle Morris, a fee-only planner with BRIO Financial Planning in Quincy, noting that it may take some lifestyle changes to stay on budget.

One of Morris's clients, for example, decided she needed to develop friendships with people who ate out less, so she joined a running club. Another budgeting tip from Morris: Learn to cook.

When it comes to using plastic to pay for purchases, remember that credit cards offer more protection from fraud than debit cards, said Compass Planning's Jennifer Lane. But it is important to pay the balance in full every month. That will keep credit scores healthy and prevent overspending.

There are some high-tech tools that can help with budget management. Mint.com, for example, is a free online service that lets people keep track of their spending, bank accounts, investments, credit-card balances, and even student loans. Another program, You Need a Budget, provides budgeting tools and is available for a $60 one-time fee.

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