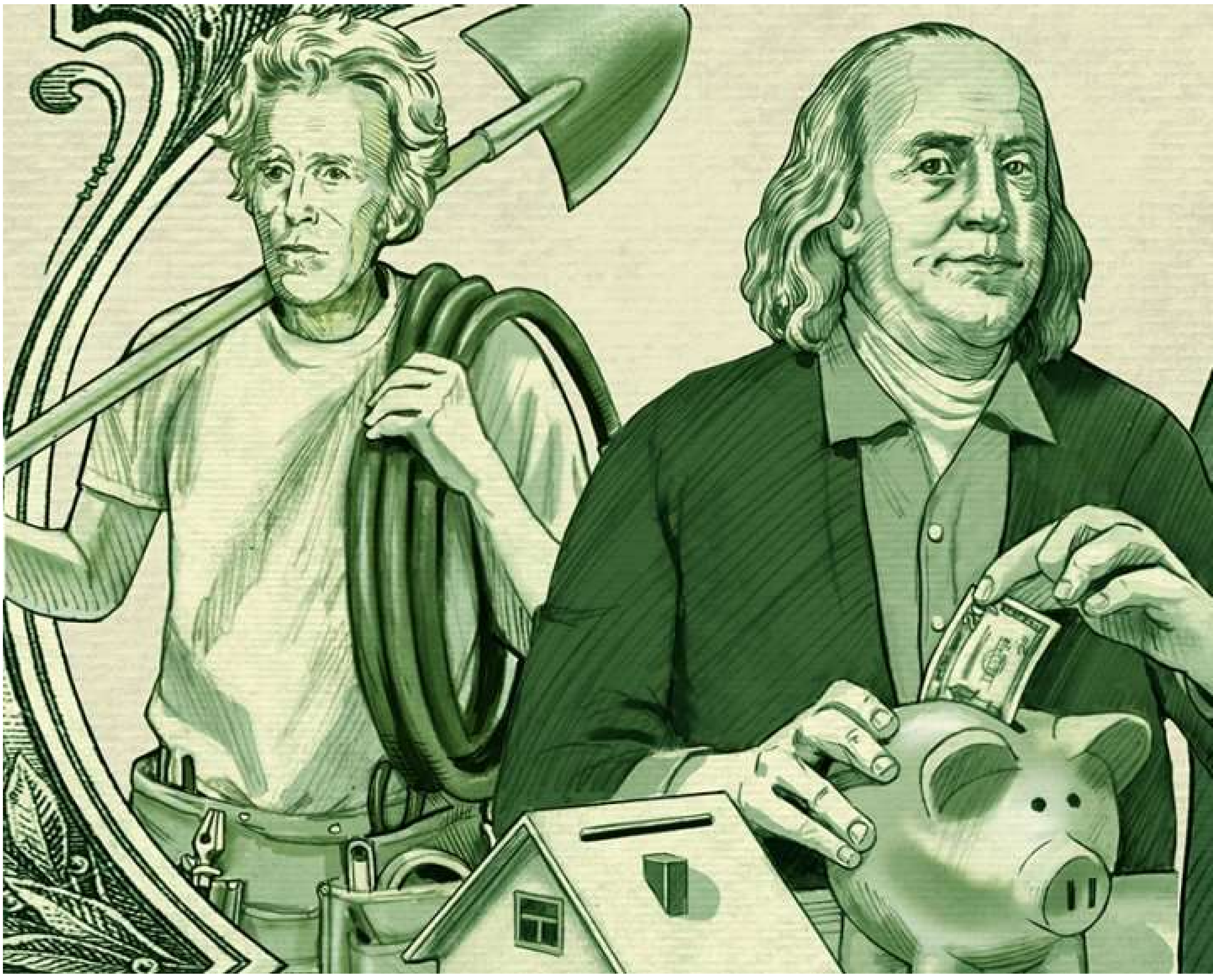
Time-Honored Financial Advice With a Twist

Follow these revised guidelines to boost savings for emergencies, retirement and investments

by Lynn Asinof, **AARP**, August 7, 2019 | Comments: 16



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The great thing about rules of thumb is that they can help turn complicated decisions into easy ones. How much life insurance does a person need? What portion of her long-term savings should she put into the stock market? Is there a way to predict the amount of money she'll spend each year in retirement? Answering questions like these could take hours upon hours of research and reflection — or just a few seconds of arithmetic.

Financial rules of thumb “can be a helpful shortcut,” says Sheryl Garrett, founder of Garrett Planning Network, a nationwide group of financial advisers. “That's sometimes what we really need."

Other times, however, those nuggets of received wisdom are a little too simple or just no longer apply. So here's a rundown of the most common money formulas you're likely to come across, along with the reasoning behind them and any revisions they might need to remain useful tools.

1. To protect yourself in case of financial emergencies, keep at least six months’ worth of living expenses in the bank.

- **The reasoning:** An emergency fund is just-in-case money set aside to cover a job loss, a medical problem, car woes or another costly shock. Financial planners recommend having enough such cash set aside to support yourself for several months — anywhere from three to 12, depending on your circumstances. (No, don't put the money under the mattress; instead, keep it in an account you can access quickly, like a savings account, a short-term certificate of deposit or a money market fund.) Six months — the length of time it commonly takes to find a new job — is generally viewed as a good number, says Dana Levit of Paragon Financial Advisors in Newton, Massachusetts.
- **The revision:** Older working people, who tend to have longer periods of unemployment after a job loss, may want to stash away 12 months of living expenses, if possible, Levit adds. The same goes for retirees who depend on money pulled from their retirement accounts. Having 12 months of cash on hand reduces the risk of being forced to withdraw money out of investments when stock or bond prices are down, she notes.

2. Before retirement, allocate 50 percent of your household's annual after-tax income for needs, 30 percent for wants and 20 percent for savings.

- **The reasoning:** These ratios help you achieve a three-way balance among everyday essentials, enjoying your life in the present and planning for the future. Fifty percent goes toward things you must have, such as food, housing and insurance. Other purchases — up to 30 percent of your spending — are wants, whether they're vacations, meals out or premium cable channels. The final 20 percent goes toward savings or, if necessary, debt repayment.
- **The revision:** Be realistic and flexible. For many people, needs add up to more than 50 percent of spending. For example, the U.S. Bureau of Labor Statistics

found that in households anchored by people 65 and older, the basic needs of housing, health care and meals at home averaged 55 percent of spending. In these cases, planners caution, it's important to pare back on the wants budget and not forget about debt repayment and savings.

3. Subtract your age from 100. That number is the percentage of your investments you should have in stocks or stock funds. The rest should be in bonds.

- **The reasoning:** When you're young, you have a longer investment horizon and are better able to ride out the ups and downs of the stock market. As such, you can shoulder the market risk posed by stocks and stock funds in exchange for the growth potential they offer compared with bonds and bond funds. These bond investments, generally speaking, have lower returns over time, but they supply regular income and can help stabilize an investment portfolio. According to this rule, a 25-year-old should have 75 percent invested in stocks, but a 75-year-old should have only 25 percent in stocks, with the rest in bonds.
- **The revision:** These percentages may no longer work. People are living longer, and they often need the portfolio growth that stock investments are more likely to provide. Without any adjustment, this rule "could cause people to be too conservative," explains financial adviser Sharon Rich of Womoney in Belmont, Massachusetts. If you have enough fixed income to weather a seven- to 10-year downturn in the economy, she says, you can afford to boost the percentage of stocks in your portfolio above what the rule of 100 suggests.

4. Set aside one percent of your home's value each year for maintenance and repairs.

- **The reasoning:** Big-ticket maintenance projects, such as a roof replacement or house painting, aren't annual events, but they're expensive. To make sure you're covered, annually budget one percent of your home's value for these. That's $2,500 a year for a home worth $250,000. If you don't use it one year, you can use it the next, says Steve Thalheimer, a Silver Spring, Maryland, financial adviser. He likes the one percent guideline, saying that, averaged over time, it should cover major home maintenance expenses.
- **The revision:** If you have an older house or if your home is in need of work, you may have to budget more, Thalheimer acknowledges. Garrett recommends two percent of your home's value.

5. When you buy life insurance, get a policy that will pay seven to 10 times your current annual income upon your death.

- **The reasoning:** If you die early, your partner or family will require lots of cash to compensate for the years of earnings you were expected to provide.
- **The revision:** Rather than using annual income as a guideline, estimate what your survivors need to avoid financial disaster, suggests New York City financial adviser Gary Schatsky, president of ObjectiveAdvice.com. That means making sure they can cover the mortgage payments and the kids' college tuition, pay for health care and have sufficient income to live. Even if you have no income, you may need insurance to pay to replace the unpaid labor you provide for your family — say, caregiving for a child or an older relative. If you're retired or if you don't have any dependents, you might skip life insurance entirely, unless you have a specific estate planning purpose, such as providing for the adult children of your first marriage to avoid conflicts with your younger second spouse.

6. In retirement, plan for your ongoing expenses to total 80 percent of your preretirement income.

- **The reasoning:** Once the kids are grown and work-related expenses disappear, the annual cost of living could go down. And though in the past you may have set aside a chunk of your income for retirement savings, after you've retired, well, that line item will likely disappear.
- **The revision:** When budgeting for retirement, pay attention to your expenses, not your income. Identify your specific monthly spending needs, then create a cash flow plan to cover them. And leave some wiggle room for spending spikes. Commuting expenses may be gone, but retirees often drop more on travel or need to hire extra help at home.

  What's more, retirees' expenses tend to vary, often rising in the early years, dropping in the middle years and then climbing if health issues arise. "Look at current expenses closely," advises Rich (who uses a spreadsheet to track spending), and project which annual expenses will go up and which will go down. One thing people often forget to include: taxes generated by retirement plan withdrawals, which become mandatory at age 70 1/2.