

HOW IT'S DONE



Financial Rules of Thumb



The basic cash flow model is called the 10-20-70 formula. The formula suggests that you save 10% of income (guarantees); limit debt to 20% (excluding home mortgage); and allocate 70% of income to living expenses, (including home mortgage and taxes). This is a starting point for a conversation about financial rules of thumb. Keep in mind that rules of thumb are widely used principles with broad application, but they are not totally accurate or reliable in every situation. Here are a few basic rules of thumb to help you with the conversation about money:

1. John D Rockefeller's rule: save ten percent and give away ten percent.
2. Bankers recommend that you allocate no more that 20% of net income to debt reduction (excluding home mortgage). The home mortgage should not exceed 3 times income. The monthly payment should not exceed 28%.
3. Total debt service including home mortgage should not exceed 36% of gross monthly income.
4. Car loan payments should be under 10% of income and for no more than 4 years. Total transportation expenses should be under 15% of income.
5. Insure your life for 10 to 25 times your income depending on your age and obligations. For more information, go to: <http://www.lifehappens.org/insurance-overview/life-insurance/>. The life insurance premium should be between 3 and 5% of Gross Income.
6. Liquid cash reserves should equal the larger of \$25,000 or six-month's income. Some people suggest that the number of months should match the current unemployment rate. E.g. rate is 7.2% unemployed; months liquid should equal 7.2.
7. Have at least 70-80%¹ of your income covered by disability insurance. For more information, go to: <http://www.lifehappens.org/insurance-overview/disability-insurance/>.
8. Purchase long-term care insurance with a daily benefit equal to the average daily rate in your community and a benefit period of at least three years. For more information, go to: <http://www.lifehappens.org/insurance-overview/long-term-care-insurance/>.
9. Insure your property for 100% of replacement value. Collision deductibles should equal one week's take home pay. As you build your cash reserves, increase your other deductibles to \$1,000 or more.
10. 401 (k) contributions should be at a level that maximizes any employer contributions. If your employer has a policy to match 50% of your contributions up to 6%, then contribute 6% of your income to take full advantage of the match. If no matching program is available, contribute at least 5% to your retirement plans.
11. Base your retirement needs on 110% of your pre-retirement expenses.

¹ With a "Catastrophic" rider you can replace 100% of earned income. For example, if you earn \$100,000 and have a group disability plan that pays 60% of your income, you would receive a taxable monthly benefit of \$5,000 when disabled. Additionally, you can purchase approximately \$1,400 of individual tax free disability income which brings your total coverage to 77%. With some insurance carriers, you can also add a catastrophic rider which would bring your total coverage up to 100% replacement.

12. Expect to safely withdraw and spend 4% of your retirement fund value every year.
13. One thought is to save \$150 per month per child and then double the amount when the first one starts college. You may not have enough to cover the entire cost, but you will minimize school loans and the amount of time it takes to pay them off. For more information on saving for college, go to <http://www.savingforcollege.com/>.
14. Net worth² should equal ten percent of your age times your income (e.g. Age 45; 100,000 income = \$450,000 net worth) - Thomas Stanley, author of The Millionaire Next Door
15. Save from your income and invest from your savings.
16. Use 3.5% as the inflation rate per year. (The average rate since 1914 is 3.30%; http://inflationdata.com/inflation/inflation_rate/historicalinflation.aspx).
17. Have X% of your portfolio invested in stocks, where X is equal to 100 minus your age. With the increase in longevity; some experts suggest that you use 110 or 120 instead of 100.
18. Invest no more than 10% of your total savings in your employer's stock.
19. To determine how long it will take an investment to double, divide 72 by the annual return.
20. Consider refinancing your home if interest rates dropped by 1-2%.

Go to the **Bureau of Labor Statistics** <http://www.bls.gov/cex/> to find tables that will help you appreciate how the average person allocates his/her income. It will help you counsel your clients and help you help them deal with their money more effectively.

Some Sample Cash Flow Tables in PDF Format:

- ✓ **By Age Group:** <http://www.bls.gov/cex/2015/combined/age.pdf>
- ✓ **By Higher Income Level:** <http://www.bls.gov/cex/2014/combined/higherincome.pdf>

Take a look at <http://www.sharesavespend.com>. You will find some great ideas there that will help you create more talking points when you are working with your clients on cash flow issues.

Neither Ed Howat and Addie Woods Consulting Co. LLC, nor its representatives give tax, legal or financial advice. Please consult with an attorney, tax or financial advisor for such advice.

² The formula is used to define an "Average Accumulator of Wealth (AAW).