

Spending habits contribute to lack of savings

Money Manager/by Karin Price Mueller

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Problem:

We've all watched money disappear, unsure where it was spent. That's the problem for Lenny and Shirley of Central Massachusetts, both age 34.

The couple, whose names have been changed, haven't saved a penny for retirement, and they fear they may not be prepared to pay for college educations for their two young daughters. They came to the Herald to get a handle on their spending and on starting savings plans.

"I don't know why we don't save," says Lenny, who works in a bakery that supplies rolls and other goods to a fast-food chain. "We end up blowing it."

With annual salaries of \$39,000 and \$25,000 respectively, Lenny and Shirley have trouble keeping track of their cash flow. Some of the couple's expenses are necessary ones, but they also spend on things they can't account for at the end of the month.

The couple pays \$518 a month towards a \$51,500 mortgage on their home, and more than \$700 a month on transportation-related expenses, including a monthly \$300 payment towards the \$7,700 loan on their 1998 Dodge Caravan.

"I'll play the lottery to try to get the pot at the end of the rainbow," says Lenny. "I buy stuff for the kids that they probably don't need and we go out to eat a lot."

For example, last week, Lenny says the family went out for meals four times at a cost of \$100 - proof that even the budget accounting he gave to the Herald for this story is probably off.

He figures food expenses rack up \$400 a month on groceries and \$200 on meals out, with another \$120 on snacks.

With a closer watch on their expenses, Lenny says the family should be able to save money. He says they have found success saving for holiday expenses with an automatic Christmas Club account, which has a balance of \$2,500. But that account makes up the bulk of their assets. They have another \$500 in a savings account and \$300 in a second savings account for their 4-year-old daughter, Ally. They haven't yet saved for their 10-month-old daughter, Sara. But Lenny and Shirley would like to do more for their kids' education funds.

"I'm looking at 529 plans," Lenny says. "I'd like to do one for each child so I'd be in that much better shape by the time they go to college."

Retirement planning is another area where the couple is lacking. Both expect a monthly pension payment of \$1,050 each at age 50.

Those pension payments are one reason why they haven't yet taken advantage of the 401(k) plan offered by their employer. Lenny also says the fact that there is no employer match offered with the plan also turned them off from using it as a savings vehicle.

"I know the pension won't be enough," he says. "But I felt we should get a match of at least 25 cents on the dollar - that's making 25 percent on your money before you even worry about what fund you're in."

Instead of the 401(k), Lenny and Shirley have considered paying down their mortgage as a means of forced savings. And because the mortgage is one of their largest expenses, Lenny feels eliminating the cost will make their budget much smoother.

A year ago, the couple started direct investing programs with three companies: Home Depot, CVS and Intel. Lenny says he thought if he bought one share, he would then invest regularly every month. But he hasn't added to the account yet, calling himself a procrastinator.

"I need someone to whack me over the head with a two-by-four and say, 'Listen you dope, you will not get anywhere if you don't start,'" Lenny says. "We make all this money and at the end of the day we say, 'Where the hell did it all go?'"

Solution:

Financial discipline should help couple meet future obligations

The good news is that Lenny and Shirley are relatively young, and time is their greatest financial ally. And, there are plenty of programs that the couple can take advantage of to help them save money before it's spent.

"They know money is slipping through the cracks," says Dan Galli, a certified financial planner with Boston 128 Companies Inc. in Waltham and a member of the Financial Planning Association of Massachusetts. "Any way they can automatically catch money before it gets into their hands is really important."

After reviewing the couple's expenses, Galli says they have about \$22,000 in discretionary income each year. Even if they've underestimated their expenses, Galli says Lenny and Shirley can redirect a lot of that lost cash to savings plans, starting with retirement.

The pensions they expect to receive will be a good foundation for retirement, Galli says, but it won't be enough. He says their 401(k) plans are the next place to go, employer match or not.

Here's why: Money contributed to a 401(k) plan is invested before taxes are withheld. A contribution of \$100 only reduces take-home pay by \$80, assuming a marginal combined tax bracket of 20 percent, Galli says.

Besides, the money will grow tax-deferred. More significantly, the biggest advantage of the 401(k) plan is its discipline - something Lenny and Shirley need.

Contributions are deducted from their paychecks and it's automatic, so it's assured that money will be saved on a regular basis.

"My gut feeling is that they ought to get the 401(k)s started right away simply because they really need to take advantage of the time they have to build up the accounts," Galli says.

So for starters, Galli recommends Lenny and Shirley each enroll in their respective 401(k) plans, contributing 6 percent of their salaries. Assuming current income and an average annualized rate of return of 8 percent, they could accumulate about \$800,000 by age 62. And if you consider pay raises, the amount saved will probably be even higher.

Assets in the 401(k) plan should be invested in a diversified manner, Galli says. He suggests 30 percent be invested in a large-cap growth fund, 30 percent in a large-cap value fund, 20 percent in a small-cap fund and 20 percent in a foreign stock fund.

Galli recommends the couple use the same automatic savings strategy for the girls' college education funds, using an automatic monthly withdrawal from their checking account to fund a 529 plan for each child.

A monthly contribution of \$100, using an annualized rate of return of 8 percent, would grow to \$43,000 in 17 years.

Combined with financial aid and other income sources, the money will put a big dent in any college bills.

The final savings account the couple needs is a cash emergency fund, set up in a money market account. They need to accumulate between three and six months of living expenses in the account.

Galli suggests they start with an automatic investment plan with a bank or mutual fund company, arranging for the institution to take out \$100 a month from their checking account.

While Lenny and Shirley get the savings plans started, they also need to address their debt load.

Their \$3,675 in credit card debt is racking up interest at a rate of 9.9 percent. With monthly payments of \$100, it would take almost four years to pay off.

Payments of \$166 a month would eliminate the debt in two years, while monthly payments of \$216 would wipe out the debt in 18 months. Galli suggests the couple pay off debt as fast as possible - without adding to the credit card balances - and then they could redirect the monthly payments to increase savings in one of their other plans.

Galli says though it's an admirable goal, pre-paying the mortgage shouldn't be high on the couple's priority list. Instead, they should concentrate on starting savings plans and paying off such "bad" debt as credit cards.

Lenny and Shirley also need life insurance, Galli says. He recommends term insurance of about \$500,000 on Lenny and \$400,000 on Shirley, which should be very affordable at their ages.

"The insurance need has been brought home by the tragedy in New York," he says. "Not to mention the emotional impact, but the financial impact of having a young family like theirs all of a sudden lose a breadwinner is devastating."