Where Did Your Money Go?

For most individuals, the amount they spend has an inverse effect on the amount they save for retirement. Many spend too much and save too little. In order to free up additional funds and save more, it's important to understand "where the money goes" and set spending limits. The first step in this process involves creating a monthly budget listing all expenditures.

Most expenditures (or debt) fall into one of three categories:

FIXED DEBT | MONTHLY EXPENSES | FLEXIBLE EXPENSES

Fixed Debt

Fixed debt represents long-term, ongoing payments made to pay off loans (debt) for items such as mortgages, school loans, or car payments. These expenditures generally represent a stable percentage of total monthly expenses. Your remaining income after fixed debt should be enough to cover living expenses with some left over for retirement savings. It is also wise to have cash set aside to pay for any unexpected expenses or financial emergencies.

For most Americans, fixed debt will consume the majority of their lifetime income.

Acceptable levels of fixed debt can be measured by a "Debt to Income" ratio (DTI). This is determined by calculating the percentage of monthly income (take home) spent on fixed debt. Most financial institutions recommend a DTI ratio no higher than 36%. A DTI of 20% or below is considered excellent. A DTI ratio above 36% makes it difficult to set aside funds for retirement and individuals with DTI ratios at 50% or higher run the risk of missing or defaulting on payments, running up credit card debt, and damaging their credit ratings.

For most Americans, there are three items that account for the majority of fixed debt – **mortgages**, **car loans**, and **school loans**. Many individuals mistakenly assume lenders will not approve loans above and beyond what they can afford. This is not the case. Before signing on the dotted line, calculate the monthly payments for all fixed debts to ensure the DTI ratio remains at or under 36%.

How much of your DTI should these three items represent? Percentages vary based on the source of the data, but as a starting baseline…

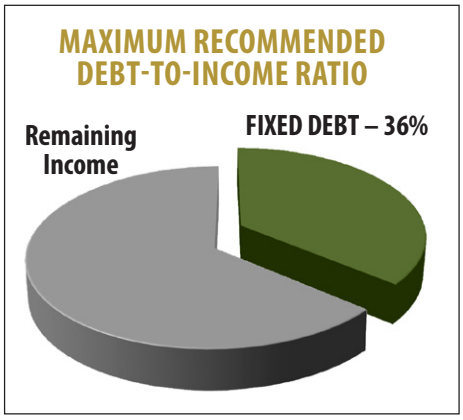
MORTGAGE

Houses account for the largest percentage of fixed debt but also represent an investment that over the *long term* will usually grow in value. Plus, you get to live in them. How much house can you afford? Many lenders recommend total monthly housing expenses (mortgage payments and maintenance) account for no more than 28% of income. When reviewing estimates, be sure they represent the total monthly cost and include items such as property taxes, insurance premiums, mortgage insurance, association dues, etc. Spending a bit more – say up to 33% - may not be a bad idea, but only if other areas of fixed debt can be reduced to keep the DTI ratio under 36%.

SCHOOL LOANS

Money spent on higher education is generally a good investment. Earning a degree can enhance career prospects and increase earning potential, but piling on too much student loan debt can do more harm than good. As tuition continues to increase, it's becoming more expensive to earn a degree. As of 2012, the total estimated annual cost (includes in-state tuition, fees, room and board) to attend the University of Nebraska–Lincoln is $17,230 (source – *CNN Money*).

So how much is too much student loan debt? It's difficult to calculate a DTI ratio as monthly payments will vary depending on the terms of the loan and there is no way to accurately predict future earnings. A ballpark amount can be calculated assuming payments of 10% of gross income averaged over a ten year time span. In other words, an individual who assumes they will earn a total of $500,000 during the ten years following graduation should limit themselves to $50,000 in total student loans.



Again, it's difficult to calculate a DTI ratio for the above scenario but chances are good the monthly payments will consume at least 15% or more of take home pay. As wages increase over time this percentage will drop, but other fixed debt should be limited during the initial years following graduation to keep the total DTI ratio under 36%.

CAR LOANS

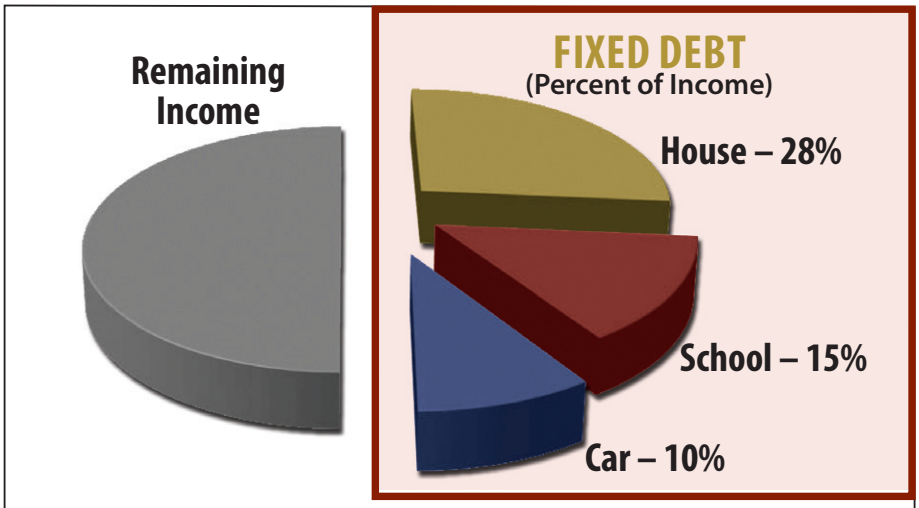
Cars are poor investments. Unlike a properly maintained home, the vast majority of cars will decrease in value over their lifetime. Americans love cars and we often spend more than we should on them. Many auto industry "experts" recommend car payments consume no more than 20% of monthly income. This is too much to allocate on an asset that will depreciate in value. To compound the issue, if mortgage payments are at 28% of income, adding another 20% of debt pushes the DTI ratio to 48% - and that doesn't include any school loan payments.

To give another perspective, the total purchase price should not exceed one-third of gross annual income. An individual making $30,000 a year (pre-tax) should spend no more than $10,000. Monthly payments vary depending on terms of the loan but generally this will result in a 9% to 11% DTI ratio.

THE TOTAL DTI RATIO

Many individuals will carry mortgage, auto and school loan debt at the same time. If they follow the above guidelines of 28% for the house, 15% for school loans, and 10% for car loans – this will put them at a DTI of 53%, well over the 36% limit. Generally the mortgage and auto are the two areas of fixed debt that can be adjusted until the school loan is paid off or the salary increases.

Of these three, the car should be the first target when attempting to reduce the percentage of DTI. Individuals with no mortgage payments or school loans (or other forms of fixed debt) may be tempted to spend more than the amount recommended above but this is not a sound financial decision. Any extra income is much better spent creating a pool of money that can be used for a down payment on a future home purchase, paying for tuition, or saving more for retirement.



The recommended percentage of fixed debt is 36%. Home mortgages and car loans may need to be adjusted until school loans are paid off or salary increases in order to attain the goal of 36%.