Budgeting Basics

Knowing your income, expenses, and perhaps most importantly, your priorities, allows you to pursue multiple financial goals while still managing your day-to-day life. There are simple yet impactful budgeting principles that can help you manage your finances.

Understand Your Income

Before determining how much you can spend, it is essential to have a strong understanding of your monthly income. Your monthly income is the money after taxes that hits your bank account each month, which informs how much you can spend without taking on debt. Budgeting within your monthly income allows you to maintain control of your finances, avoid expensive debt, and live within your means over a long period of time.

Important questions to ask when determining your monthly income include:

- How much will I earn each month after taxes and other withholding?
- What is the schedule of my payments?
- Will my income be consistent month-to-month?

Prioritize Expenses

Next, categorize your expenses into needs vs. wants and fixed vs. variable to prioritize your payments.

	Fixed: Expenses that remain constant every month	**Variable:** Expenses that may change each month
Needs: Expenses that are necessary each month for survival	• Rent/mortgage payments • Utilities • Internet/phone • Insurance (e.g., car, renters, pet) • Loan payments • Medications	• Groceries • Gas/transit costs • Car repairs • Medical copays • Pet expenses • Savings
Wants: Expenses that you desire but can live without	• Streaming subscriptions • Gym memberships	• Outside food/delivery • Personal shopping • Events/travel • Gifts

It is recommended to pay expenses in the following order:

1. **Fixed Needs**
2. **Variable Needs**
3. **Fixed Wants**
4. **Variable Wants**

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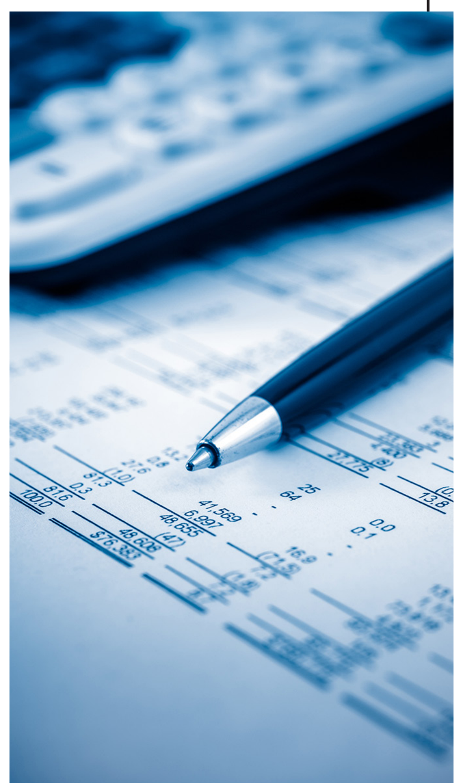
By fulfilling needs before wants, you ensure your basic living requirements are covered each month. Next, prioritize fixed expenses over variable because you may have flexibility to reduce your variable expenses based on your monthly needs. For example, pay rent before groceries because, if you find yourself short one month, you can decrease your grocery bill with what meals you prepare and what brands you get.

If you are finding it difficult to afford your total monthly expenses, review your expenses and look for ways to reduce or eliminate some altogether, even if it's temporary. For example, you might skip the order takeout for dinner until your emergency fund has been replenished. Additionally, take a closer look at your variable expenses to determine how much each fluctuates and how they can be controlled. Each variable expense will have a range so opt to use the higher number for your budget to prepare for the worst-case scenario in a month.

Budgeting Methodologies

1. **The 50/30/20 Rule**

   There are many budgeting methods, but one of the most common is the 50/30/20 rule, which suggests allocating 50% of your monthly income to needs, 30% to wants, and 20% to savings. This template is proportional to your monthly income and can serve as a benchmark for your current spending habits. If you spend more in one category than another, understand where that money is taken from and if that can be adjusted to suit your long-term goals.



2. **The 80/20 Rule**

   For some, simpler is better. The 80/20 rule allocates 80% of monthly income to spending and 20% to savings. This stripped-down version of the 50/30/20 rule makes tracking purchases easier and assists with mental budgeting in the moment.

   This rule also reduces confusion when the line between needs and wants blur, such as buying gas for a road trip to see family. With this example, the 50/30/20 rule would have difficulty classifying the expense as a need or want. With the 80/20 rule, it would fall under general spending category.

3. **The 50/15/5 Rule**

   Life can be unpredictable, so you may need more flexibility with your budget. The 50/15/5 rule allocates 50% of your monthly income to needs, 15% to retirement savings, and 5% to an emergency fund. The remaining 30% is up to you to decide what fits your goals.

   This rule is similar to the 50/30/20 rule but allows you more control over what is considered a "want." If you would prefer to pay off a student loan as soon as possible, you can include that in your flexible 30% category. Alternatively, if you are aiming to save for a new car or a down payment for a home, you can also save towards that.

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Tips and Tricks

1. Automate Your Savings

Minimizing the amount of action you need to take to contribute to your savings is a great way to become a good saver. By setting up an automatic, recurring bank transfer between your checking and savings account, you can reduce the temptation to spend those funds. Additionally, if you are paid through direct deposit, you can have a portion of each paycheck automatically deposited into your savings account.

Treating savings like a mandatory bill payment can create a separation of funds that encourages saving and discourages unnecessary withdrawals.

2. Name Your Accounts

Most financial institutions allow you to edit the names of your accounts and you can name them for specific purposes, such as Emergency Fund, Personal Care, Pet Care, and Travel. Separate accounts help to visually see how much you have saved for specific purposes and if you need to save more into an individual category. Naming the accounts also deters you from pulling the funds for unrelated expenses.

3. Sinking Funds

At the crossroads of automating your savings and having funds available for unplanned expenses, you can also automate savings for planned expenses to build up funds over time. For example, if a flight home for the holidays will cost $500, you can set up an automatic deposit for $42/month so that the funds are available when you need them.

Saving over time can be more feasible for many, and it can be helpful psychologically to see the money in a separate account as a way to track progress towards savings goals. This philosophy applies to other expected expenses as well like entertainment, personal care, and large purchases.

4. Needs vs. Wants Card

Once you've established your budget and know your target spending budget, it can be helpful to track your spending by dedicating one account or card to each category. You may use one credit card for your needs and another card for your wants.

Not only does this help you keep record of how much you have spent in each category, but you can also optimize credit card rewards based on the category. For example, one credit card may offer better rewards for groceries than another and can be your needs card, while a travel rewards card could be for your wants.

Keep It Simple

Setting up a budget doesn't have to be a complicated process. You can use Microsoft Excel to build a free spreadsheet to document your income and expenses. Alternatively, budgeting tools like Every Dollar or Tiller offer comprehensive platforms to track your money.

Once you track your spending habits over a few months, review your history and create an ideal monthly budget for each expense category. Use these values as a benchmark to determine when you are over or underspending. Review your spending patterns quarterly, ensure they align with your budget, and adjust as needed to satisfy your goals.

Find what works for you and stick with it. Starting good habits early will set you up for success in the long run.

The Importance of an Emergency Fund

There is no single definition of an "emergency" as it should be based on that is most important to you. An emergency may be a sudden layoff, unexpected veterinarian visits for pets, or flights for family events to name a few.

These abrupt needs can be one-time events or can last for multiple months. It is recommended to have enough saved to feel comfortable sleeping at night, often 3-6 months of need-based expenses available in a liquid savings account. This includes rent, groceries, and transportation costs.

For many, it is difficult to save this much money at once. Therefore, you should add to your emergency fund over time and consider depositing any work bonuses or tax refunds you receive. The goal is to leave this money untouched until a true emergency occurs.

If you have any questions, please reach out to your D.A. Davidson financial professional.