Where Should I Save My Next Dollar?

It can be hard to know what to do with your next dollar to make the most progress when pursuing multiple financial goals at once. Perhaps you want to save for retirement, pay down your student loan debt, and would also like to own a home one day. Your priorities and flexibility will change throughout your life as your personal income and resources change; however, there are a few things to consider first that can help you make the most of your money, no matter what stage of life you are in.

Keep in mind that this does not replace professional financial advice nor is it a doctrine, but more of a guideline. Your financial professional can help you tailor your savings order to your needs.

1. Small Emergency Fund: Cover Your Deductibles and Co-Pays

As a precaution, most people carry insurance for the three largest, and possibly the most impactful, incidents in your financial life: health, home, and auto. Insurance is intended to offset some of the cost when an unexpected or sudden expense occurs so you don't suffer a financial setback. To effectively use your insurance policies during an emergency, you need enough money readily available to cover your insurance deductibles and co-pays. If you cannot meet your deductible, insurance won't be available to you, even if the event is covered. Without insurance, you will have to pay out of pocket and spend down your emergency fund or take out unwanted loans or debt.

Emergency funds are most often held in a savings or checking account for timely access during an emergency. Availability is key. You can also consider a high yield savings account to earn additional interest, but avoiding a certificate of deposit (CD) for at least a portion of your emergency funds is important to avoid early withdrawal fees, despite the potential for higher interest. See also #4.

2. Maximize Your Free Money: Employer Match

To further your savings goals, take advantage of a benefit many employers offer to attract and retain top talent: employer matching. Employers can choose to save for your retirement alongside you and match your contributions to your retirement account. This is often done one of two ways: partial matching or dollar-for-dollar matching.

Partial matching often reads something like "50% match, up to 6% of your salary" or "50%, up to 6%." In this example, your employer will deposit half of what you contribute, up to 3% of your salary. If your salary is $50,000 and you contribute 6% ($3,000) to your 401(k), your employer will deposit 3% ($1,500). You can contribute less than 6%, but to make the most of the "free money," you must contribute 6% to get the additional 3% in this example.

Dollar-for-dollar matching is similar in that employers will have a contribution limit (e.g., 3% of your salary), but they will match 100% of your contributions until you get to that limit. If your salary is $50,000 and you contribute 3% ($1,500), your employer will also contribute 3% ($1,500).

Not only are matched contributions free money from your employer, but they also grow tax deferred. This means earnings are not taxed until withdrawn from the account, which allows for a bigger balance to grow over time. Additionally, contributions are taken directly from your paycheck, so they reduce the potential of accidentally spending the money instead of saving.

3. Pay Off High-Interest Debt

There is not a strict definition, but generally high-interest debt is anything with an interest rate that exceeds the average interest rates for mortgages and student loans. The most common forms of high-interest debt include credit cards and personal loans. Without careful management, high-interest debt can compound very quickly, having a large, negative effect on your finances. When paying down high-interest debt, focus on the account with the smallest balance first. As you pay off a debt and shorten the list of debts you owe, you can increase your payments on the remaining debts. This method has shown to have a positive impact mentally and improve good financial habits.

While it may be necessary to take on high-interest debt in some situations, you should avoid accumulating new high-interest debt when possible. When using a credit card, set calendar reminders to check your balance twice a month and pay down any new purchases as soon as you can. Treat your credit card like a debit card, and only spend money you already have in the bank. Lenders typically prefer credit utilization rates below 30%.

4. Larger Emergency Fund: 3-6 Months

Emergency funds (in excess of your deductibles and copays) are often a first stop in financial planning because they allow you to protect the progress you will make along the way. 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 family health emergencies, to name a few. For many, it is difficult to save this much money at once. Add to your emergency fund over time and consider depositing any work bonuses or tax refunds you receive. The goal for this money is to avoid high-interest debt should an emergency arise.

How much? As a general rule, is recommended to have 3-6 months of total living expenses that you can easily access (via savings account, checking, or high-yield savings. See #1). This includes rent, groceries, transportation costs, and other non-negotiable expenses. You may choose to save more or less depending on your capacity for risk and ratio of income to expenses. These abrupt needs can be one-time events or can last for multiple months.

You may find it helpful to open a new savings account specifically for your emergency funds to create a separate pool of money aside from your usual spending money. If your financial institution allows, give your accounts a name to further reinforce their purpose, e.g., Emergency Fund, New Car Fund, Patio Repair Fund, etc. This can help reduce the feeling of availability and discourage early withdrawals.

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5. Maximize Your Roth IRA and Health Savings Account (HSA)

Both Roth IRAs and HSAs have tax advantages, including tax-free growth. This benefit allows you to withdraw funds tax-free for qualified distributions.

To make the most of your benefits, you should aim to contribute to your Roth and HSA each year up to the annual maximum contribution amounts. Roth IRAs have contribution limits based on your income, so if you are a high-income earner, you may not be able to contribute to a Roth IRA. Talk to a financial professional to discuss which option may be best for your situation.

6. Maximize Your Retirement Contributions

After getting the employer match in your employer plan and using accounts with tax-free growth for retirement (Roth IRA) and health-related expenses (HSA), the next step is to seek to contribute the maximum amounts to your retirement accounts. By maximizing your annual contributions, you reap the compounding benefits and tax-deferred growth of your employer plan and/or Traditional IRA.

IRA contribution limits are shared between Traditional and Roth IRAs. If you contribute to your Roth IRA, you will have to contribute less to your Traditional IRA for that tax year. Conversely, if you were not able to contribute to a Roth IRA due to the income limit, then you can fully contribute to your Traditional IRA.

7. Save for Other Important Goals

In addition to retirement, you may have other goals you want to save for in the short to intermediate future. Create a good saving habit by treating your savings goals like an expense in your monthly budget, just like a credit card payment or your grocery bill. A common budgeting method is the 50-30-20 budget, which means allocating 20% of your monthly income (after taxes) to savings goals. Having goals to look forward to, such as travel or a large purchase, can help motivate you to reduce overspending on smaller purchases day to day.

Break up your short- and intermediate-term goals into bite-sized pieces by committing to a dollar amount and time frame. For example, if you've always wanted to visit Greece, consider things like the cost of airfare, lodging, meals, and activities. If you commit to saving $3,500 and want to take this trip 18 months from now, save $194 per month ($97 per paycheck if you're paid bimonthly). You can even create a Travel Fund savings account and set up a portion of your paycheck to be deposited automatically.

8. Diversify Investments

Outside of checking, savings, and retirement accounts like IRAs, there are other investment vehicles that can diversify your overall portfolio. Two common options are brokerage and advisory accounts. These accounts allow investors to participate in financial markets by buying and selling stocks, bonds, and other holdings. Unlike with IRAs, investors are taxed annually on any earnings or income made in the account. Also consider how you will access your savings if you retire early, as many retirement accounts have early withdrawal penalties.

Another investment avenue is real estate. Whether you are buying your first house or other forms of property, the value of real estate fluctuates with a variety of factors including location, regulations, and condition. You should research other properties in the area to understand the relative value before committing to the investment.

9. Prepay Future Expenses

Depending on your goals and aspirations, some future expenses can be prepaid in advance. These expenses may include saving for a home, a wedding, or a family. If you, a spouse, or family member plan to attend college, a 529 plan may save you money in the long run with tax-deferred growth and tax-free withdrawals for qualified education expenses.

Future expenses vary greatly by individual, so there is no hard-and-fast rule on how much to save in this category. These future goals tend to have longer time frames, so investing the savings into a brokerage, advisory, or high-yield savings account can help you accumulate the most while doing the least.

10. Pay Towards Low-Interest Debt

Low-interest debt includes most mortgages and student loans. Making the minimum monthly payments will pay off your low-interest debt over time. However, making additional payments (more frequently), applying additional payments toward the principal (more than the minimum), or both will reduce the total cost of the loan overall and free up those resources for other goals.

If you have multiple student loans, you can consolidate the loans into a single payment and try to lower your interest rate or begin by paying the loan with the highest interest rate first, while making the minimum payments on the rest.

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