

Saving for the Future

The basics of saving for the future are to

1. Determine what kind of life you want to live and examine ways to accommodate the future in your present
2. Examine your current financial situation
3. Take note of any goals you may have for the future
4. Make adjustments to your lifestyle based on what your goals are

What kind of life do you want to live?

Do you want to live a life where you eat out often? Or spend a lot of money on shows & other forms of entertainment regularly? Would you prefer quiet nights at home and borrowing books from the library? Do you like to cook or have your meals be pre-prepared?

All of those preferences and decisions are fine. Just know that every decision, regular habit and recurring expense is going to shape the way that you save for your future and the kind of future you'll have. Essentially, the more you spend of your income now - the less you'll have for later. That being said, you shouldn't sacrifice the core things that make you happy. Generally, you should be able to reduce your expenses to a certain point without losing the things that spark joy (thanks Marie Kondo!).

For example, let's say you have an awesome group of friends that you hang out with regularly. Those hangouts generally compose of going to a great restaurant where lots of delicious food and compelling alcohol is consumed. These nights bring you and your friends a lot of happiness and foster an ever deepening friendship. The downside of these nights is that it runs at about \$60 per person every time you go.

An example of reducing expenses without losing what makes your life wonderful would be to take on hosting those friend nights at your place (or take turns hosting) and experiment together with cooking meals that you can still enjoy. Plus, alcohol is much less expensive when not being purchased at a restaurant, :). That way you can still hang out together, learn to cook and even expand the range of activities you do together (board games, video games, cards, movie nights).

This sort of thinking can be applied to many situations. What is it about an activity that makes you enjoy it so much and spend money on it regularly? Is there a way to get that same enjoyment at a reduced cost? Sometimes the answer is yes. Sometimes the answer is no. But you can examine your major expenses and adjust accordingly. You may be surprised at how much progress you can make. You may even learn some new things in the process!

By thinking through how you're spending you can live in the present while taking into account the future. It is a bit intimidating, but every dollar spent now is a dollar that you can't put towards your future self (and have grow alongside you in the form of investment returns). You'll want to balance things in order to avoid over committing to one or the other (present or future). I'm still figuring out that balance myself!

How are you currently doing financially?

So you've thought about what kind of life you want to live and where your major sources of expenses might be coming from. Here's the fun part. You'll get to look at the actual data tied to the decisions you're making and see if your assumptions line with reality.

What you'll want to do is figure out how much money you are getting after withholdings from your paycheck and then see how much of that you are spending on a monthly basis. Hopefully, you're spending less than you're earning post tax (if you're not, you'll need to consider if you need to dial back things in order to live within the limits of your current income).

Once you have your post tax income (the money that shows up in your bank account after every paycheck) you can see how much of that money tends to go towards expenses and how much you have left over. That amount of money in % percentage form (e.g. \$1000 post tax, \$400 after expenses would be 40%) is what people typically refer to as their savings rate (https://www.reddit.com/r/financialindependence/wiki/faq#wiki_how_do_i_calculate_my_savings_rate.3F). Some people like to track savings rate and find it motivating to see it increase as they make changes or keep their spending flat even when they're getting raises.

The next step is to dig into your expenses to better understand how you come to that savings rate number. It may be helpful to use something like Mint (<https://www.mint.com/>) or Personal Capital (to import your transactions and bunch them into categories. If you'd rather not sign up for a service and share your information it is totally doable to download transactions in CSV form and play around with them in a spreadsheet (typically I use Google Sheets or Excel for this).

Once you've roughly categorized your expenses you should be able to put together a breakdown that looks something like this.

Post tax income (monthly) - \$3000
Rent - \$1900
Utilities -\$ 100
Food - \$400
Entertainment - \$100
Travel - \$200
Health and Fitness - \$75
Transportation - \$150

This sample breakdown sums up to monthly expenses of \$2925 which leads to a 2.5% savings rate. Once you have this big picture you can dig into what you should do next. For example, in this scenario we're dangerously close to spending past what we're earning on a monthly basis. Given how big of a contributor Rent is, we might want to look into that category first and see if there are improvements to be made.

Some additional categories that you might include could be things like Children and Education. You may also want to break categories down further depending on where your expenses are coming from. For example, if you buy groceries and spend a lot on eating out it could be good to break those down separately in order to better understand where your spending is coming from (too much eating out vs. spending too much on groceries).

For significant intermittent expenses that don't come up monthly (like Travel) you can average them out on a monthly basis based on spending over the course of a year. Your expenses will vary based on your situation and your treatment/examination of them should as well!

Once you're at a good point with regards to your spending vs. what you're earning on a monthly basis you can then look at where your excess money should be going!

Do you have any big goals for the future?

Do you want to buy a home for yourself at some point? Return to school? Have a kid? Go on a long trip? Retire by a certain age? All these things require a decent amount of money to be saved up in order to be pursued successfully. With that in mind, it is helpful to think about how you might get there and how long it will take.

There are a few components to planning savings for goals in the future

- How much do you need to meet your goal?
- When will you need the savings to be available for your goal?
- At what rate will you need to draw down from those savings to attain what you've been saving for?

How much do you need to meet your goal?

For example, if you're looking to buy a house you might consider roughly what kind of house you'd like and what sorts of areas you'd be interested in buying in. With a bit of research you can settle in on a rough range of prices you'd be willing to consider and then decide on how much of a down payment it makes sense for you to put down upfront. With that in mind,

you'll know how much you'll need saved by a certain point in time and you can start planning towards it.

Let's take the purchase of a \$500,000 home for example.

Using a 20% down payment as our baseline (lower interest rate, avoids PMI - https://www.reddit.com/r/personalfinance/comments/7poswg/how_much_is_an_actual_reasonable_down_payment_on/) we'll need \$100,000 on hand when purchasing the house. We should add another \$15,000 in closing costs for the various things you need to pay for when buying a home (inspection, agent fees, lawyer, etc - <https://www.nerdwallet.com/blog/mortgages/really-costs-buy-home/>).

At that point it just becomes an equation to determine at which point you'll be able to reach your goal. Take your excess, post-tax income that you're saving on a monthly basis (let's use \$3000/month for simplicity) and divide your savings goal by that (in this case, $115/3 = 38.33$ months or almost 4 years).

Seeing how long it will take you to save up to your goal may provide you with an impetus to reexamine how you're spending money in order to get there quickly, give you some encouragement that things are more attainable than you thought or lead you to decide to focus on other goals in the meantime.

For something like saving up for a house, you may be looking at a long time horizon which leads into my next question.

When will you need the savings to be available for your goal?

Generally, as you're saving you should be putting money into your chosen allocation of index funds (more on that later) but you may want to alter how you're saving up money based on when you're anticipating you'll be needing it.

In the case of saving up over the course of 4 years for a downpayment for a house you'll likely want to choose to save your money in a form that makes sense in relation to your time horizon. If you take the simple math that we did previously, $\$115,000 / \$3,000$ per month you get 38.33 months. However, it isn't quite that simple as there are a few things that could lead to a different outcome.

Given that you're waiting 4 years before you have enough money to buy this house:

- The cost of the type of house that you're interested in could change between now and four years from now
- Your money could increase (or decrease) over time depending on how you've decided how to save (or invest) it.

Which brings us back to a form of storage for your money that makes sense for you and your situation. In the case of a house that takes a long time to save up for, you'll probably want it to be in a place where it is working for you (i.e. earning returns) while you're working toward your goal.

Generally, when it comes to investing money you'll want to find the investment opportunity that matches your risk tolerances. Riskiness of your various money storage options are as follows (least risky to most risky):

- Cash holdings (checking account, actual cash on hand, etc)
- Bonds
- Stocks (also known as equities)
- Real estate
- Private company shares

Another rule of thumb is that, the more diversified your investment is, the less risky it becomes. So, even though stocks are generally riskier (and provide higher returns) than bonds, holding a stock index fund could be less risky (and provide a lower return) than an individual bond.

With that in mind, you may want to pursue a strategy where you put your money into more volatile investment types earlier on as you're saving up and gradually move into a less risky allocation as you get closer to your savings goal (and to wanting to be able to actually spend the money you've been saving up).

In the case of saving up for this house, you could do the following:

- Invest in equity index funds (100%)
- Invest in equity index funds (50%) and bond index funds (50%)
- Sell your investments and move your money into a high interest savings account or term deposit (if you know exactly when you'd like it to be available)

With this strategy, you'd be able to get much higher returns on your money as you're saving up vs. storing your savings exclusively in cash (see this chart - <https://novelinvestor.com/asset-class-returns/> - to see how returns tend to vary by asset class). However, there is a downside as there is always a chance that your investments will decrease in value as you're saving up. We're trying our best to mitigate that risk by reducing the risk of the holdings as we approach wanting to make use of them but you can never guarantee returns from an investment (despite what anyone tries to tell you).

In short, depending on how long you need to save for to reach your goal you should invest in appropriately risky asset classes in order to make use of the returns you can earn on your money over time. As you get closer to your goal it's best to reduce the risk of your investments to avoid too much fluctuation and end up missing your target (in terms of the timeline you are aiming for).

Do you want to make any adjustments to the way you're doing things?

Now that you've thought through what kind of life you'd like to live, your current financial situation and goals you'd like to reach in the future. You might want to make adjustments to the way that you're currently doing things in order to get to where you'd like to be. You may also be perfectly happy with the way things are, but if you've never thought about this sort of stuff before it is likely that you'll want to make at least a few changes.

If you're facing a scenario where you're not progressing towards your goals at a rate that you'd like to you might make some of the following changes:

- Change of career for better hours, benefits or pay
- Reduction in non-core expenses (eating out, entertainment, etc)
- Change living situation to reduce costs (move to a smaller place, get a roommate, etc)
- Shed unneeded assets and services (car that you don't frequently use, subscriptions that you're paying for but not using, etc)

You might also not be moving along at the pace that you'd like but uncertain of where you can make changes without ending up unhappy/sacrificing too much in your life. That's fine too. Now that you're aware of the pace that you're moving at and where you'd like to be you can use that to make more informed decisions about how you choose to live your life!

Keep looking for ways to live smarter and get to where you want to be without giving too much of what makes you happy in the present moment. You'd be surprised by what you can find when you start looking at and paying attention to the choices you make.