Examining Financial “Rules” of Thumb

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Some of the most common financial advice deserves a ‘thumbs up.’ But others, not so much.

It’s summertime and the living is easy—but maybe not where your personal finances are concerned.

The “rules” of finance—whether pertaining to how much to pay in taxes, how much to contribute to your retirement plan, and even how much you can give your kids gift tax-free—seem so convoluted. “Why,” you ask as you lounge in your deck chair, “does money management have to be this complicated? All this world needs is another cool drink and some simple financial ‘Rules of Thumb.’”

If you are a regular reader of this blog, you already know that financial planners are apt to take a dim view of such rules of thumb. CFP® professionals are trained to look deeply and comprehensively at each individual’s situation before making any recommendations. By contrast, financial advice meant for the “average” person is usually just that: average. It’s not good enough to nail that worry-free retirement, the dream of a small business, or paying for kids’ education.

But given that many Americans are all thumbs at money management, I will concede that there are a few general rules that provide useful direction, even if they are not sufficient to get consumers to their ultimate destinations. By the same token, there are other rules of thumb that, in my opinion, have too many exceptions to be very helpful.

So in the spirit of keeping it light and simple for the summer, here are my “THUMBS UP” and “THUMBS DOWN” evaluations of the most common “Rules”:

“RULE” OF THUMB: *Subtract your age from 100 to get the percentage of stocks you should hold in your portfolio. The rest should be in fixed income.*

THUMBS DOWN! This assumes all individuals of a given age are financially identical. Your portfolio allocation needs, at very least, to also take into account the size of the portfolio. An 80-year-old millionaire probably does not need to hold 80 percent in low risk bonds, when those assets will likely never be used by him, but rather by his younger heirs. Those who have ample retirement pensions may also be exempt from this rule, even if their portfolios are far more modest.

“RULE” OF THUMB: *A good plan for retirement is to have 7 to 10 years of annual living expenses always available in cash, short-term bonds and/or guaranteed income.*

THUMBS UP! This ensures a retiree has ample liquidity to get through a down period in the financial markets, without having to sell stock holdings. It also gets to the heart of the retirement issue: namely that retirement success depends on the level of your living expenses.

“RULE” OF THUMB: *You’ll need 80 percent of your earnings for annual expenses in retirement.*

THUMBS DOWN! This old rule needs retiring. Today, many people retire to an active lifestyle. They travel, go back to school, remodel their homes, and therefore spend more than when they were working. Then there are escalating medical costs, combined with the likelihood that we’ll be paying more of those costs out-of-pocket. A better approach? Throw out the rulebook in this instance and do a bottom-up, rather than top-down, analysis of your actual retirement expenses.

"RULE" OF THUMB: *You can afford a house 2.5 to 3 times your annual income.*

THUMBS DOWN! This rule falls short in many ways. There are professionals with seven-figure incomes who cannot afford a $500,000 home and there are couples just starting out who thrive on the financial discipline of stretching to pay for a home that is four or more times their income. Affordability is not necessarily a function of income, but what people do with that income.

"RULE" OF THUMB: *Your total debt should be 36 percent or less of your gross income.*

THUMBS UP!: This is a better "affordability" rule than the previous one, and is often used by banks to determine how much of a mortgage—and thus how much house—you can get. It also takes into account the fact that two people with the same income can look very different financially, depending on their liabilities.

"RULE" OF THUMB: *Financial success requires living within your means.*

TWO THUMBS UP! This is a true golden rule of personal finance and comes as close to being a universally applicable rule of thumb than any other. Even I, with my professional training, resort to this rule to give me an instant read on an individual's ability to meet financial goals. If I see someone who invariably consumes less than they make, it's almost a sure thing that they will be financially secure, regardless of their level of income or size of their portfolio.

Now for that cold beverage? **THUMBS UP!**

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