Motley Fool's *Rule Your Retirement* Newsletter

Financial Rules of Thumb

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I know you're not lazy. But if you're like most people, you appreciate a good shortcut. Also, you have a thumb.

The phrase "rule of thumb" has been around for centuries and has equivalents in many languages; my favorite is the Danish "tommelfingerregel." In some countries, the thumb isn't enough, so they use the "rule of fist" ("Faustregel" in German), whereas in Persian, a "fingertip's rule" is good enough. The source of the phrase isn't exactly known, but it was probably used by builders as a means of measurement. Why get out a ruler when you have stick-like things hanging off your hand?

Just as using a body part to measure length won't be as accurate as using a tape measure, financial rules of thumb may not provide the precision of deeper analysis or fancy software. But sometimes precision gives a false sense of security, and it's fine to take a best guess and move on to more productive uses of your time.

Use your Foolish wisdom in determining whether a financial rule of thumb is good enough for your situation. But before you do that, get to know some of the most common ways to use your opposable digit to analyze your financial digits.

How Much You Should Be Worth

If you added up the value of all you own — your portfolio, your house, your more than 18,000 owl-related items (as possessed by Pam Baker of Leeds, Maine, who holds the Guinness world record for her strigine collection) — and then subtracted your debts, you'd have your net worth. Given all you've earned, bought, and invested over your life, is your net worth where it should be?

To help answer that question, authors Thomas Stanley and William Danko proposed the following formula in their book *The Millionaire Next Door*:

Target Net Worth = Age x Annual Pretax income ÷ 10

For example, a 40-year-old who earns $100,000 a year should have a net worth of about $400,000, a 50-year-old earning the same amount should be worth $500,000, and a 60-year-old with that six-figure income should be worth $600,000. Stanley and Danko came up with the term "prodigious accumulator of wealth" to describe a person whose net worth exceeds the figure calculated using that formula; an "under-accumulator of wealth" is someone who doesn't meet that mark.

There are many reasons this formula (and its judgment) could be misleading, starting with the presumption that the past year's income is indicative of your earnings over your career. But it's still an interesting starting point.

How Much You Should Spend on What

Life is full of things to buy, and there are many thumbs with rules on them about those purchases.

- **Overall budgeting:** Devote 50% of your income to necessities (taxes, mortgage, food), 30% to discretionary purchases (entertainment, vacation), and 20% to future financial goals. People who live in higher-cost areas or pay more in taxes might have to bump up the allocation to necessities to 55% or 60%. This rule of thumb is also helpful for people with variable incomes; they immediately allocate money to savings and necessities, and only then does the "discretionary" account (and it's often an actual separate account) get funded.
- **Buying a home:** The price you pay shouldn't be more than 2.5 times your annual income. I've heard variations that apply that rule to just the size of the mortgage, not the price of the house. That might be necessary in high-cost parts of the country or if you have a bigger family.
- **Buying a car:** The most common rule of thumb is 20/4/10: Put 20% down, get loan that will be paid off in four years or less, and don't get a payment that exceeds 10% of your income. Another: If you plan to own a car for more than 10 years, buying new may be better than buying used.

How Much You Need Before You Retire

You may have heard that you need 20 to 25 times your gross income before you can retire, and it's not bad advice. For most people, 20 is good enough when you consider that expenses drop in retirement (you're no longer contributing to your 401(k) or paying Social Security taxes). Even if you need the same amount of income after you retire, some of it will be provided by Social Security (all those taxes are finally paying off!), a pension, or other sources. And even if you don't consider those sources and your income needs don't drop in retirement, having 20 times your annual income means you'll need 5% of your portfolio each year. That's higher than that 4% safe withdrawal rate (another rule of thumb!) you hear about, but as we've written, 4% might be playing it too safe, especially if you have the flexibility to cut costs when times are tough.

How Much Life Insurance You Need

I've used many life insurance calculators available on the Web. They seem useful because they allow you to include how much you have in your bank and investment accounts, how much household expenses would drop when a person passes away, how much the survivors would get from Social Security, and other factors. The problem is that the results can vary significantly from tool to tool. So I often fall back on this rule of thumb: Get a policy that is 10 times your annual income. That should keep your family secure for a while, especially because life insurance proceeds are tax-free. If a member of the household is a stay-at-home spouse taking care of the kids, that person should get a policy that is 10 times the amount it would take to hire people to provide the services the spouse is currently providing.

Keep in mind that life insurance is usually only necessary if there are people relying on your income, such as kids, infirm relatives, or a non-working spouse. So older folks whose kids have left the nest (or soon will) may need a policy that's just 5 times their annual salary, if they need insurance at all. The big exception is if a qualified estate-planning attorney recommends that life insurance be a part of your estate plan.

How Big Your Emergency Fund Should Be

You've probably heard that you should have a three- to six-month emergency fund in safe, accessible cash, assuming you didn't fall asleep from overwhelming boredom because it's the least exciting financial advice in the world. However, despite the mundanity, many folks don't agree on what it actually means. Are we talking three to six months of expenses? Income? And is that pre-tax or after-tax? Here's our take: The amount should be based on monthly, must-pay expenses — you know, food, shelter, health care, and so on. You can adjust the number of months according to your family and financial situation. If you don't have dependents or a mortgage, then you might not need as much cash on hand.

How Fast Your Portfolio Will Double

Yes, we've come to one of the most well-known financial rules of thumb: the rule of 72. Divide 72 by the return of your portfolio, and you'll get the number of years it will take for your current portfolio (not factoring in contributions or withdrawals) to be twice as big. For example, if your investments earn 8% annually, you'll have twice as much money in nine years. Conversely, you can use it to determine what you need to earn to double your money in a certain number of years. Want twice as much in five years? Then you need to earn more than 14% annually.

Although the rule of 72 is very popular, it's also an example of how a rule of thumb isn't perfect. For example, let's say your investments earn 72% this year (congrats!). Following the rule, you'd divide that return by 72, giving you 1 — which is the number of years it would take for your portfolio to double. But if you want a portfolio that's twice as big a year from now, you have to earn 100%. The rule of 72 is a fine guideline in middle-range scenarios but begins to falter as you get to extremes.

The same can be said of most rules of thumb. For situations in which your life isn't that much different from everyone else's (even though you are more attractive and drive better than the average person ... just like everyone else), rules of thumb can be both time-saving and helpful. But the more unique your situation, and the bigger the decision ("Do I have enough to retire?"), the more you should dig deeper and use fancy software, no matter how fun it is to say "tommelfingerregel."