

Budgeting

Where are you now?
Where are you going?
Where do you want to go?

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What is a budget?

- ❑ A budget is a document for recording actual and projected income and expenditures over time
- ❑ A budget forces you to consider
 - What's important to you?
 - ❑ Life is a series of trade-offs
 - Belonging to health club or eating at nice restaurants
 - Paying for your kids education or a new Ferrari
 - Retiring at 50 or enjoying work until 65
 - Having your spouse work or stay home with the kids
 - ❑ Stay-at-home parent makes equivalent of \$100,000 a year
 - Helping others less fortunate or helping yourself
 - Living in a comfortable house or a mansion
 - How do you want to live?
 - What will it take to accomplish your goals?

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The budgeting steps

- ❑ Budgeting is the **process** of setting financial goals, forecasting future financial resources and needs, monitoring and controlling income and expenditures, and evaluating progress toward achieving the financial goals

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Budgeting **process**

- Setting goals
 - Making life style decisions
- Gathering data
- Forecast future needs
- Implementing the budget
- Controlling your spending
- Evaluating your performance

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Setting goals

- Set long-term goals (1, 2, 5, even 40 years)
 - \$40,000 in 5 years for house down payment
 - To be debt-free by end of year 3
 - \$100,000 for college by daughter's 18th birthday
 - Stock dividends = 10% of your salary by age 50
- Annually review, change, add goals
- Set short-term goals (<1 year)
 - Pay off Visa in 6 months
 - **Need to be explicit** – otherwise of little value
 - YES => save \$3,000 by January for a new Shelby Mustang
 - NO => save for car down payment – too vague

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Example of a long-term goal

- Be able to buy a \$150,000 condo in 5 years**
- Assumptions
 - Condo now costs \$150,000
 - Housing prices will grow at 3%/year
 - Earn 4% on your savings
 - Want to buy in 5 years with 15% down
- What you need and how to get it
 - Condo will cost $150,000(1.03)^5 = 175,000$ in 5 years
 - Down payment = $.15 \times 175,000 = 26,300$
 - $26,300 = PMT(FVIF_a - 4/12\% \cdot 5 \times 12)$
 - $26,300 \Rightarrow FV .333 \Rightarrow i \ 60 \Rightarrow n$ solve $PMT = -396.69$
 - **You need to save \$400 per month, every month**
 - Round figures to make them more conservative

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Let's make a budget

- Tools you'll need
 - One Phillips head screwdriver (not included)
 - **Small notebook**
 - Green eye shade
 - You are required to dress like an accountant when doing accounting work
 - **Graph paper or Excel – either is OK**
 - **Calculator**
 - **Data**

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Gathering data

- Record all (<\$2.00?) your income and expenditures
 - Carry a small pocket notebook and jot them down
 - Could be a real eye-opener for you
 - Keep all credit card receipts – file them away
 - Keep all debit card receipts – file them away
 - KISS principle applies

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Page from your notebook

DATE	PAYEE/PAYOR	AMOUNT	NOTES
9 - 1	<i>Shady Pines Apts</i>	1,150.00	<i>Rent</i>
9 - 1	<i>Local (Groce)</i>	7.75	
9 - 1	<i>Gas</i>	45.80	
9 - 2	<i>Local (Ho)</i>	12.45	
9 - 2	<i>Wegman's</i>	85.79	<i>Sale on cat food</i>
9 - 2	<i>L.L. Bean</i>	56.80	<i>Flare top</i>
9 - 3	<i>Telly Ho</i>	12.50	<i>Tax to trans</i>
9 - 3	<i>Beth. School Dist</i>	1,312.50	<i>Pay check</i>
9 - 4	<i>Direct TV</i>	145.50	<i>Premium package</i>
9 - 4	<i>Gas</i>	44.00	<i>Exxon</i>
...
9 - 30	<i>Progressive Insur.</i>	214.89	<i>Budget plan</i>
9 - 30	<i>Beth. School Dist.</i>	1,312.50	<i>Pay check</i>

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Divide and conquer

- Income
 - Salary
 - Non-salary
 - Dividends, interest, odd-jobs, gifts, alimony
- Expenses
 - **Fixed**
 - **Variable**
- Savings – two schools of thought
 - Fixed “expense” – pay yourself first
 - Left-over residual after all other expenses
 - Problem is there may not be anything left over

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Fixed expenses

- Rent or mortgage
- Utilities
 - Consider “budget” plan of 11 equal payments plus a 12th adjustment payment (up or down)
 - AC in summer and oil or gas in winter (could be a shock)
- Insurance
 - Consider “budget” plan if several policies with same agency
 - Life, car, homeowners, personal liability – add up premiums and divide by 12

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More fixed expenses

- Property taxes
 - Usually required to be included as part of mortgage payment – **good idea!**
- School loans – usually at low rates
 - Don't be in hurry to pay off early
- Savings
 - **Good idea to pay yourself first**
 - **Don't treat savings as a passive left-over**

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Variable expenses

- Food
- Gasoline
- Clothing
- Health care
- Entertainment / vacations
- Personal and miscellaneous expenses

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More variable

- Cable
 - Pay for 6 or 12 months in advance to save
- Newspaper
 - Climb into the bins on the subway platform
- Health club dues – pay in advance to save
- Church donation

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After two months of data

- Organize and transfer notebook data
 - **Monthly** is best control period to use
 - Many expenses are monthly and you'll get paid monthly or semi-monthly
 - Could **use graph paper and make your own ledgers**
 - Could use Excel (after you've done it a couple of months)
 - Could use Quicken or Microsoft Money
 - Overkill in the beginning

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Using Excel to make a budget

- Transfer notebook data to Excel at end of each week
 - Have built-in sum formulas ready to go
- Use a system that makes sense to you**
 - Won't use it if you don't like it – tweak it over time
 - Add, subtract, combine categories

September										
FIXED EXPENSES				VARIABLE EXPENSES				TOTAL	Income	Difference
Rent	Insurance	School Loan	Savings	Trans & gas	Discretion	Entertainment	Utilities	Expenses		
1,100.00	214.88	179.36	300.00	44.00	82.50	56.00	60.00		1,312.00	
				110.00	42.00	34.00	88.00			
				199.00	207.17	218.00	58.00			
							128.50		2,654.72	2,625.00
										-29.72

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Projecting future cash flows

- Based on detailed records for a couple months of where your pay check went...
- Make initial budget estimates**
 - Make realistic (conservative) estimates
 - High on expenses and low on income
 - Round expenses up and income down
 - Use disposable take-home income
 - Gross minus all taxes and employer withholdings
 - Don't forget seasonal expenses
 - 8 nieces and nephews @ \$40 each = \$320 in December
 - Summer vacation \$1,000 – plan so you won't need to charge

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Too easy to rationalize one-timers

- Christmas only comes once a year
- Boyfriend's birthday comes once a year
- Ice hockey clinic is a great opportunity
- The shoes were on sale
- How often do I buy a new cell phone?
- Maybe allow for some "mad-money" but not too much
 - Could keep you on your financial diet if you can cheat once in a while

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Making some tough decisions

- Estimated expenses > estimated income
- Either raise income or lower expenses
 - Reduce eating out at restaurants
 - Walk to work
 - Buy used treadmill and quit health club
 - Work at health club nights and weekends
 - Cut back to basic cable
 - Drink tap water instead of beer
 - Buy solar powered Honda Civic

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Inflation and your budget estimates

- What if interest rates rise?
- \$200,000 house with 10% down
- \$180,000 mortgage for 30 yrs @ $i=5\%$
 - Monthly payment = \$966
 - $180,000 = PMT(PVIF_{i=5\%} - 5/12\% - 30 \times 12)$
 - $180,000 \Rightarrow PV \ 5/12 \Rightarrow i \ 360 \Rightarrow n$ budget for PMT=\$966
- 6 months later when you get mortgage @ $i=6\%$
 - Monthly payment = \$1,079
 - $180,000 = PMT(PVIF_{i=6\%} - 6/12\% - 30 \times 12)$
 - Actually need PMT=\$1079
- Need \$113 more each month

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Planning for intermittent bad things

- Holiday gifts, April taxes, summer AC bills, vacation, semi-annual car insurance
- Insurance and utilities offer budget plans to smooth out expenditures
 - Insurance – 12 **equal** monthly bills
 - Utilities – 11 **equal** monthly bills + 12th adjustment
 - You'll know in advance if 12th is up or down
- Vacation, gifts, taxes
 - Join vacation and Christmas clubs at bank
 - Essentially auto transfers each pay to specialized accounts
 - Make your own specialized sub-accounts

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Bank with Wachovia or the Buells

- I have \$150 automatically transferred each month to a Wachovia savings account used only for summer vacation
- I deduct \$150 each month from my checking account balance and put it in a "sub account" of checking for Christmas expenses
- I deduct \$125 each month from my checking account and put it in another "sub account" of checking for kids' clothing (hockey gear)

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Controlling your spending

- Try to control where the money goes – reduce impulse spending
 - How should you pay for stuff?
 - Checks – easy to keep records, not always practical
 - Cash – not always practical and easy to waste cash
 - Keep going to ATM for cash – lose control
 - Definitely record what you spent it on
 - Debit card – the way of the future
 - Very easy to lose control of your money
 - Must keep records of where the cash goes
 - Continually update checking balance
- Writing it down may cause you to think twice

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Two methods of control

- Keep running remaining balance of each budget category
- Use envelope system

Gas (Budget = \$120)			Balance
3-6	Shell	\$40	\$80
3-14	Mobil	\$25	\$55
3-21	Mobil	\$32	\$23

- Try to pay cash each time
- Put \$120 in envelope at start of month
- Can you take from the gas envelope to pay the Ho envelope?

Both of these seem very constraining to me and very unnecessary if you can discipline yourself to sticking to the budget and using common sense. Have to know yourself!

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Evaluating your performance

- Examine short-term goals and how you're doing
 - Need to reduce expenses and/or increase income?
- Adjust long-term goals accordingly
- Got a surplus?
 - Put into revolving savings fund to take care of seasonal deficits or put into real savings account
 - **Pay off credit card debt (highest interest)**
 - **Pay down mortgage**
 - **Put it in mutual fund**

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Budgeting observations

- Much of this module is overkill
- But still not a bad exercise to keep track of your expenses for a few months
 - Might find some surprises
- Having key goals is good idea
 - I want a down-payment for house in 5 years
 - Therefore, I need to save \$X a month
- Budget plans for insurance and utilities help prevent unexpected shocks

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More observations

- Automatic transfers to holiday accounts, vacations accounts, etc. help
 - "Sub-accounts" work for me
 - Easier to budget if you never see the money
- If you're disciplined, use common sense
- Being anal retentive about budgeting could make you wealthy some day
- It could also suck all the fun out of your life

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