012 - Where To Put Your Money - Transcript

Tim Mullooly: Welcome back to Living With Money. This is Tim Mullooly. Tom's here with me today.

Tom Mullooly: Hello, everyone. Welcome to Episode 12.

Tim Mullooly: Yep. Today, this episode is called Where to Put Your Money. There are a number of different accounts that people can have money in. A lot of people don't understand what the money in each account should be used for or what purpose it serves in your life, so that's kind of the point of today's episode is to break down what kind of money should be in what type of account.

Tom Mullooly: It's amazing to see how many folks come into our office, and they have nothing in a checking account but everything in savings or the opposite, everything in a checking account, no money anywhere else.

Tim Mullooly: Right. That's a good place to start because, for most people, you're going to have at least a checking account and a savings account, probably both, but at least one or the other.

Tom Mullooly: But they're really not the same.

Tim Mullooly: Right. A lot of people think of checking and savings accounts kind of as the same thing. They really shouldn't be lumped together. They don't serve the same purpose. It'll benefit you, really, to keep those accounts mentally and physically separate.

Tom Mullooly: There's still a lot of checking accounts that won't gain any interest whatsoever.

Tim Mullooly: Right. That's one thing to keep in mind when using your checking account is that the money that's sitting in your checking account is earning a whopping zero percent.

Tom Mullooly: This is really where you pay your bills from and where your discretionary spending comes from, the money that's in that checking account.

Tim Mullooly: Right. I like to think of a checking account kind of as, essentially, your home base. A lot of your funds will start there in your checking account and then can be either manually or automatically dispersed from there into other accounts. Like Tom said, this is where you're going to pay your monthly expenses from, whether it's bills or just money that you want to have in your account for when you got out to dinner, or go to a movie, or something like that.

Tom Mullooly: That discretionary spending.

Tim Mullooly: Right.

Tom Mullooly: Tim, once you figure out your monthly numbers, then where do you go?

Tim Mullooly: Once you figure out those numbers, it's a good idea to keep just what you need in your checking account, maybe a little bit extra if you like to ... you're not sure how much discretionary spending you're going to do each month. Essentially, around what you need, that's what I would keep in our checking account, and the rest can be better spent in other places. For example, the next account we're going to talk about is the savings account.

Tom Mullooly: The savings account is really where you want to have your emergency fund. Tim and I have written about this on our website, and we've blogged about it. We've talked about it in videos and podcasts. You have to have that safety net, that emergency account that's got ... What do you think, Tim, a good rule of thumb to have there?

Tim Mullooly: Generally, we say it's anywhere from three to six months of expenses is a generally safe number to have in your emergency fund, so however much money you spend a month, if you lose your job, you want to have at least three to six months covered while you're looking for work or you don't have income coming in.

I wouldn't recommend having anything less than three months, but if you want to have more than six months, that's up to you. Some people like to be extra safe and have 12 months of expenses in their savings account in the emergency fund. That's really up to you, but anything less than three months I would deem a little sketchy.

Tom Mullooly: That's something that we usually address initially. One of the very first things that we'll talk about with a new client is we need to boost up your safety net, your emergency fund. Even though we talk a lot about investing, it's a lot safer to invest if you've got that nest egg behind. If you're betting the rent, not a good idea.

Tim Mullooly: The stakes are a lot higher, at that point, when you're investing with rent money, essentially.

Tom Mullooly: I think once you get a good grip on what your monthly spending habits are going to be, then you can come up with a number that you need to have in your checking account all the time so that you're not constantly going back and forth moving money from savings into checking. It may take a few months, though, to figure out what the average is going to be.

I think the caveat to that is that people who have irregular cash flows, they're going to need to have more money in savings. If you work on commission, for example, your paycheck is probably going to change from month to month. People in those kind of positions are absolutely going to need to have more money in savings to help smooth out the bad months.

Tim Mullooly: Right. Another example would be seasonal jobs. Someone like a summer landscaper, for example, they do most of their work in between April and September, and then they have the off months when people aren't really doing too much landscaping, so you might want to have more money in savings for the off season while income is slightly lower than it would be during the busy season in the summer.

Tom Mullooly: What we really want to reinforce when we talk about this is that it's a savings account. It's there for emergencies. It's got to be liquid, so you really ... Having this money in the stock market or even in short-term bonds may not be a good match. It's got to be the right fit for everyone.

Tim Mullooly: While we're recording this, actually, there are some online savings accounts out there today that are actually yielding anywhere from 1 to even upwards of 1.5% for a savings account with no risk to your money. Feel free to shop around a little bit. You might be able to find an online savings account where can get at least 1%, maybe 1.5% on your money, but be careful.

Focus more on the safety of your savings account instead of the earnings. You don't want to get greedy when it comes to your emergency fund, so if you can get 1%, 1.5%, that's great, but at the same time, that's not the main focus of what that money is for.

Tom Mullooly: Next, Tim, we want to cover some different types of investment accounts.

Tim Mullooly: Everyone's situation is different. There are a lot of different factors to consider when determining which investment account you should put your funds first, so instead of telling you which ones to put money in first, second, last, we're going to kind of break it down based on the most accessible type of account to the least accessible type of account.

Tom Mullooly: First up are the brokerage accounts that are taxable. These accounts are very accessible in terms of getting your money out with having to have some kind of tax penalty or tax bill or some kind of problem with that. You may have some capital gains that you have to deal with, but it's not like you have to wait until you're age 59 1/2 or anything like that, so that would be the next level up on the ladder.

Tim Mullooly: Keep in mind, like Tom said, you're going to have to pay taxes on dividends each year and capital gains when you sell.

Tom Mullooly: There's also no limit on the amount of money that you can put into these accounts, so you can put as much money as you want each year into a brokerage account, but we recommend you consider what the money's for and if you can afford to start investing before you actually get started. One of the worst conversations we have is someone starts some kind of periodic investing, and then they call up six months later, and they're like, "Hey, I need the money," and we got to rip apart the plan. It's like ripping a tree out six months after you plant it.

Tim Mullooly: Right. You're not going to get much progress there. On any given six-month span, there's no telling, really, what the market is going to do, so if that money is for something important like buying a house or some other large purchase, it'd be better served in your savings account, like we mentioned before, so make sure that the money you're going to be putting into a brokerage account can afford to be there for a little while before you need it. You don't want to be yanking that money out three months, six months in. That just won't get you anywhere.

Tom Mullooly: As Tim mentioned, you still have to pay taxes on a year-to-year basis for dividends, and if you sell some things with gains, you're going to have some capital gains involved, but you don't have any kind of tax-deferred growth like you would within a retirement account, so that's a little bit of a trade off when it comes to these taxable brokerage accounts. Really, if you don't want to tie your money up for years in a retirement type of account, then a regular brokerage account is ... it's probably the way to go.

Tim Mullooly: Yeah. I would have to agree with that. You can't have it all, so you can't get the tax-deferred growth, and be able to put as much money in, and not be able to take it out whenever you want. Can't have it all. There are some trade-offs there.

Tom Mullooly: We're moving up the ladder. What would you say is next?

Tim Mullooly: I would say is a Roth IRA. Like I said, slightly less accessible than a standard brokerage account. In a few ways, it's more accessible than a traditional IRA.

Tom Mullooly: Right, so let's go through some of the things that make Roth accounts unique. You can contribute up to 5,500 per year to a Roth IRA. Tim, I think we can do 6,500 if you're over 50.

Tim Mullooly: Right.

Tom Mullooly: One thing that confuses a lot of people is you can take your principal from a Roth IRA out with no penalty, so over a couple of years, if you put in ... you maxed out the contributions for, say, four years, you've already put in $22,000. The first $22,000 that you take out of the Roth IRA is your own principal coming out, but I think a lot of people lose sight of that.

Tim Mullooly: Yeah, so if you were to take that $22,000 out before you turn 59 1/2, there is no penalty on it, but if that account grows to, let's say 26,000 over the first couple of years, and anything that you take out over that 22,000 would be subject to a 10% penalty, so keep that in mind when you're trying to take money from a Roth IRA account before the year you turn 59 1/2.

Tom Mullooly: Golden rule when it comes to Roth IRAs is that any money that goes into a Roth IRA is always, always, always, always ... Did I say always? After-tax dollars. It's always going to be after-tax dollars. Unlike a traditional IRA, though, you can contribute to a Roth even after you turn 70 1/2, and you can leave the money in as long as you live.

Tim Mullooly: Right. That's different from a traditional IRA. Also, with after-tax dollars, the money gets taxed on the way in, so the good thing is it doesn't get taxed on the way out. That also differs from a traditional IRA, so that's another benefit of a Roth IRA is that the money has already been taxed, so when you take it out at retirement, you don't have to worry about paying taxed on that again.

Tom Mullooly: Tim, there are some limitations on who can contribute to a Roth IRA. Do you want to just kind of roll through some numbers?

Tim Mullooly: If you're married filing jointly, you can contribute the max to your Roth IRA as long as your adjusted gross income is less than $189,000 combined, and it starts to get phased out after that, but if you make over $199,000 in adjusted gross income, you cannot contribute to a Roth IRA.

Tom Mullooly: Okay, so that's married filing jointly. What if you're single?

Tim Mullooly: If you're single, it's a little less than that. You can contribute the max if you're single, as long as your AGI is less than $120,000.

Tom Mullooly: Okay, so AGI ...

Tim Mullooly: Sorry, adjusted gross income. I want to keep saying that word, adjusted gross income, because, a lot of times, people come in, we're talking to them about Roth IRAs, and they're like, "Oh, I make too much money to contribute to that," and it's like, "Well, on the top line you might, but that's not what adjusted gross income is."

Tom Mullooly: Yeah. Adjusted gross income is at the bottom of the first page of your tax return, so before you flip to page two, you've already calculated what your adjusted gross income is going to be. It's important to understand that distinction that Tim just made, that it's not the top line. It's not your gross revenue. It's your adjusted gross income.

That's so, so important. We have found that a lot people have assumed that they made too much money, and we've been able to show them, hey, you can still sock money away. Letting this money grow on a tax-deferred basis, after tax, can really compound pretty nicely over time.

A Roth IRA that you have in a brokerage account, there's really no restrictions in terms of how you can invest the money, so if you want to put it into mutual funds, or exchange traded funds, or you want to buy a basket of stocks, go ahead. There's no restrictions on that. If you want to put it into CDs or a savings account, you can do that too.

Tim Mullooly: The one thing that I did want to mention, you can't deduct contributions from a Roth IRA since they're made with after-tax dollars, so keep that in mind. You can't write off the contributions that you make to your Roth IRA each year since they're getting taxed on the way in.

Just to finish up that point about limitations on single filers, if you make less than $120,000 in adjusted gross income, you can contribute the max. If you make more than $135,000 as a single filer, you cannot contribute to a Roth IRA, and that's 135,000, again, in adjusted gross income.

Tom Mullooly: Okay, Tim. We've talked about the Roth IRA. Now let's talk about a traditional IRA.

Tim Mullooly: Sure.

Tom Mullooly: I mean these things have been around now since the early '80s, so they've been around for 35 years. A lot of people don't use them anymore, though.

Tim Mullooly: There are some similarities to the Roth IRA, but we've already pointed out a couple differences, but we're just going to run through the rules and limitations that go into a traditional IRA as opposed to a Roth IRA.

Similar to a Roth IRA, you can contribute the max of 5,500 a year to a traditional IRA, 6,500 if you're over the age of 50. One thing to note is that that number is a combined 5,500, so let's say you have a Roth IRA and a traditional IRA, between the two accounts, you can put $5,500 total.

Tom Mullooly: You can't double up and put 5,500 in a traditional IRA, 5,500 in a Roth.

Tim Mullooly: Right. Yeah, you can't do that and try and put $11,000 a year into those accounts. It's a combined number, combined total of $5,500 a year.

Tom Mullooly: Hey, Tim. I'm curious. Are we able to split that money between a traditional IRA and a Roth IRA?

Tim Mullooly: Sure. Yeah, you can split it up. You can, say, put $3,000 into your Roth and then $2,500 into your traditional IRA for a total of $5,500 each year.

Tom Mullooly: Okay, so let's talk a little bit about ... we had some income thresholds with Roth IRAs. What about income thresholds with traditional IRAs?

Tim Mullooly: With a traditional IRA is that there are no income limits when it comes to a traditional IRA. You can make as much money as you want and still be able to contribute to a traditional IRA, so people who make more money, if you make too much money to contribute to a Roth, you still have the option to do a traditional IRA instead.

Tom Mullooly: If you take money out of a traditional IRA before 59 1/2, you're still going to be subject to a 10% penalty.

Tim Mullooly: That's correct.

Tom Mullooly: We just went through an example with a client in the office where they took $40,000 out of an IRA, and they said, "Oh, it's going to be taxable," so they were getting ready to make their tax withholdings, and then I said, "And don't forget there's a 10% penalty as well." Now, they took $40,000 out, so in addition to it being taxable, there was another $4,000 in a tax penalty that they had to account for, so they had to withhold quite a bit from their distribution.

Tim Mullooly: That's something to keep in mind with these retirement accounts. With the Roth, you can take your principal out without a penalty, but with a traditional, that's not the case, so the money that goes into these IRAs, whether it's a Roth or a traditional IRA, you really want to make sure that this money can be tied up until you're 59 1/2 to avoid any sort of penalty.

Tom Mullooly: There's one other thing that I think a lot of people overlook is that you cannot make contributions after you turn 70 1/2 to a traditional IRA. In fact, you have to start taking distributions in the year that you turn 70 1/2.

Tim Mullooly: Right. Those are called RMDs, you might hear people say, or required minimum distributions. Like Tom said, that starts the year you turn 70 1/2.

Tom Mullooly: Let's talk a little bit about retirement accounts that you can get through work.

Tim Mullooly: Sure. There are three really more well-known kind of standard workplace retirement accounts that you hear a lot. They're called the 401(k), which is probably the most well-known, a 457 plan, and then a 403(b) plan, so we're going to kind of break down some of the rules and limitations of those quickly.

Tom Mullooly: Understand that these funky names came from the section of the tax code that permits these plans to be created. 401(k)s are for profit-driven companies. 403(b)s are for nonprofits. A lot of educational institutions, hospitals have these kind of plans. 457s are for municipal employees, so you may find someone who works for the state or their local government may be involved in a 457. Tim, why don't you talk a little bit about a traditional 401(k) plan?

Tim Mullooly: Sure. In 2018, the contribution limit is $18,500.

Tom Mullooly: That's a lot more than an IRA.

Tim Mullooly: Yeah, significantly more than an IRA.

Tom Mullooly: But like an IRA, there's a 10% penalty if you take the money out prior to 59 1/2.

Tim Mullooly: Right.

Tom Mullooly: The money really is designed for your retirement.

Tim Mullooly: Right. That's why it's called a workplace retirement account. Again, similar to the IRAs, if you're going to be contributing to a 401(k), make sure that this money can sit there until you're 59 1/2, that you can afford to have that money not in your paycheck each pay period going into your retirement account.

Tom Mullooly: Speaking of the paycheck, the money is automatically deducted, in most cases, right from your paycheck on a pre-tax basis, so the money goes straight into your 401(k). You don't have to do anything except sign up.

Tim Mullooly: Right. That's important. There are things called hardship withdrawals that you can apply for to be able to take money out of a 401(k) early and not incur a penalty, but every scenario is different, so it depends on your situation if the plan would grant you a hardship withdrawal to be able to take that money out.

Tom Mullooly: They're usually very hard to satisfy the requirements because the administrators of the plan don't want this to happen very often. You need to be, basically, on the verge of being evicted from your home. It's very difficult to get a hardship withdrawal from the account.

Tim Mullooly: One thing that differs from an IRA, or a Roth IRA, or a standard brokerage account, for that matter, in a 401(k) is that you're limited to the number of options to invest in depending on your plan. Your plan will pick the funds that you can invest in within your plan, and you're limited to that. If your plan offers not the greatest selection of mutual funds to invest in-

Tom Mullooly: That's all you got.

Tim Mullooly: ... kind of stinks for you, but you do have to pick with what they give you, so you don't have that freedom available in a 401(k) plan. You're kind of at the mercy of what the plan gives you.

Tom Mullooly: This is a lot different than a Roth IRA, or a traditional IRA, or a brokerage account where you can pretty much ... anything goes in terms of how you invest the money. One of the things that has to happen with a retirement account is your required minimum distributions have to begin, like an IRA, at age 70 1/2. It's based on the value at the end of the year prior, so go to your statement for December 31st of last year, and that's the number that they use as the basis for determining what you need to take out this year.

We have run into a couple of unique situations where people are working past age 70. Believe it or not, they can contribute to a 401(k) at work, but they are also taking money out of a 401(k). It doesn't happen very often, but it's-

Tim Mullooly: Yeah. It seems kind of silly.

Tom Mullooly: It does seem kind of silly because, in a lot of cases, the money's kind of crossing in the mail, but it can be done. More people are working longer and longer, so it's important to know that.

Tim, let's talk a bit about 457 plans.

Tim Mullooly: Sure. Like Tom said before, only employers who are exempt from paying federal income taxes and non-church organizations can offer a 457, so like we said, state, local governments, hospitals, educational organizations and foundations, things like that, they're the ones that are going to be offering these 457 plans. I think one of the biggest things, for me, that I noticed about 457 plans that differs from a 401(k) is that you can take money from a 457 plan before you turn 59 1/2 without a penalty.

Tom Mullooly: It's still going to be taxable income because it wasn't taxed on the way in, so just ... I mean sometimes people lose sight of these things. If your 401(k) or your 457 contribution wasn't taxed on the way in, it has to be taxed on the way out, but Tim brings up a very good point. You can take money out if you're separated from service. Say you retire, you've got a municipal job, and you retire after 25 years, and you're 54, okay, you can still take that money out of your deferred comp. It's just going to be taxable, but there's none of that 10% penalty nonsense that comes with an IRA or even a 401(k).

Like a 401(k), the money goes straight through payroll, so it goes in before taxes. A lot of these 457 plans have catch-up provisions. If you're over the age of 50, you can contribute more. Some of them have special catch-up provisions. If you didn't max out your contributions early in your career, you may be able to do even more. Each plan varies a little bit, but 457s are a good option for people who work in those state and local government situations where a 457 is offered.

You want to talk briefly, Tim, about 403(b) plans?

Tim Mullooly: Sure. 403(b)s, these plans are usually seen mostly for teachers, workers for a school, public schools, universities, state colleges, things like that. Those are the most known for utilizing these types of plans. The 403(b) works pretty much the same way as a 401(k) does. It's not like a 457, so taking money from a 403(b) early, you will incur that penalty, so keep that in mind when you're putting money into that 403(b), but essentially, it does work pretty much the same as a 401(k).

Tom Mullooly: When we're talking about 401(k)s, a lot of times, the question comes up about, "Hey, my employer doesn't match anything," or, "My employer has a really low match, so I don't think is a good plan."

Tim Mullooly: If your employer does have some sort of match program for any of these workplace retirement accounts, that's something I think that you should definitely take into account when determining where your money is going to go first. Like we said in the beginning, everyone's situation is different, so we're not really going to tell you definitively you should put money here first or here second, but if your company does have a match for your workplace retirement account, that might be something that bumps that up to the top of the list in terms of putting money to work.

Tom Mullooly: Right, so it's important to understand that, but it's also important to read the fine print when it comes to what they're going to match. Some plans will say, "We're going to match 100% on the first 3% of your contributions," meaning if you put 3% in, and that works out to be $8,000, they're going to match a like amount into your plan. That's fantastic, so some ... It's hilarious talking to some folks because they have their plans, and they say, "My company matches up to 6% of my contributions," and I'll say, "Gosh, that's fantastic. Can I see that?" What they do is they actually have a schedule where they'll match 100% on the first 2%, and then they'll do 50% up to 6%. Do the math. Understand how much they're going to be on the hook for matching. If they're giving you a match, it's free money. Don't pass that up if you can.

Tim Mullooly: Yeah, that's what we mean by that should probably head to the top of your list in terms of where you're putting your money first.

Tom Mullooly: I think it's important, Tim, to also point out that, even when you're in your 20s and 30s, it's really hard to think about retirement because it's so far away, but the fact of the matter is, people are living longer, and they're retiring in their 60s, and so this money in retirement has to last for 25, 30, maybe 35 years. That's a really long time, so I don't think you should be considering this play money.

Tim Mullooly: Right, and if you do have money that you just want to play around with, that shouldn't go in these retirement accounts. That should go in a regular brokerage account if you just want to flip stocks for a year or two.

Tom Mullooly: I think the sooner you begin putting money into a retirement account at work the sooner you'll forget about it, which I think is also important because the saving has to become a habit, and you have to put this money away, and the sooner you start paying yourself, the faster it's going to be for you to accept that. It's hard for people who are just scraping by when someone tells them, "Hey, you know, you need to start putting 300 or $500 away for retirement." They're like, "That's so out of whack. I can't even think about that right now," and they push off starting for years and years and years until, for most people, it's too late.

Tim Mullooly: One thing that you should keep in mind when you're determining how much money you want to save is that these contribution limits that are on these workplace retirement accounts and IRAs, you're not going to be able to just contribute the max on one of these accounts and expect to be wealthy in retirement. Just putting 18,500 away in a 401(k) each year probably isn't going to set you up nicely in retirement, so when you think of savings, it shouldn't be in a dollar term. It should be more in a percentage of income term because if you're making $45,000 a year, saving $18,500 in a 401(k) is outrageous.

Tom Mullooly: It's like 40% of your income, your gross income.

Tim Mullooly: Right, but on the flip side, if you're contributing 18,500, and you're making 350,000, $400,000 a year, that's a significantly lower percentage. You could probably afford to be putting more away, whether it's in your savings account or a standard brokerage account. Just maxing out those retirement accounts probably isn't going to be enough to get you to where you want to go.

Tom Mullooly: I think we did a video about that where we said, "Hey, if you're maxing out your contributions," and most people don't, but if you're maxing out your contributions, thinking that you're going to put 18,500 away is going to have you all set in retirement, that's not going to make it. I mean even over 20 years, if the max were 18,500 for the next 20 years, you're talking about putting $380,000 away, if my math is right. That's not even going to-

Tim Mullooly: Some people are retired for 30 years now. $300,000 and change isn't going to last 30 years.

Tom Mullooly: Right, and you will have an opportunity for the money to grow, but it wasn't all that long ago that the contribution limit for 401(k)s was $11,000. It's been rising steadily over the last few years, so ... Yeah, just maxing out your contributions for your retirement account at work is not enough for a comfortable retirement.

Tim Mullooly: Kind of wrapping this up, the good thing with all of these accounts, and putting money away, and sending money to each of the different accounts in 2018, technology is a great thing. Automation can be a pretty useful tool if you use it correctly. You can have your paycheck direct deposited into your checking account. You can set up automatic transfers to your savings account. You can set up transfers from your bank into your IRAs. You have the money automatically deducted from your paycheck into your 401(k), so you don't even have to think about it. A lot of times, we find that, with some people, if you actually have to manually write a check, it doesn't get done, and then you put yourself behind the eight ball, and you're kind of stuck at that point, so automating can be very good for certain people who tend to forget to write a monthly check.

Tom Mullooly: That's right. You should use automation to help you make these things a lot smoother so it's all done automatically.

Tim Mullooly: Right.

Tom Mullooly: What should people do if they have questions about these kind of things?

Tim Mullooly: If you've got a question about any of these accounts, if you have a investment advisor or a financial planner, reach out to them, and if you don't, reach out to us over here at Mullooly Asset Management. Also, feel free to send us questions at Living With Money. Our email is livingwithmoneypod@gmail.com. We'd be happy to answer any questions you have. You could also head over to the Mullooly Asset site. We have blogs, and videos, and good articles, and information over there for you as well.

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Tom Mullooly: Well, we appreciate you listening to us today on Episode 12, and we look forward to speaking with you again real soon.