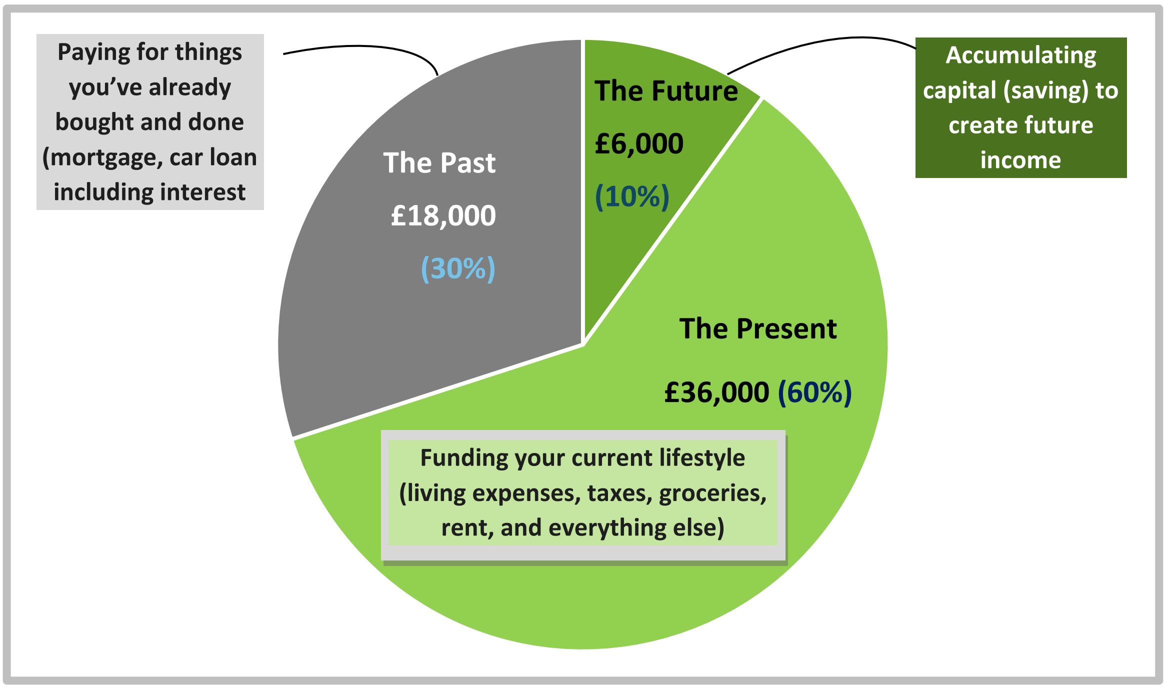
Three Numbers that can help with your budget

Am I saving enough? How much debt is too much? What's a good balance? The answer lies in using the the Three Numbers, which are the percentage of your gross income allocated to your past, present and future.

For example, for someone earning £60,000 a year:



… so these Three Numbers come out at 30 | 60 | 10.

The Past: Your debt-to-income

To calculate the past portion of your Three Numbers, add up all of your monthly debt payments (principal* and interest). Then divide this by your gross monthly income and multiply by 100.
For example, if you earn £6,000 a month before taxes and pay £2,000 a month toward your mortgage, credit cards, car loan, and any personal loans, then the past portion of your Three Numbers would be 2,000 ÷ 6,000 x 100 = 33.3, meaning that 33% of your income is directed toward paying off past purchases.

* Many people want to exclude the principal on mortgages from this calculation, reasoning that this expense is more appropriately assigned to the "present" because it's a current housing expense. However, firstly you borrowed the full amount, and the principal you pay is a contractual debt obligation, not a monthly rent payment. Second, creditors include the entire mortgage payment (principal and interest) when considering your creditworthiness, so you should use the same debt-to-income ratio as they do.

How much debt is too much?

Overwhelming debt can be a poverty trap. Borrowing to invest in income-generating assets like real estate and career skills can put you in a better financial position in the long term. Home and university loans are considered "good debt" by creditors and don't hurt your credit score nearly as much as other types of debt.

Borrowing for things like holidays, eating out, cars and TVs usually weakens your financial position in the long run because you pay interest on things that you can't resell at retail, let alone with interest. You're effectively poorer at the end of the transaction than you were at the beginning. Therefore, consumer debt is treated as "bad debt" by creditors and drags your credit score down more than "good debt" does.

Regardless of the quality of your debt, **you should aim to keep your total debt payments at or below 30% of your gross income**. The ratio of your monthly debt payments to monthly gross income is also known as your debt-to-income ratio; it is used by lenders and credit bureaux to determine your creditworthiness. As a rule, you want to keep your total debt obligations at or below 30% of your gross income. This can also help in times of interest rate and base rate rises, as you have room to manoeuvre, as many lenders will allow you to go to 40%.

However, if you find yourself overwhelmed by debt or if you simply want to pay off some or all your debt as quickly as possible, then by all means put more than 30% toward the past. It is only when your *required* debt payments reach 30% that you need to be concerned.

Bottom line: Keep the past portion of your Three Numbers below 30, where possible.

The present: Your consumption rate

This portion of your Three Numbers is 100 - (Past + Future).

Using our previous example, if you earn £6,000 a month, save £1,000 a month, and pay £2,000 a month in debt, then your Present = 100 – (33.3 + 16.7) = 50, meaning that 50% of your income is consumed by your present lifestyle.

You can think of this as your consumption rate or burn rate. Taxes, groceries, rent, gifts, and so on. if you don't save it, consider it spent. End of.

The Future: Your savings rate

To calculate the future portion of your Three Numbers, add up all of your monthly savings contributions, divide these by your gross monthly income, and multiply by 100.

Building on the previous example, if you earn £6,000 a month before taxes and save £1,000 a month, then the future portion of your Three Numbers would be 1,000 ÷ 6,000 x 100 = 16.7, meaning that 16.7% of your income goes toward your future.

How much you *should* save depends on your goal and your time horizon (the number of years between today and your goal). You need to have a rough idea of both to know if you are saving anything close to "enough."

It's debatable how much a person needs to fund a secure retirement. We recommend having 20 times your desired retirement income saved, where possible, is recommended so that you could retire at 67. This goal can be called a 20 x income multiple. But add in your State Pension these multiples could be significantly lower.

In the case of someone earning £60,000 pa, they would need £1,200,000. Someone who wants a £100,000 a year lifestyle would need £2m, and so on.

Saving anything is better than nothing, but aiming for a consistent 10% savings rate over time is a sound rule of thumb.

Adding it up and setting goals

Let's run through an example from beginning to end. For simplicity, imagine a person who earns £60,000 per year (£5,000 per month). Their monthly debt payments add up to £1,750, and they save a total of £750 per month.

A	**PAST**	**£1,750 ÷ £5,000 x 100**	**= 35**
B	**PRESENT**	**100 - (A + C)**	**= 50**
C	**FUTURE**	**£750 ÷ £5,000 x 100**	**= 15**

Their Three Numbers would then be: 35 | 50 | 15.

If this person is trying to grow their assets, they will need to make some changes. They can use these numbers to set goals for a healthier cash flow.

First, their past is greater than 30, so they could set a goal to reduce this to 30 as quickly as possible.

Second, their savings rate could be larger. Let's assume they set a goal to have the Three Numbers as 30 | 50 | 20 within two years. They can do this by refinancing high-interest debt, paying it off and then putting the money saved on interest toward their savings.

There are many different views on how much a person needs to save to fund a secure retirement. A good benchmark is having 20 times your desired retirement income saved so that you can stop working at age 67.

In the case of someone earning £60,000 a year, they would need £1,200,000 to retire at age 67, using this rule of thumb. Someone who wants a £100,000 a year lifestyle would need £2 million, and so on.

Aiming a bit higher involves saving enough assets to live off the interest without touching the principal. If you are aiming for this, then (based on the 4% rule, which is itself a subject of hot debate) your goal would be a 25 x income multiple or higher.

A consistent 20% savings rate over time is a great starting point. If that's not possible, then start with what you can save and work your way up but aim for 10% over a longer period of time.

In conclusion, if your debt is healthy and you have achieved your savings goal, you can spend the rest guilt-free! It doesn't matter if you spend it on restaurants or holidays or clothes or model trains. If your past and future are in good shape, then you can skip all the itemising and agonising and just enjoy your life and your money.

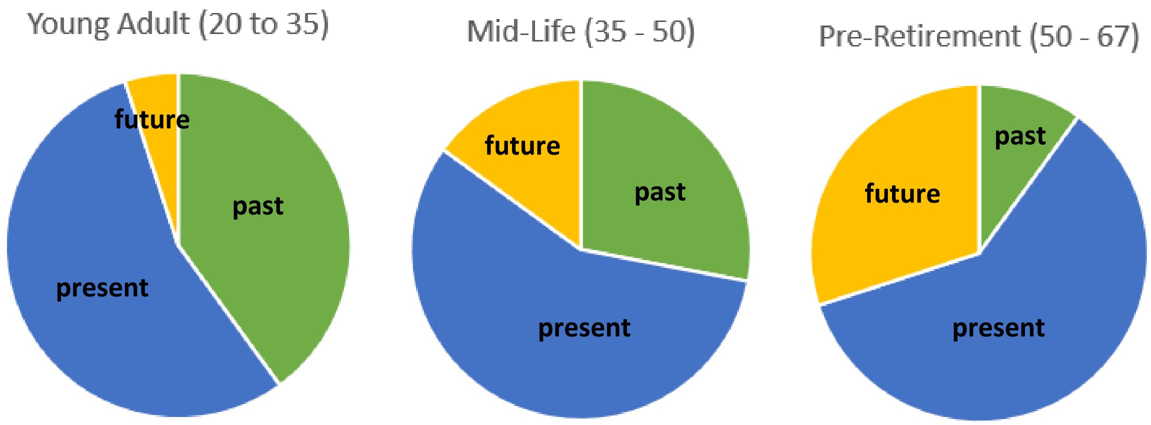
This is where the Three Numbers are really powerful: They distil your cash flow into one very informative metric so you can know instantly if you are on or off track. If you are off track, you'll know where to focus. If debt is the issue, look at refinancing high-interest-rate accounts and making a budget that is both satisfying and sustainable. If saving is the issue, the same strategies can help you find cash to devote to your future.

Andy Maher is aiming at **10 | 60 | 30** for his Three Numbers. What are yours? Andy says:

> *"I remember when both Molly and Tom were at nursery and we were just moving house and extending our mortgage - our disposable income was minimal. The idea of being able to save 20 to 30% of my salary seemed far in the future and irrelevant to my current needs. However, as they went to school salary levels increased and mortgage levels dropped I was able to look at increasing my savings".*

All of us can save different money at different stages of our life, and we have to accept when we are younger we have less ability to save, but as disposable income increases it's important to look to the future. Your Three Numbers will change as you go through life: A younger adult may be spending a lot on things like childcare and a mortgage. As the children grow up and your salary increases, you may be spending on school fees but you'll have more disposable income, and in later years the kids may be off your hands allowing you to spend more on luxuries as well as saving for your retirement.

Stages in your life could be illustrated as follows:



40 | 55 | 5 **28 | 57 | 15** **10 | 60 | 30**

So what's your ideal for saving for the future: Is it 10, 20 or 30%?

If you need any help or wish to further discuss this fascinating piece of research that we have adapted please do not hesitate to call me.

Andy

Adapted from an article by Sarah Newcomb Ph.D, Behavioural Economist at Morningstar