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Save Like Crazy

This eye-catching headline is actually a piece of advice commonly given by one of my favorite personal finance writers – Jonathan Clements of the Wall Street Journal. Clements rightly points out that you can't control the behavior of the financial markets, but you can control the most important driver of your financial success: how much you save. Unless you're one of the few people who will receive a financial windfall, your ability to save will be the biggest determinant of your ability to reach financial independence.

How *much* you save is the most important factor, but you can maximize how your dollars work for you by saving in a specific order:

- First, save into your employer retirement plans up to the point where your employer stops contributing their matching dollars. Even if you have to rob Peter to pay Paul, this probably makes sense. For example, if one spouse is over 59 ½ and retired, it makes sense to take distributions from the retired spouse's IRA in order to fund the working spouse's 401(k) plan. An employer match is free money – take it.

- Second, fund a Roth IRA. Your ability to fund a Roth IRA phases out at certain income limits, but if you're under them, a Roth is a great account to have in retirement, and an even better account to inherit. You don't get an upfront tax break, but if you meet the IRS requirements (primarily, tapping after age 59 ½), you can take the dollars out tax free. A significant Roth balance provides protection against rising tax rates in the future – just the opposite of saving into an employer plan.

- Next, for most people the next best thing to do is to save into their employer plans up to the IRS limit ($15,500 this year, plus another $5,000 if you're 50+). This is an easy and efficient way to save; you don't have to think about it as the dollars are deducted from your paycheck, and you're dollar-cost-averaging your investment purchases, again, without thinking about it.

- And finally, save into a taxable account, in a tax-efficient manner. That means holding securities that don't throw off a lot of annual interest, dividends, or capital gains distributions -- tax efficient stock index funds, for example.

The above is a general guideline; your specific circumstances will drive how you should best allocate your savings dollars among the various accounts available to you.

-- Therese Govern. Posted 02/15/08.