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Don’t blow your pay rise

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Deciding what to do with a salary bump is your financial *Sliding* Doors moment.

You’re likely to be earning more now than early in your career. So why are you living from payday to payday? By Nigel Bowen.

It's not uncommon for professionals' salaries to double, triple or quadruple as they climb the corporate ladder. Given that, one might expect those in their 30s and 40s to be in a far superior financial position than their juniors.

But lifestyle creep means that's often not the case with expenses creeping up even before added responsibilities such as kids and mortgages are taken into account.

Think back to when you got your first job out of uni and were still living with your parents, suggests Evalesco Financial Services director Marshall Brentnall.

"You had close to 100 per cent disposable income," he says. "Long-term planning meant working out where you were going on Saturday night. Suddenly, it's 15 years later. You're [potentially] earning three times as much. Two or three investment cycles have come and gone. Yet apart from a bit of equity in your home you're not much better off. Why?"

One possible explanation is that you haven't thought much about where your money is going. "Every time your income has increased, so has your spending," says Brentnall.

It's a pattern seen time and again by financial planner Claire Mackay of Quantum Financial.

"As you take on more responsibility at work and earn more, it's easy to justify to yourself going to better restaurants and wearing fancier clothes," she says. "Even if you're happy living an $80,000 lifestyle if you get a $20,000 pay increase, you'll probably start living a $100,000 one. Most people spend what they have in their bank account."

The suggested formulae

Both Brentnall and Mackay have provided their clients with formulas to help them manage pay rises. (Naturally, they need to be tailored to the individual to suit their circumstances.)

"I've found 20-20-20-20-20 [can] work well for pay rises," says Brentnall. "That is, you devote one-fifth of the increase to treating yourself, put one-fifth into your super, use one-fifth to pay down debt, stash one-fifth in a 'rainy day' savings account and invest the rest."

Mackay uses a 30-30-30-10 model. She suggests using 30 per cent of your income to cover mortgage or rent, 30 per cent for other expenses, 30 per cent for saving or investing and putting 10 per cent away in an emergency 'buffer' account'.

"The important part is that 30 per cent of your income goes to saving or investing. So if your pay after tax doubles from $50,000 to $100,000, the amount you're saving or investing doubles from $15,000 to $30,000."

Case study: Jackie and Jill

Brentnall gives the example of two clients in similar circumstances, who he'll call Jackie and Jill. Both are professional women in their mid-thirties earning good incomes who'd recently bought homes when they came to see him.

"Jackie followed my 20-20-20-20-20 strategy religiously," he says. "Five years on, she's almost paid off her house. She has an investment property. She has $150,000 in other investments and has been in a position to take six months off to go travelling."

Jill, who had been to see him on Jackie's recommendation, didn't fare so well.

"Jackie disappeared for years and when she came back, she hadn't made much of a dent in her mortgage," says Brentnall. "Apart from some nice holidays, she didn't have much to show for half a decade of slogging away. That was a real sliding doors moment for me. It illustrated the consequences of being smart about leveraging a rising income as opposed to mindlessly succumbing to lifestyle creep."

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Splurging responsibly

At this point you're no doubt bracing for a lecture on the need to adopt a grim regime of scrimping and saving. The good news is that you can enjoy salary bumps, albeit it in a sensible manner.

"I subscribe to the 3s's philosophy: that is, money can either be used for spending, storage or savings," says Brentnall. "Spending is about immediate gratification. Storage is about setting aside money to pay for important expenses, such as insurance premiums. Savings is about delayed gratification. It's about making sure you can enjoy what's to come because you've, for instance, fattened up your super balance.

"[Some] people get trapped in a cycle of either saving up to spend or paying off debts from previous spending. They don't put enough aside for storage or saving. Of course, that then limits the spending they could otherwise have looked forward to."

It also reduces your chances of reaching your longer-term goals.

"Sooner or later [you may] want to put a deposit on a home," says Mackay. "Or take a trip around the world. Or retire early. If you haven't been saving and investing money in a systematic way over a considerable period, it [can be] harder to achieve those goals."

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