A Step-By-Step Guide To Managing A Windfall

By Zina Kumok • January 22, 2018

Did you just come across some extra money? If you manage your windfall correctly, you could pay off most of your debt quickly. Here's our step-by-step guide to getting it right.

Have you ever read a follow-up story about someone who won the lottery? They're almost always tragic tales of someone given an opportunity to change their life—only to throw it all away by mismanaging their winnings. In many cases, the lucky individual actually ends up in worse financial shape than they were before hitting the jackpot.

That's because receiving a windfall is a double-edged sword. It can give a false sense of financial invincibility, leading you to make irresponsible choices you would never consider otherwise. Eventually, those can turn into expensive habits and an unsustainable lifestyle. The key is to have a solid plan from the start.

The same principle holds true even for small windfalls. There's nothing wrong with treating yourself after receiving a year-end bonus or inheritance from a loved one, but the bulk of that money should be put to good use.

Every windfall is an opportunity to take a step toward your goals—or a distraction that takes you further away. It all depends on how you choose to spend the money.

If you've recently received a big chunk of change, here's a step-by-step guide on what to do with it.

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The number one step to take after receiving a windfall is to pay off any high interest debt, such as credit cards or personal loan bills. If the interest rate is eight percent or higher, you should always pay that off before doing anything else.

"If you have debt of any kind and are considering splurging on a big ticket item, slap yourself," said financial planner Jeff Rose CFP® of GoodFinancialCents. "Seriously. Or pay a friend to do it for you. A windfall is an extraordinary opportunity to finally free yourself of your debt and to waste it on a big screen TV, European cruise or Tesla Model S would be a travesty. Don't blow this golden opportunity."

Freeing yourself from high interest debt will save you the most in the long run. You can then use your extra cash flow to pay off low-interest debt, save for retirement, or contribute to your child's 529 account.

Step 2: Bulk up your emergency fund

Once you've cleared your most important debts, it's time to focus on your emergency fund. Go through your bank accounts and determine how much liquid cash you have to use in case you lose your job, require an overnight stay at the hospital, or your car breaks down. Write down that number.

Then, go through your monthly budget and determine how much you really need to live on each month, excluding any discretionary expenses such as movie or concert tickets, retirement contributions or take-out meals. Give yourself a little leeway.

Compare the two figures to determine how many months' worth of expenses you have saved up. Most experts recommend stashing at least three months' worth of expenses, but if you have a home, an unstable job or a child, you should have between six to 12 months' worth of expenses.

That money should only be used for true emergencies—not for costs you can anticipate, like your biannual car insurance premium or travel expenses to your annual family reunion.

Step 3: Increase your retirement contributions

Adding money to your retirement accounts is a smart next step, because the money you invest will pay off when it's time to stop working. The power of compound interest could turn a $50,000 windfall into a $165,510 nest egg after 20 years at six percent interest—even if you don't add an extra cent.

You likely have several options for retirement accounts, either a 401k or similar vehicle through your employer or an IRA that you manage yourself. However, you can only contribute up to $18,000 a year to your 401k or $5,500 to your IRA (or $24,000 and $6,500, respectively, if you're 50 and older). If you want to invest more than that amount, you should talk to a financial planner about how to properly take advantage of your windfall.

A financial planner can help you determine your retirement goals, how much you'll need to live on comfortably and what other sources of income you could generate. They'll be able to say how much you should invest in stocks and bonds and how to best minimize your tax obligations.

Step 4: Pay off other debt

If you have a mortgage, car loan, student loans or personal loan, a windfall can help you wipe them out entirely. If you don't have enough to pay off all your debt, there are two methods you can use to decide which ones to choose.

The snowball method recommends paying off debts with the smallest balances first and using those monthly payments to add onto your other debts. After the smallest balance is paid off, you start adding that amount to the next smallest balance. Eventually, the payment snowballs until you're debt free. This method has been highly recommended for years, because it incentivizes people to pay off their debt by rewarding them with small wins.

with the highest interest rate. Paying as little interest as possible will save you the most money in the long run. It will take longer to pay off each individual debt, but this solution makes the most sense mathematically.

Step 5: Hire a professional

Angie Furubotten-LaRosee, CFP® of Avea Financial Planning once helped a young woman who received an $100,000 inheritance. She created a plan for her to follow and allotted money for her to save, invest and follow her dreams.

A few years later, the woman contacted Furubotten-LaRosee again after receiving another windfall. Furubotten-LaRosee created a similar plan, but discovered that the woman hadn't followed her initial recommendations.

"The behavior part of receiving a windfall might require more than just having a plan, it might require coaching to implement the plan," Furubotten-LaRosee said.

It's easy to get a big pile of cash and feel rich for the first time in your life, but it's harder to be responsible with that money. A professional planner will show you how to stick to your goals. They can also outline how your life could look in the future if you stick to the plan—and how it could be if you deviate. Seeing the long-term consequences of your actions could make it easier to stay on course.

Summary

If you manage your windfall correctly, you could pay off most, if not all, of your debt quickly. But it's important to make sure your tackle the right debt first. If you're unsure how to do this, hiring a professional might help.

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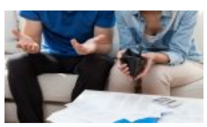

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