Pay Down or Save Up?

You have extra cash. Should you use it to pay down debt or build up your retirement savings?

By Christopher J. MORRIS, CPA
Financial Advisor

Our comprehensive financial planning tool involves learning our clients' retirement goals, finding out where they are in their financial journey toward their goals, then using sophisticated planning tools that consider thousands of possible return outcomes to determine how much they need to set aside to reach those goals. The process includes recommendations on investing excess cash in qualified and nonqualified retirement savings plans, which invariably leads to one question: "Should I use excess cash to pay down debt as opposed to investing in a retirement savings vehicle?"

Most simply, the decision is based on which approach will provide the best net gain — and that depends on your particular situation and circumstances.

Broadly speaking, you should invest the money if you expect a better return on it than the "effective" interest rate you're paying on your debt. If you are considering paying down your mortgage principal, for example, and your interest rate is 4 percent, you'll likely get a better return long-term on your money by investing it. In the early stages of a mortgage, a higher percent of your monthly payment goes to interest than in later years. Your decision should take into consideration the actual interest you are currently paying, that is, your effective interest rate.

If you have a 401k through an employer with a matching contribution, it is almost always beneficial to capitalize on the maximum amount of your employer's match. Not only is your employer's match free money, it is invested tax-deferred, meaning you're not taxed on the income you contribute or your employer's match until you start taking money out in retirement, when your tax rate is likely to be lower than it is during your earning years.

Another benefit of a 401k plan is that it is more systematic. Your payroll deductions are automatic, so you are not likely to find other uses for the money. It goes directly to your retirement account.

You do have the option of systematically contributing in your own IRA on a tax-deferred basis. Just make sure your contributions don't exceed IRS annual limits. The limit for 2018 is $5,500, or for individuals age 50 and older, $6,500. If you exceed the limit the IRS will take 6 percent of the excess as your penalty.

Your decision to pay down debt gets simpler with revolving credit, like credit cards. Those interest rates are likely higher than the average returns you can expect investing. So prioritize your debt and pay down your highest interest loans first.

We always advise our clients to keep an emergency cash fund sufficient to cover at least three to six months of normal expenses. Deposited funds are earning almost nothing during this period of low interest rates, but having the cash on hand in case of a job loss, a medical emergency, or another significant and unexpected expense, will keep you from having to take money out of your retirement savings, which often comes with an early withdrawal penalty.

When it comes to weighing debt against savings, it doesn't have to be an all or nothing decision. You might find it makes sense to use your extra cash to fund your emergency cash account, pay down some debt, then put what's left toward your retirement.

Christopher J. Morris, CPA

Financial Advisor, HBKS® Wealth Advisors

Christopher "CJ" Morris is a financial advisor in the HBKS Wealth Advisors office in Sarasota, Florida. He began his professional career with the Ohio State Auditor's office as a staff auditor. He relocated to Sarasota and began his career with HBK CPAs & Consultants (HBK) in November 2011. CJ's CPA experience includes accounting, auditing and taxation matters with small business clients from myriad industries. While with HBK, he also worked with many individual high-net-worth clients.

CJ transitioned to HBKS in July 2015. As a member of the financial services team, CJ works closely with team members Dean Piccirillo, Kerri Goldsmith, Keith Veres and Charlotte Dearborn servicing client relationships and providing asset management and technical expertise to the team through his CPA experience. He also helps clients to reach their financial goals through personalized financial planning, investing and risk management services.

CJ graduated from Youngstown State University, earning his Bachelor of Science degree in Accounting and Business Administration. He is a member of American Institute of Certified Public Accountants (AICPA) and the Florida Institute of CPA's (FICPA).