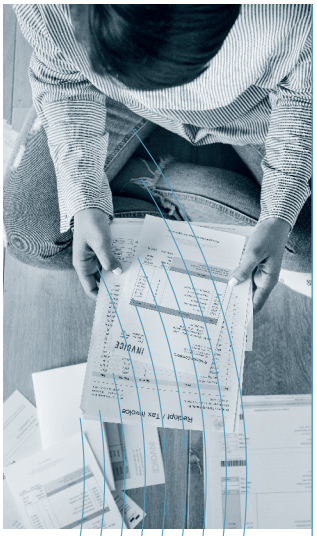
HBKS Wealth Advisors

Invest or Pay Down Debt?



What's Right for You?

By Joseph E. KLOECKER, MBA, CPA
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ONE OF THE QUESTIONS we get most frequently in our financial planning sessions is about investing versus paying down debt, specifically, "Should we do general non-retirement investing, or should we aggressively work to reduce debt, in particular, non-mortgage debt?" Of course, different people in different situations require different solutions, but I can offer some perspective and guidance based on many years as a financial advisor.

One of the most satisfying accomplishments is to be debt free as early as possible in your life. One of the most successful wealth-building strategies is to avoid, minimize, and ultimately eliminate non-mortgage debt as quickly as you can.

It is critically important to have a solid retirement savings plan that starts when your work career begins and does not stop until retirement. You will want to start with your very first job, get to saving 15 percent of your earnings as soon as possible, and continue to maximize your retirement savings. Being free of unnecessary debt will allow for significant retirement savings.

WHAT IS UNNECESSARY DEBT?

If you start with the simple concept of living within or below your means, you can build a primary cash reserve for emergencies. If you do so, you will not need to incur credit card debt for the unforeseen, such as a car or home repair. It's also much better to save for a purchase and pay cash for it than to incur a high interest rate to buy something you cannot yet afford.

The habit of buying expensive vehicles with large monthly payments over a lifetime can significantly reduce your lifestyle in retirement. Why not make that first vehicle one you

There are planning options to lessen the impact of the new IRS rule.

can easily afford and start a cash reserve to pay for the next vehicle? Driving vehicles you can easily afford as opposed to borrowing to buy more expensive vehicles will make a substantial contribution to your long-term financial security.

The same is true for your home. It is too risky to buy a house that can only be afforded with two incomes. If you drive a car and live in a home within your means, debt will not be another stressor in your life.

SHOULD YOU START A FORMAL PROGRAM OF NON-RETIREMENT INVESTING WHILE YOU STILL HAVE NON-MORTGAGE DEBT?

If you have credit card debt or student loan debt, pay them off before you even think about non-retirement investing. Eliminate your debt as soon as possible and never fall back into the credit card trap. If you then build a primary cash reserve, you'll be able to pay for the unforeseen car or home repair. And if you want to purchase something, save until you have sufficient funds to make that purchase or take that vacation.

Consider vehicle debt. If you have a loan at a 5 percent rate, you'd have to earn a minimum of 5 percent on an investment to justify investing versus paying off the car loan.

What about your mortgage? Hopefully you live in a home you can easily afford based on your income. Given the historically low interest-rate environment of the last several years, you should have a low interest rate loan. Assuming a low rate and an affordable payment, it may be time to consider non-retirement investing. If you have a substantial primary cash reserve in the bank, $20,000 for example, you can now consider investing to achieve pre-retirement goals. Even if you don't have a specific goal, I recommend building at least $30,000 in after-tax investments to fund goals that could appear in the coming two to ten years but well before retirement. If you don't spend that money, it becomes more after-tax savings for your retirement. You will want to retire with substantial after-tax funds to supplement your taxable qualified retirement plan withdrawals.

DOES IT MAKE SENSE TO PAY OFF A LOW-RATE MORTGAGE?

There are many reasons to consider paying off your mortgage early, even if you have a rate as low as 3 percent or less. You do not want a mortgage in retirement. And consider the satisfaction of being debt free.

The best way to invest in volatile markets is monthly over a long period. Let's say you have a 3 percent mortgage rate and access to an investment paying 3 percent guaranteed. That 3 percent is much better than you could get today on a savings account. So think of paying that additional monthly amount on your mortgage as a guaranteed 3 percent return. Even though you might earn more than 3 percent on your investments in the coming years, remember that you would have to earn at least 3 percent just to break even — and nothing in investment markets is guaranteed. Would you borrow on your home at 3 percent and invest it in hopes of earning more?

Not likely, so it follows that you should be happy to pay aggressively on your mortgage and achieve the desired debt-free goal as early in life as possible.

When we take our clients through the financial planning process, we're able to show them how balancing debt reduction with saving for retirement will affect their long-term goals and overall financial well-being. There are reasons for leveraging in business ventures. But for your personal financial plan, living your life within your means, eliminating non-mortgage debt as soon as possible, working toward eliminating mortgage debt, then becoming a long-term investor are the surest ways to build real wealth.

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Joseph Kloecker offers his clients broad financial expertise amassed over more than 35 years — as a senior financial accounting officer in a large bank and as a financial planning and wealth management professional.