SHOULD YOU PAY OFF DEBT OR SAVE FOR RETIREMENT?

Written by: Pam Peters | Transamerica **March 23, 2018**

Why It Matters

- 56% of Americans with debt report negative health impacts
- Preparing for retirement may entail paying off debt first
- Everyone's situation requires a different financial strategy

Does thinking about your debt cause you physical and emotional stress? Consumer financial debt is correlated "higher perceived stress and depression, worse self-reported general health, and higher diastolic blood pressure." according to a Social Science & Medicine survey. For many people, deciding whether to save for retirement before paying off debt is one big piece of a stress-causing puzzle.

If you Google this topic, you'll find hundreds of ideas about how to best use your income. Instead of heading down the internet rabbit hole, read these professionals' opinions about paying off debt versus saving for retirement. Of course, our professionals assume you'll pay living expenses such as housing, transportation, food, utilities, and childcare first. Then, with the remaining money, you may consider whether to first pay off debt, save for retirement, or maybe do both.

When considering paying off debt, "We need to realize that not all debt is created equal. There are two kinds of debt, one is good, and the other quite bad," says Chris McGovern, a director with Transamerica's Advanced Markets Group. He explains that, "installment debt, like your mortgage or student loan, usually has a low interest rate and it's really good debt. Also, you are decreasing the principal with every payment, so you're always making progress and paying less interest with every payment."

On the other hand, revolving debt, such as a high-interest credit card debt can really work against a consumer. "When you only make a minimum payment, you can never really make progress," McGovern said. "This type of debt works against someone trying to get ahead."

McGovern suggests that people pay off high-interest debts quickly. And that they don't pay off their mortgage or student loan until the term is due. "The low interest rate may give you more income to invest in an account that offers a higher rate of return and can compound over time," he said.

Though this math makes sense, it's more complex than these simple rules. Every person's situation is different. There's no one way to do it. These financial professionals' examples, illustrate various stages of people's lives, and may help you better identify a path that works for you.

Millennials with significant student loans

Recent college graduates who have student loans report they are struggling financially and often hold down a second job. "Younger clients may have student loan debt and feel like they shouldn't save for retirement until their student loans are paid off. As such, they may miss out on the trifecta of the employer match, tax deferral, and the time value of money," said Marguerita M. Cheng of Blue Ocean Global Wealth. But some people's emotional state may give them enough concern that paying off debt is better for their health in the long run. Only the individual can decide how much debt and anxiety he or she can tolerate.

Divorced couple

Michelle Buonincontri, Certified Financial Planner® professional, CDFA, and founder of Being Mindful in Divorce, discusses the challenges for recently divorced couples. "Debt paydown and saving for retirement can be difficult for clients to reconcile after a divorce," she said. "Both parties need to work toward both goals to rebuild their finances. I usually advise them to pay off debt first because credit impacts so many areas of their lives. However, I believe it also depends on the emotional needs of the client.

"The client may need small, quick motivational wins or achievable goals to feel empowered and committed." Buonincontri believes it's part of her role as a financial professional to listen and pay attention to the emotional needs. "It's not just about the numbers."

Out of work

Being laid off from work can present another life challenge that may affect someone's financial strategy. Alexander G. Koury from Values Quest shares a story: "In 2008, a client was making $80,000 a year before being laid off. He paid his bills and accumulated about $20,000 of debt, which he planned to pay off that year. However, the layoff put a wrinkle into his plans. Once he found stable employment again, he only earned $35,000 a year. At that point, he didn't just focus on paying off all the debt. He wanted to feel productive, like he was accumulating money for the future."

Koury urged the client to put a two-pronged plan into place. So, he paid off the debt and started saving. "Yes, he could have paid off debt faster, but it also was important to focus on the positive — to keep him motivated to move ahead," Koury said. Koury ensured that he had a plan, prioritized goals, and took action.

Unexpected windfall

What happens if you get a cash windfall and inherit some money, sell a business, win the lottery (we can all dream), or get a legal pay out? This situation may throw another set of issues your way. Does it make sense to pay off all debt at this point? Or, to sock it all away? It's important you involve professionals at this point to help you decide the best course of action. You may want to keep the money a secret until you have your money manager or lawyer in place. A professional may advise you to continue to keep the situation confidential, even though you may want to announce it on social media.

Empty nesters and close to retiring

After the kids have graduated from college, an individual or couple may be in the unique position to become debt-free. Major expenses like mortgages, college costs, and automobiles are in the past. Jon L. Ten Haagen, Certified Financial Planner™, from Ten Haagen Financial Group, believes it's time to "stop paying too much interest." He urges clients to pay off any high-interest credit card debt quickly. "Credit card companies charge 19% and higher. People should pay off the highest interest rate first, then the next, then the next, until they are debt free. Do not contribute to a 401(k) until the debt is gone. Today clients cannot earn more than a 4% to 6% return so they should pay off debts first." And, if they "are 10 to 15 years from retirement, use the time equity to give them a better total return on investment." And contributing to a health savings account may be beneficial at this time to cover unforeseen medical costs.

Retirement

When people get close to retirement, their situation can change, and they may need to shift their payoff-versus-investment strategy. Financial professionals can help guide clients to determine what makes the most sense given their priorities. Cheng: "One of my clients retires this year. She'll be receiving Social Security and a modest pension. Since she retires soon, saving money on taxes isn't much of a priority. During her career, she saved enough in her 401(k) to receive the employer match. She used the rest of her cash flow to pay off her car and some other bills. She has reduced her monthly expenses by $800. How amazing that she can retire with relatively low living expenses." It pays to retire with as little debt as possible since your income will decrease and it will become more difficult to pay off those debts in retirement.

Hopefully you can see the importance of weighing all parts of the equation when choosing whether to pay off debt or invest for retirement. Keep in mind your debt tolerance, 401(k) matching proceeds, upcoming expenses, time until retirement, and potential unforeseen expenses. Also, don't forget to spend some of that hard-earned money on something fun that fits into your budget.

Things to Consider:

- Individual debt tolerance may affect how much debt you want to carry into your future.
- One size does not fit all when it comes to debt payoff versus saving.
- Make a plan, execute on it, and then revisit it annually.