Reilly Financial Advisors

# Wealth Strategies

## Debt Managment

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# *Wealth Strategies:* Debt Managment

## What Is Debt Management?

As a consumer in today's world, you need credit. The average cost of a house, car, or college education has increased rapidly in comparison to average household incomes; therefore, it's not unusual for consumers to borrow money if they want to purchase a home, drive a car, or educate themselves or a member of their family. And with greater credit needs, the appropriate management of debt becomes essential to financial freedom and flexibility.

Proper debt management ensures you will not only have credit when you need it but also be able to make wise borrowing decisions and avoid disaster if you become overextended.

**Here are some key points to be aware of if you are just getting started:**

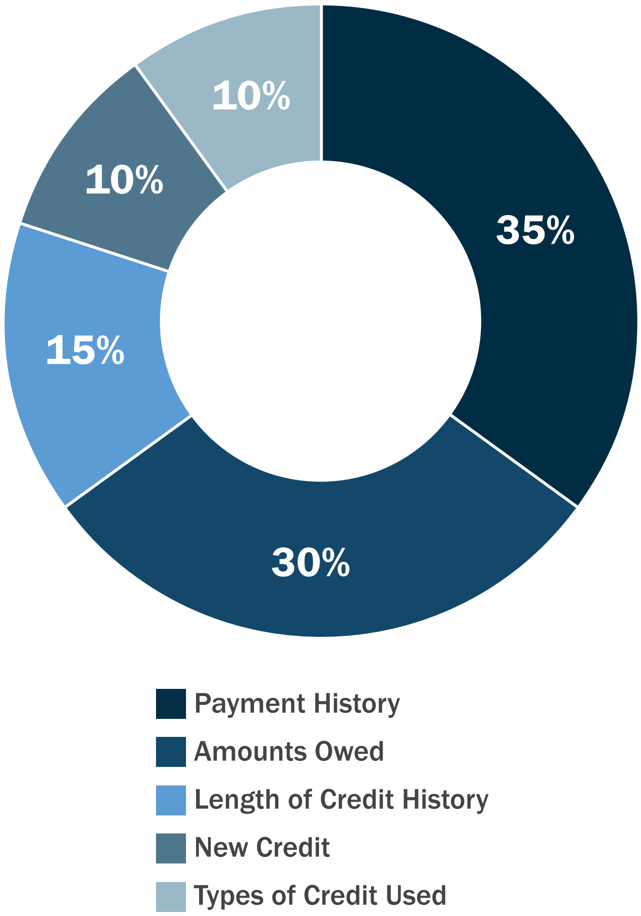
- **You can ensure that loans are available when you need them by establishing and maintaining a positive credit record.**
- **You can benefit from many specialized loan programs if you are aware of your borrowing options.**
- **You can save money by taking steps to reduce the cost of debt.**
- **You can save yourself from disaster if you know what to do should there come a time when you can no longer meet your financial obligations.**

## Establishing Credit

In order to have access to loans, you will need to establish a good credit record. Your credit record is established by borrowing money from a lender or using a creditor who reports to a credit bureau. Unfortunately, this is a catch-22 because most lenders won't give you a loan without a credit record, and a large proportion of your credit record is determined by the amount you borrow. However, there are other variables that make up your credit record, which brings us to our next topic of discussion: your credit score.

Based on your FICO credit record, lenders calculate your credit score so that they can assess the risk you pose to them before they decide whether to give you credit. The higher your score, the less risk you pose to creditors. Your score can range anywhere

## FICO Score Breakdown




from 300 to 850. Aiming for a score above 700 will most often put you in good standing.

The first step in maintaining a good credit score is to pay your obligations on time. However, simply paying your bills is not enough. It's not uncommon for credit reports to contain errors that are of a clerical nature or caused by misidentification (when someone's bad credit gets put onto your report). Although these errors may not be your fault, they can still impact your ability to get a loan.

In order to avoid such complications, you should consider getting copies of your credit reports from the various national credit reporting agencies: Experian, Equifax, and TransUnion. Usually, copies of your credit report require a fee; however, you may request up to one free credit report each year. Once done, you'll need to review the information provided and determine if there are any errors. If you find inconsistencies, you can contact one of the agencies and request an investigation of the error. Upon completion of the investigation, the agency will either correct, confirm, or delete the error. Regularly reviewing your credit report is a great habit to get into and also a good way to ensure that your identity has not been stolen (identity theft has become a growing problem with the dawn of social media and increased use of credit cards).

If you have no credit experience, don't worry—there are still other ways to build your credit history. You could put down a large down payment or post collateral to increase lenders' and creditors' confidence that you will be able to pay them back. Another good way is to open a credit card. Once you begin to build up a history of consistently meeting your obligations, lenders will be more willing to offer you credit.

## Borrowing Options

So you've established a credit record and now need to borrow some money. What's the next step? Knowing what borrowing options are available to you is important when shopping for credit. Some types of loans carry lower interest rates, some have tax-deductible interest, and others are subsidized by the government or have special repayment terms.

When you have the need to finance an expense, it's important that you educate yourself about your borrowing options to ensure you don't end up making a mistake that could cost you thousands or even tens of thousands of dollars.

Be aware that lending is a competitive and lucrative industry. And while competition does help to lower the cost of loans, it can also force lenders to loosen credit standards, making loans available to those who can't afford them or for those they may not be appropriate for (as we saw in the credit collapse that ignited a recession in 2007–2009). In order to make loans more appealing, lenders may also incorporate low-cost startup fees. But more often than not, those loans include inflexible terms that may end up costing the borrower more over the entirety of the loan than they were originally aware of. It's important to know your options and be willing to shop around. If you find yourself confused or hesitant, talk to a professional who can guide you through the costs, the benefits, and other available alternatives.

## Good Debt vs. Bad Debt

When evaluating your borrowing options, it's important to understand which debts can be considered good debt and which can be considered bad debt. In case you're unfamiliar with the term "good debt," debt can be considered favorable when the money borrowed is used for an investment or something that will increase your ability to earn more. Debt acquired to purchase a home can be considered good debt, because homes tend to appreciate in value. Another example of good debt is a student loan taken out to finance college or graduate school. Learning specialized or professional skills can increase your earning power over your lifetime, so it is considered an investment in yourself.


Just like there is good debt, there is also bad debt. When you use debt to finance something that is consumed or considered a depreciating asset, you are taking on bad debt. Credit card debt can be considered bad debt because it is usually used for everyday items like food and clothing. If a credit card is used for those types of items, you should be able to pay the balance off each month. Consistently maintaining an outstanding balance for longer than a few months is a red flag that you are spending too much.

It's important to understand that the way we define good or bad debt is a matter of concept and context. In practice, good debt is obtained through making wise decisions about your future—not for the sole purpose of having good debt.

**Example #1**

You may make the decision to obtain a master's degree in engineering to increase your earning potential as an electrical engineer. Taking out a student loan, if you have no other way of financing your education, is a good reason for taking on additional debt. However, taking out a student loan for a master's degree in art history when you plan to make a living as an electrical engineer may fall into the bad debt category. Student loans are usually interest-free while enrolled in school and for up to six months after graduation. But be careful, as the interest rates on these loans can become extraneous once payment begins, making it an important consideration in your debt management strategy.

**Example #2**

You may take out a mortgage to finance the purchase of a home with manageable monthly payments. In addition to providing the opportunity to purchase a home, the interest can be tax-deductible and make the purchase more favorable than renting over the long term. However, simply being tax-deductible does not create a good use of debt. Taking out a mortgage that requires a monthly payment equal to half your income or more can easily become unmanageable if you were to lose your job or experience a short-term disability. It's important to realize that while a tax deduction lowers your taxable income, it is not a dollar off taxes for every dollar you spend. For example, if you are in the 22% tax bracket, for every dollar you deduct you only receive a $0.22 tax break, **not** a dollar.

On the next page, we share some examples of good and bad debt. Remember that certain debt classified as "good" may not be good for you personally, as this distinction requires context. If you are overloaded with debt, it doesn't matter whether debt is good or bad—it still hurts your overall financial health.

| DESCRIPTION | VALUE | TAX-DEDUCTIBLE INTEREST | APPRECIATING ASSET |
|---|---|---|---|
| **Home Loan**<br>Home loans (mortgages) are considered good debt, because homes tend to appreciate in value and mortgage loan interest is deductible up to a certain limit. | GOOD | ✓ | ✓ |
| **Home Equity Loan**<br>With the Tax Cuts and Jobs Act of 2018, home equity loans and home equity lines of credit are only tax-deductible if used to acquire, build, or substantially improve the residence. | OKAY | ✓ | ✓ |
| **Margin Loan**<br>Margin loans are secured by an investment portfolio to purchase additional investments. | RISKY | ✓ | ✓ |
| **Consumer Debt**<br>Consumer credit loans are used to purchase items that rapidly decrease in value like furniture, appliances, and automobiles. | BAD | ✗ | ✗ |
| **Credit Card**<br>If not paid off each month, credit card obligations can lead to serious debt problems and increase the real cost of purchases. | BAD | ✗ | ✗ |
| **Student Loan**<br>Student loans provide opportunities to increase earning power for yourself. They typically come with very favorable short- to intermediate-term financing options but can become an excessive burden if the payoff is not managed properly. | GOOD | ✓ | ✗ |
| **Business Loan**<br>This is usually a term loan to invest in your business to increase its value and income. | GOOD | ✓ | ✓ |

| TYPE OF LOAN | DESCRIPTION |
|---|---|
| **Term Loan** | A loan with a fixed maturity and an amortization schedule. These loans are usually used for autos and homes. |
| **Line of Credit** | When a lender extends an amount to a borrower, usually without a fixed maturity. Examples of these types of loans are credit cards and home equity. |
| **Secured Debt** | When a lender loans money secured by some form of collateral, such as a home. |

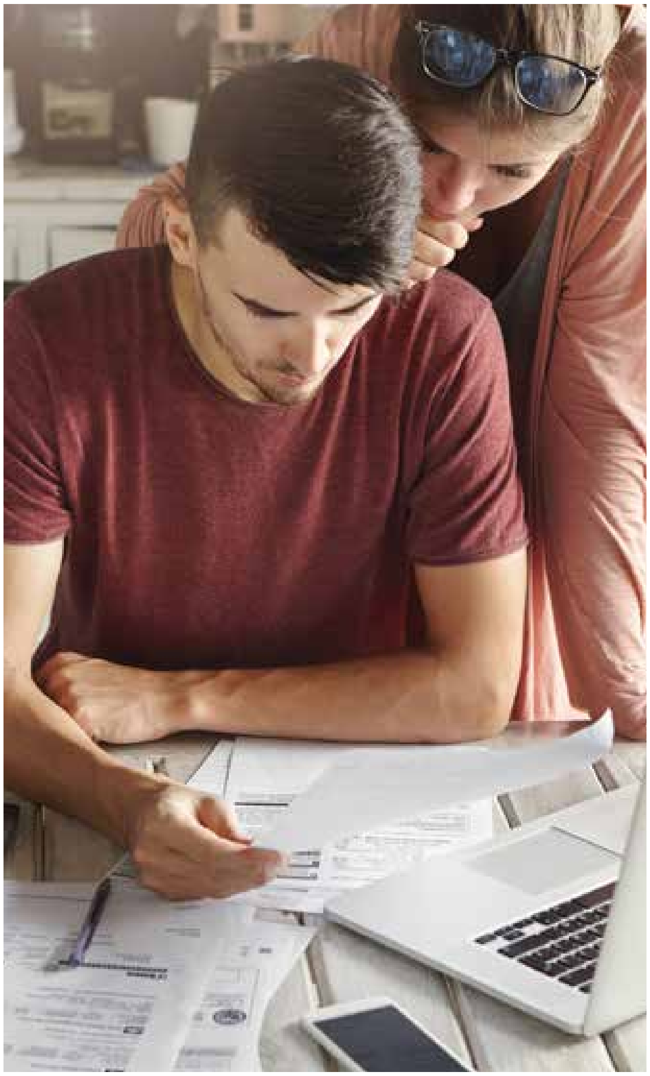
## Reducing the Cost of Debt

What if your problem is not access to debt but, rather, the amount of debt you currently have? It's good to periodically evaluate your debt situation and determine whether you can reduce the cost of your debt. In other words, it makes no sense to be paying more money in interest if you can be paying less.

There are several ways to reduce the cost of debt: you can refinance loans to get lower interest rates, use the equity in your home to pay off high-interest loans and credit card balances, or transfer your credit card balances to cards with lower rates. Additional options include prepaying debts and liquidating assets to pay off loans to avoid further interest charges. You may also seek to reduce or eliminate non-interest costs related to borrowing, such as private mortgage insurance (PMI). If you have kept your mortgage payments current and built up sufficient equity in your home, you may be able to cancel your PMI coverage. Many of these options have trade-offs. For more information, consult a financial professional.

## When You Can't Meet Your Financial Obligations

You should never take on more debt than you can afford. But if you are past that point, your next action should be to recognize you are financially overextended so that you can do something about it right away. While a mountain of debt can cause many people to give up trying, doing nothing is the worst possible choice. The longer you wait, the faster your financial troubles will spiral out of control (which can cause stress not only for you but for your family as well).



The simple solution is to increase your income, but in reality this isn't always feasible. If additional income is not an option, there are several things you can do to reduce your debt obligations. Reducing the cost of debt or negotiating directly with your creditors may enable you to lower your monthly payments by either lowering your interest rate or restructuring your terms. If you need professional advice, you can hire a credit counselor or contact a non-profit consumer credit counseling service (CCCS) that can help you organize a repayment plan. If your debt is more severe, you may want to consider consulting with a bankruptcy attorney. The most important thing is that you get started today!

# An Effective Debt Payoff Strategy

If you have found yourself in a pile of debt or are simply looking to reduce your debt load, there are a number of strategies for paying it off that you may want to consider.

## Make More Than the Minimum Payments

Lenders typically set a minimum payment that you are required to pay monthly in order to avoid penalties, an increase in interest rates, and/or default. The minimum payment is usually what is quoted on statements or account logins and may be what you have considered to be the regular monthly payment.

However, simply making minimum payments can result in long repayment schedules, which can cost you a lot of lost money to interest. **To truly tackle debt, you need to consider larger payments.**

**For example:**
Let's assume you have current debt on which you owe $100,000. The interest rate is 10%, the monthly payment is $1,075, and you have a remaining term of 15 years. If you make minimum payments, your total interest over the life of the loan is $93,429. However, if you pay an additional $250 per month, it will only take you 10 years to pay off the loan and the total interest paid will only be $58,318. You would save $35,111 in interest alone.

However, keep in mind that it is always a good idea to confirm that there are no prepayment penalties on the debt in question.

## Pay Off Highest-Interest Debt First With Extra Funds

One way to optimize the payment of your debt is to first make the minimum payments required for each debt, then allocate any remaining dollars to your debt with the highest interest rate. Once one debt is paid off, you put the money you were using to pay off that debt toward the next-highest-interest debt, and so on. Over the last few years, this method has been popularized and is often referred to as avalanching debt payments. **However, the key driver in this method is to attack that highest-interest debt first.**

**For example:**
Let's assume you have two credit cards. You owe $10,000 on each, and each has a monthly payment of $200. The interest rate for one card is 10%; the interest rate for the other card is 20%. If you make minimum payments, it will take you 109 months (about nine years) until

both debts are paid off, and you will pay total interest of $14,670.

If you are able to instead make monthly payments of $600 ($200 more than the minimum payment on both cards), here's what that would look like:

By paying the extra $200 per month on the card with the 10% interest rate first, it would take you 46 months to pay off the credit cards, and you would save $7,585 in interest over making only the minimum payments.

By paying the extra $200 per month on the card with the 20% interest rate first, it would take you 43 months to pay off the credit cards, and you would save $9,196 in interest over making only the minimum payments.

So, by simply routing your extra $200 per month to the higher-interest card, you increase your savings by $1,611 and pay off your debt three months earlier.

## Cash Out Some of Your Savings

You could use some of your cash savings or investments to repay debts. Of course this isn't ideal, but sometimes it makes sense.

**For example:**
If the interest rate on a loan is 15%, your investments would have to return 15% after federal and state taxes to equal that outflow in dollars. Paying off debt with a 15% interest rate is the same as getting a 15% return without the risk of loss. The higher the interest rate on your debt, the more attractive repayment becomes compared to investing.

## Consolidate Your Debt

If you have multiple debts with high interest, it may be possible to transfer the higher-interest-rate debt to your lower-interest-rate debt. For example, you may be able to transfer the balance on a higher-interest credit card to a lower-interest credit card.

Do you own your own home? If so, another option is to pay off those debts by getting a consolidated loan. This type of loan will typically be a home equity line of credit (HELOC). Therefore, the interest rate on it would most likely be much lower than interest rates on the debt being consolidated. However, it's important to realize that you are potentially putting your home at risk, because it serves as collateral for the loan. Additionally, closing costs and other charges should be considered.

## Renegotiate Terms With Your Creditors

What if you've done all you can, all your savings are gone, and not even your friends and family will lend you money anymore? Is bankruptcy the only choice? No. Before actually filing for bankruptcy, use the threat of bankruptcy to negotiate with your lenders. Call your creditors, tell them your situation, and let them know that if they are unable to renegotiate your terms, you'll have no choice but to declare bankruptcy. Points of negotiation could include a lower repayment schedule or a lower interest rate. Many creditors will do what they can to avoid a total loss. If you are unable to do this yourself, there are several non-profit organizations that can help you with it.

## File for Bankruptcy

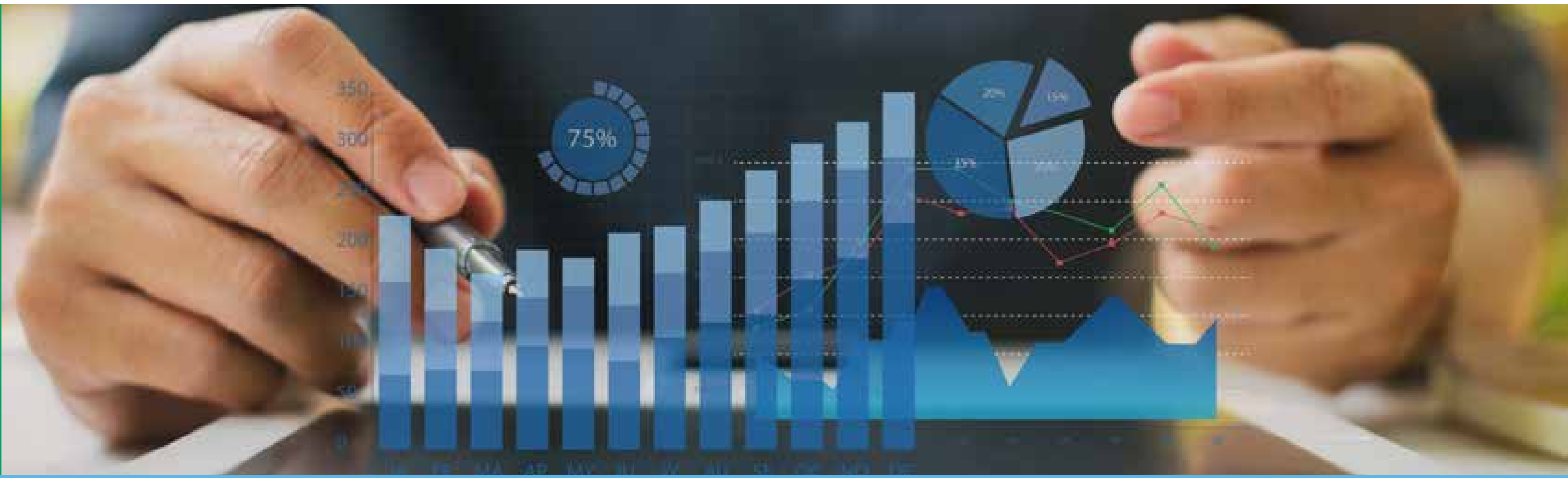
If none of the above methods are feasible, then as a last resort you must consider bankruptcy. There are two types of bankruptcy relief: Chapter 7 and Chapter 13.

**Chapter 7** is straight bankruptcy that allows the discharge of almost all debts. However, be aware that certain debts can't be discharged (this includes alimony, child support, taxes, loans obtained through filing false financial statements, legal judgments, and student loans, among others). Oftentimes you will be required to surrender much of your property to satisfy debts, but each state has different laws and exemptions in place.

**Chapter 13** allows you to keep your property, but you surrender control of your finances to the bankruptcy court. The court approves a repayment plan based on your financial resources over a stated period of time. During that time, creditors are not allowed to harass you for repayments, and, if all conditions are met, you will come away free of debt at the end of the stated period.

*Before actually filing for bankruptcy, use the threat of bankruptcy to negotiate with your lenders.*

It's important to consult a lawyer, because different states may have different laws and regulations regarding bankruptcy.



# Pay Down Debt or Save for Retirement?

According to the Federal Reserve Board, nearly one-third (31%) of U.S. adults say they have no savings or pension to help them afford retirement, and one-quarter didn't know how they would afford their golden years. Not only that, but according to a 2014 survey conducted by creditcards.com, one in five Americans believe they will die while still in debt.

Those are two very scary statistics. With that in mind, many are beginning to ask if it's more important to pay down debt or save for retirement. Just as with all other things financial, there is no one answer that's right for everyone.

## *Here are some factors to consider when making your decision.*

### Rate of Investment Return vs. Interest Rate on Debt

Probably the most common way to decide whether to pay off debt or save is to consider the opportunity cost. Ask yourself if can you earn a higher after-tax rate of return by investing than the after-tax interest rate you pay on your debt.

For example, say you have a credit card with a $10,000 balance on which you pay non-deductible interest of 15%. By getting rid of those interest payments, you're effectively getting a 15% return on your money. That means your money would generally need to earn an after-tax return greater than 15% to make investing a smarter choice than paying off debt.

However, the decision about whether to save for retirement or pay off debt can sometimes be affected by the type of debt you have. For example, if you itemize deductions, the interest you pay on a mortgage is generally deductible on your federal tax return.

Another thing to keep in mind is that investment returns are anything but guaranteed. In general, the higher the rate of return, the greater the potential risk. If you make investments rather than pay off debt and your investments incur losses, you may still have debts to pay and you won't have the benefit of any gains. By contrast, the return that comes from eliminating high-interest debt is a sure thing.

### An Employer Match May Change the Equation

If your employer matches a portion of your workplace retirement account contributions, that can make the debt versus savings decision more difficult. Let's say your company matches 100% of your contributions of up to 3% of your salary. That means you're earning a 100% return on that portion of your retirement account contributions.

This may make saving at least enough to get any employer match for your contributions a higher priority than focusing on debt.

And don't forget the tax benefits of contributions to a workplace savings plan. By contributing pretax dollars to your plan account, you're deferring taxable income. Depending on your federal tax rate, that could be anywhere between 12% and 37% that you're able to put to work immediately using money that would ordinarily go toward taxes.

## A Life of Balance

A successful strategy will most likely include a mix of paying off debt and saving for retirement. For example, let's say you're paying 5% on your mortgage and 15% on your credit card debt, and your employer matches 100% of your retirement account contributions up to 3% of your salary. You might consider first meeting your company's contribution match while continuing to pay tax-deductible mortgage interest, then putting some extra money toward your credit card debt.

There is another good reason to explore ways to address both goals: time is on your side when saving for retirement. If you decide to wait to start saving until your debts are completely paid off, you run the risk of never getting to that point; your good intentions about paying off your debt may waver at some point. Putting off saving also reduces the number of years you have left to save for retirement.

## Other Considerations

When deciding whether to pay down debt or save for retirement, make sure you take into account the following factors:

- **Having retirement plan contributions automatically deducted from your paycheck eliminates the temptation to spend that money on things that might make your debt dilemma even worse. If you decide to prioritize paying down debt, make sure you put in place a mechanism that automatically directs money toward your debt.**

- **Do you have an emergency fund or other resources that you can tap into if you lose your job or have a medical emergency? Remember that if your workplace savings plan allows loans, contributing to the plan not only means you're helping to provide for a more secure retirement but also that you're building savings that could potentially be used as a last resort in case of an emergency. Some employer-sponsored retirement plans also allow hardship withdrawals in certain situations (such as to prevent an eviction from or foreclosure of your principal residence) if you have no other resources to tap.**

- **If you focus on retirement savings rather than paying down debt, make sure you're invested so that your return has a chance of exceeding the interest you owe on that debt. While your investments should be appropriate for your risk tolerance, if you invest too conservatively the rate of return may not be high enough to offset the interest rate you'll continue to pay.**

Talking to a financial planner can help you sort through the options available to you for reducing debt and saving for retirement. Regardless of which goal you choose to prioritize, perhaps the most important decision you can make is to take action and get started now.

**The sooner you decide on a plan for both reducing your debt and building your retirement savings, the sooner you'll start to make progress toward achieving both.**

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- **Wealth Building**
  For those still accumulating their investment portfolios
- **Wealth Management**
  For those who have amassed savings and have specific needs associated with their wealth
- **Wealth Legacy**
  For those who have accumulated a significant amount of wealth and face unique wealth transition needs
- **Corporate Retirement Services**
  Providing tailored solutions for plan sponsors and participants

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At Reilly Financial Advisors, it is our goal to be clients' first point of contact for all their financial needs, serving as their trusted financial partner for life.

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