

SIMPLE MATH MAY LEAD TO A SIMPLE ANSWER

The question of whether you should pay off your debt or start investing is one that is quite common. Whether it's a mortgage, car loan, student loan, or credit card, you probably have some amount of debt in your life. It is only natural that you want to pay it off as soon as possible. On the other hand, it is understandable that you want to start putting money away for your retirement or some other financial goal you have. Since there is only so much cash to go around, a decision normally has to be made between the two, neither of which leaves a person feeling completely satisfied.

What should you do? The answer depends on two variables:

1. The rate of after-tax interest you are paying on your debt
2. The after-tax rate of return you expect to earn on your investments

Before you answer the first question, you must understand that there are two different kinds of debt. On one end of the spectrum is high-interest credit card debt that originates from things such as credit cards and department store charge accounts. This type is the deadliest and generally should be avoided unless absolutely necessary. The second type of debt is the lower interest variety; your mortgage, student loans, etc. Often, the interest on these types is partially or wholly tax-deductible, making it even more attractive.

With that in mind, from a pure financial numbers perspective, the answer to the debt reduction vs. investing question can be solved with this one statement: **If you can earn a higher after-tax return on your investments than the after-tax interest rate expense on your debt, you should invest. Otherwise, you should pay off your balance.**

EXAMPLE OF DEBT REDUCTION VS. INVESTING CALCULATION

Scenario 1

Assume you have a fixed 30-year, \$250,000 mortgage at a 6% rate. Also assume you are in the 25% tax bracket. Due to the itemized deduction of mortgage interest, your **after tax** annual percentage rate is really 4.02%, not the 6% you are paying. Hence, if you expect to earn an after-tax return higher than 4.02% on your investments (odds are substantial you will if you have a long-term horizon), then you should invest.

Scenario 2

Assume you have a \$10,000 balance on a credit card with a 22% annual percentage rate. Credit card interest expense is not tax deductible, meaning you should only invest if you think you can earn a 22% after tax return on your investments. Given that the historical long-term return on equities has been somewhere around 10-12%, this seems highly unlikely. In this case, it would be advantageous to work towards aggressively paying off the credit card.

THE BOTTOM LINE

Although you may be eager to invest, you need to do what is best for your bottom line. Regardless of which is the wiser course of action at this stage in your life, the ultimate goal should be to have no debt and an abundance of great, high performing investments.