What's First with Your Next Dollar: Investing Or Paying Off Debt

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Today's young professionals often begin their careers staring at a mountain of debt: student loans, car notes, credit card balances and not infrequently a mortgage. When constructing your personalized financial plan, a review of your debts and investment assets is the first step in answering the question: Should I use available income to pay down debt or should I invest it for the future?

The answer is part science and part art. The science portion involves understanding your financial position. What do you own and what do you owe? If you have outstanding debt, what kind of debt is it? What is the interest rate?

Debt has two uses: to inflate your current lifestyle or to help you acquire an asset. Lifestyle debt, or bad debt, includes personal loans, credit card debt or any other loan that allows you to spend more than you have coming in. This debt usually comes with high interest rates, which can fluctuate. While credit cards make purchases efficient and easy, only making minimum payments on an outstanding balance increases the cost of the items you bought dramatically. Indeed, regularly running up balances larger than you're able to pay off every month can create a deep, dark financial hole.

If you hold bad debt, your top priority is to pay it off as quickly as possible. Attack the highest-interest-rate debt first to lock in the highest return for your money. Then move on to the debt with the next highest interest rate until your lifestyle debt is gone.

Generally, a loan to help acquire an asset is good debt. This type of debt tends to have a lower, fixed interest rate and includes items such as a home mortgage, business loan or purposeful student debt. A reasonable home purchase allows you to obtain an asset that can increase in value, and, if needed, you can borrow against it. Business owners use debt to build their businesses and add assets. Taking on student debt to pay for college in an intentional way can increase your future earning potential.

Auto loans represent a bit of a special case for many consumers. While cars are officially considered an asset, they defy categorization this way by predictably depreciating. In addition, auto loans aren't great debt to carry because the interest isn't tax-deductible. On the other hand, right now the range of interest rates available on loans for new and slightly used cars is comparatively quite low.

Next, start organizing your outstanding good and bad debts. I use a spreadsheet, so it looks something like the following table. The must-haves in any system you choose to track your loan information are the type of debt, interest rate, term (how long you have to pay it back) and amount outstanding.

Debt Type	**Interest Rate**	**Term**	**Outstanding Balance**	**Monthly Payment**
Student Loans	7%	10 Years	$125,000	$1,451.36
Home Mortgage	5%	30 Years	$300,000	$1,610.46
Car Loan	2%	5 Years	$20,000	$351.00

Once you understand your debt, compare the interest rate on your debt to the expected return of your investments. Paying off debt has a guaranteed return; for each additional dollar you use to pay down debt, you earn a return equal to the interest rate. In the preceding example, each dollar used to pay off the student loans earns a 7% return. Investments do not have those guarantees. Let's say you are 100% invested in the S&P 500, an index of the stocks of 500 large U.S. companies. (This is a thought exercise, of course, because you can't invest directly in an index, only a fund that tracks an index and earns its returns less expenses. Also, I don't recommend investing only in U.S. large-cap stocks.) Since 1926, the S&P 500 has posted an average annual return of just about 10%. While the average return was approximately 10%, that number does not tell the entire story. From year to year the value can increase or decrease, sometimes dramatically. In 2008, the S&P 500 returned a negative 38.5%, but in 2013, it was up almost 30%! When determining if you should pay off debt faster or instead invest in the stock market, understanding the potential fluctuations of investments is important. Considering a longer horizon, the math indicates the better approach is to pay only the required amount on lower-interest-rate debt and invest additional available dollars in a diversified stock portfolio. But the math is only part of the decision.

The other part, the art portion I mentioned earlier, reflects your feelings on debt. Does having debt make you anxious or keep you up at night? Or do you see it as just a normal part of life? If the thought of having debt feels like a giant weight hanging above your head ready to crush you, then allocating more money to pay down debt than to your investment account is a prudent strategy. Just remember, though, that time can be one of the greatest benefits your portfolio has going for it. Paying off debt quicker may be gratifying, but you are giving up compounding returns and future growth by not investing those dollars sooner. Of course, your peace of mind may be worth that price.

Just because there is an arithmetically "optimal" strategy does not mean it is the best one for you. The best plan is the one you can stick with through the twists and turns or life. Working with a fiduciary financial professional can help you create just such a financial plan and prepare the right strategy to both reduce your debt and meet your long-term goals.

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