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Thinking of the future: Invest or pay off debt?

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QUESTION: We have some money saved and have some loans. Should we invest the money or pay off the loans?

Podnos: The only general conflict of interest in fee only financial planning is when I am asked whether a client family should apply funds towards paying off debt or increase investments under my guidance.

There are a number of factors to consider. There are the psychological factors of reducing and eventually eliminating debt. I believe this is a powerful thing that leads to great peace of mind-although hard to measure strictly from a financial viewpoint.

One thing I do see often over the last few years is a family having investments in fixed income that are yielding very low returns (especially in cash or short term bonds). If you are sitting on a great sum in such low return vehicles, why not pay off higher interest debt? The only reason I can think of is a loss of liquidity — i.e. the money is not readily available after paying off the debt. So, consider how important the liquidity is in view of other sources of cash flows and savings. Most people should have an emergency fund equal to a few months of lifestyle expenses even if the return is low.

A direct consideration is the interest rate on the debt and whether or not it is tax deductible (say as with a mortgage). You have to compare this interest rate with the expected return on investments (expected, not certain is the key here). It always makes sense to pay off debt with a higher interest rate than you are making or are expected to make with investments.

An unusual but possible reason to save rather than pay down debt is if you are participating in a 401(k) plan with an employer match. For example, the plan may offer a 1:1 match dollar for dollar for up to 3 percent compensation. If so, you are receiving a 100 percent return on this amount, and should not pass up this free money by paying down debt instead.

So, in terms of an “order”-I’d recommend that initial savings go to catching a 401k match. Then, have enough emergency savings. After that, start paying down your highest interest debt and move down the ladder of debt sequentially.

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