DEBT

THE HIDDEN COST OF DEBT: COMPOUNDING INTEREST

1 BEYOND YOUR BANK ACCOUNT: HOW IS DEBT AFFECTING YOU?

It is important to consider the effect debt has on your mental health as well as on your financial health. In a study done at the University of Nottingham, researchers found a strong correlation between debt and mental health struggles. In the study, 29% of participants with high debt stress also reported high anxiety.[1] If your finances are causing stress, reducing debt may provide relief.

2 DEBT AND YOUR FUTURE

Your age, goals, type of debt and interest rates are all factors that may influence the rate at which you pay off debt.

1. Generally, it is a good idea to pay off high interest debt as quickly as possible. Choosing to invest extra cash, even with a guaranteed return of 10-12%, instead of paying off a credit card with a 20% interest rate will keep you behind.
2. If you have a longer time horizon until retirement, weigh the pros and cons of investing more for retirement in lieu of paying off your low interest mortgage or student loans early. As a pre-retiree with a 5-10 year horizon, lean into paying off your debt sooner rather than later. Walking into retirement with debt may add additional risk and stress.
3. For some individuals, being debt free means more than any potential financial benefits they might gain by saving. If your goal is to be debt free regardless of your retirement timeline, stay focused on that goal.

3 STRATEGIES FOR ELIMINATING DEBT

- **The Debt Snowball:** This strategy relies on human behavioral tendencies to want to make progress quickly. Start by paying off your smallest debts first, then apply that payment towards your next debt. The idea is that you will feel rewarded when you see the progress you have made, encouraging you to stay focused and pay the remaining debts off faster.
- **The Avalanche Method:** This strategy leverages the mathematical benefits by paying off debt with the highest interest rates first.

SO WHAT DOES THIS MEAN FOR ME?

Jayce and his wife Janice have a household income of $85,000, a $120,000 mortgage, vehicle loans that total $32,000 and $4,500 in medical bills. At ages 55 and 53 they are saving 10% of their income towards retirement. As they begin to plan for retirement they realize their budget cannot handle the mortgage and vehicle payments. They have interest rates lower than 5% on all of their debt and decide to use the snowball method to start paying off their debts. They start with their medical bills then apply that payment to their vehicle loans. When Jayce turns 65, they've paid off their consumer debt and only have a mortgage balance of $15,000. Applying extra payments to their mortgage and paying off their consumer debt has saved them thousands of dollars in interest over the past ten years. Without car payments, they have also been able to put more into their cash emergency fund for retirement giving them a stronger safety net.

[1] (1) John Gathergood, Debt and Depression: Causal Links and Social Norm Effects, The Economic Journal, Volume 122, Issue 563, September 2012, Pages 1094–1114, https://doi.org/10.1111/j.1468-0297.2012.02519.