

Pay off your debt, don't just pay it down

Patricia Lovett-Reid, Financial Post

Do you remember when people bought only what they could afford? My father used to say, “most debts are fun when you are acquiring them, but none are fun when you set about retiring them.”

One of the biggest challenges Canadians face is trying to balance paying down debt while saving for the future. Deciding when it makes sense to do either is about considering the effects of compound interest — when it is working for you and when it is working against you. With debt, time and compounding are working against you. For example, if you have a \$3,000 outstanding credit card balance at 18% interest, and just pay the minimum balance of 3% or \$10, whichever is higher, it will take 14 years and nine months to pay off the balance and cost you about \$2,350 in interest. You can't save for the future and get ahead when you have a balance outstanding on a high-interest loan or credit card. These need to be paid off, not just paid down.

Here are three scenarios of savings versus paying down debt:

1. Save in a non-registered account versus paying down debt A very simple way to look at this conundrum is to compare the rate of interest you are paying on your non-tax-deductible debt to the rate of return you could earn on your portfolio. For example, if you are paying 8% on your loan and you are in the 30% tax bracket, you would need to earn approximately 11.5% to break even.

If you don't think your portfolio can consistently beat the break-even rate, paying down debt is the safer way to go. You will save interest and get out of debt faster, which will free up your monthly cash flow.

2. Contribute to a TFSA versus paying down debt The return earned in a TFSA is tax-free. If you are paying 8% interest on your loan, you would need to earn 8% inside your TFSA to break even. If you typically invest your savings in GICs or government bonds that yield much less, it might make sense to pay down debt first.

But contributing to the TFSA provides ready access your cash and can be a great emergency fund. Just remember that the amount withdrawn is added back to the contribution room only in the following year.

3. Contribute to an RSP versus paying down debt Paying down debt is important, but many pursue it single-mindedly to the detriment of saving for a secure retirement. In some cases, it may be better to take a balanced approach.

If you have a five-year fixed-rate mortgage at 4.5% and expect the long-term potential return on your portfolio to average 6% to 8%, then it makes sense to contribute to the RSP. You will not only be earning a higher net rate of return, but will also benefit from the reduction in your tax liability in the current tax year.

Time and compounding are key elements in the growth of a retirement nest egg. For example, if you start contributing \$100 a month to an RRSP that earns 6.8% per year (compounded monthly) at the age of 25, your total contribution of \$48,000 could grow to \$234,500 by the time you turn 65. Now, if you wait until you are 35 to start investing, you would need to increase your monthly contributions to \$208 a month or \$74,880. That's 56% more! When it comes to improving your net worth, you don't have to think just linearly. An effective solution could be to make your RSP contribution and apply your tax refund to any outstanding debt.

There are two ways to improve our personal balance sheet: save more or pay down debt. You need to find the optimal combination of debt repayment and savings. It is all about you taking charge and setting priorities for your next dollar of discretionary income.

<http://www.financialpost.com/your+debt+just+down/3310355/story.html>