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Choosing between setting aside savings or paying down debt

By Jeff Wuorio - For the Deseret News

The question of "Which is the best choice: Paying off debt or saving?" might be the financial equivalent to "heat versus humidity:"

Like the meteorological puzzler, there's no ready yea or nay response. As certified financial planner Matt Cosgriff put it, "The save or pay off debt question is a perfect example of why personal finance is both an art and a science, which is to say there is rarely a perfect answer and certainly none that are a one size fits all."
The type of debt, amount of debt and interest rates are just a few factors to consider when deciding whether the focus should be on savings or eliminating financial liabilities or a balance between the two.

The case for ridding debt

For some financial professionals, the answer is an obvious one: Debt can be a financial death sentence, so make that job No. 1.

One compelling reason to tackle debt first is the high interest rates that many forms of debt command. As of late May, the average fixed interest rate credit card stood at 12.52 percent. Variable rate cards were even steeper at 16.03 percent.

"Without a doubt, I generally recommend that people pay down consumer debt. They should consider paying off credit card debt first because it tends to have the highest interest rates, often in the double digits," said certified financial planner Gary Watts. "Any investing or saving plan usually can't keep up with a double-digit interest rate on a credit card balance. Credit card debt is toxic and a wealth destroyer - this has to be a top priority."

It's important to note Watts' specific mention of consumer debt, such as credit cards. Even if they differ on the save/debt pay-down question, most financial pros don't include mortgages in the pay-down first directive. Not only are mortgage interest rates hovering at historic lows but, with few limitations, interest on mortgage loans is fully tax deductible.

The case for saving

There are circumstances when an emphasis on setting money aside first makes sense. Perhaps the most enticing option involves workplace retirement savings programs, such as 401ks and, for public sector employees, 403b plans.

The case boils down to a series of advantages. First, with workplace savings programs, funds are withdrawn before they're considered employee income, which provides a return via tax savings. Prioritizing savings becomes all the more attractive if there's an employer match added on.

And with so many Americans facing retirement with inadequate savings, ramping up your own retirement program as much as possible can make debt paydown less of an immediate necessity - or, by the same token, more viable.

"In many cases, the employer matches, which may help give the employee a significant first year rate of return on their contribution," said P. Jeffrey Christakos of Westfield Wealth Management. "The investment grows tax deferred and there is an initial tax deduction for the contribution. The tax savings can be used to increase the contribution or be applied to a debt payment."

The choice

If the decision between saving and debt paydown seems irreconcilable, there's always the option of doing both at the same time. As Portland, Oregon, financial planner Glen Clemans explained, exclusive focus on debt paydown can rob investors of years of valuable retirement savings compounding.

"There are folks who say that you should not be putting any money into retirement until you are out of debt, but I disagree," he said. "If a person has a plan at work with a match, I generally recommend that they do the matching amount, even if they have debt. Then, I focus on high interest consumer debt first and rank the various items in order of the interest rate. I help them come up with a plan to pay off the debt in a reasonable period of time, depending on income and the level of debt."

Don't ignore psychological factors in whatever decisions you make. For many, paying down debt is almost liberating in its appeal. Others - perhaps wary of coming up short financially in retirement - may prefer a greater emphasis on saving.

Still, it never hurts to run some numbers to gain an empirical view of which option offers the most bang for the buck.

"A helpful framework for determining the best course of action is to use the science and art framework, which is simply to run the numbers to see what the math says you should do," Cosgriff said. "Then work on determining what your personal preferences are. Do you hate debt, even if it's a super low interest rate? Try to find the middle ground behind balancing what the math says you should do and your personal preferences."

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