

Balancing debt and savings

Should you settle your debts before you start saving?

One of the biggest obstacles to saving is debt. Traditional advice is to settle your debt and then start saving.

This is a good strategy for **short-term debt** like credit cards, store cards or personal loans with high interest rates (above 17%). By paying them off quickly, you effectively guarantee a return of 17% as this is what you will be paying in interest. There is no investment that can guarantee you those returns. The key to building wealth is not to take on further debt but to start a savings plan.

However, for **long-term debt** such as a home loan, delaying savings does not necessarily make financial sense as interest rates on this debt are lower than the growth on investment savings. For example, if your bond repayment is 9% and your investments are delivering 11% growth, after tax, that additional 2% compounding over time will have a significant impact on your final lump sum.

Pay off your mortgage or save for retirement?

Many young people find themselves caught up in debt and this leaves them with little ability to save.

Australian employee benefits expert Anthony Asher argues that forcing young people to save into a pension fund and introducing compulsory preservation of retirement savings is “an assault on the young, it is a decision made by older people telling them to save.” He argues that the financial pressure on young couples trying to buy a home and educate children can cause marital problems. He advocates boosting savings once the house is paid off and the kids are financially independent.

Asher’s point is a valid one. During those SITCOM years (Single Income Two Children Oppressive Mortgage) it is difficult to pay your mortgage, educate your children and keep saving. So you need to have a long-term strategy to save as much as possible when you do not have family commitments so that you can cut back on savings during the crunch years and still have enough to retire on.

The problem with delaying retirement savings or cashing in your retirement fund early to settle your mortgage, is that you would have to double your retirement contributions to make up for the loss of compound growth over ten years. Normally the rule of thumb is to budget 15% of your income for retirement saving, that figure would double to 30% of your salary. This would be unaffordable for most people.

Finding the balance

The first rule of debt is that you should be able to earn your way out of it: debt is a claim on *future income*. Retirement saving is a call on our *current income* to meet future requirements when we are too old to work.

Find a balance between using *future income* now and saving *current income* for the future:

- Save as much as possible from your first pay cheque until you purchase your first home so that you have a significant deposit. Don’t use the deposit to buy a more expensive home, but rather to reduce your monthly repayments.
- Continue to save the maximum into your retirement savings (15% of salary) until you start a family and commit yourself to a bigger mortgage. You can cut back (not cut out!) retirement savings only if you have built up a solid financial base in your 20’s.

- Use bonuses and salary increases to pay off your home by the time you are 50. Avoid the temptation to tap into the equity you have built into your home by drawing down on an access bond or buying a more expensive home.
- Once you are bond-free, use your extra cash to maximise your retirement savings until age 65.

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