RETIREMENT INVESTMENT ADVISORS, INC.

2925 United Founders Blvd.
Oklahoma City, OK 73112
(405) 842-3443
(800) 725-4530

2952 Via Esperanza
Edmond, OK 73013
(405) 246-0404

9300 John Hickman Pkwy.
Suite 504
Frisco, TX 75035
(972) 377-2850

www.TheRetirementPath.com

left to right: Brenda C. Bolander, Joe Bowie, Randy Thurman, Carol Ringrose Alexander, Chad Rudy, and Andrew Flinton

Financial Briefs

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Paying Off Debt Isn't Saving

Save your money or pay off debt? It probably comes as no surprise to hear that the answer varies. But one thing is certain: paying off debt is *not* the same as saving. Here's why.

The rational objective for all sound financial planning is to increase your net worth, which is the true measure of your financial health. Calculating your net worth is simple: total up the value of everything you own and subtract from that all of your debt.

Net Worth = Assets – Debt

When you pay off debt, it feels good. And, in fact, it almost always improves one aspect of your financial wellbeing: it lowers your monthly bills, which means you can either spend or save more. But if you look carefully at the formula for net worth, it's clear that paying off debt doesn't immediately increase your net worth, because it reduces your assets by as much as it reduces your debt. So, by itself, paying off debt doesn't advance your goal of building wealth. It only helps if you save the amount you no longer have to send to your creditor.

Higher Priorities Should Come First

Paying off debt can also make your financial situation more precarious. For example, if you deplete your savings, you may be in a worse position to cover your expenses in the event of an emergency. In fact, it's one of the principles of good planning to maintain an emergency savings account equal in value to your living expenses for three to six months. So unless you already have enough tucked away in your emergency fund, you should think twice about using any free cash to pay off debt. And if you have a partner and dependent children, maintaining a life insurance policy sufficient to meet their needs should also be a higher priority than paying off debt.

But let's say that you have both of these objectives covered. Does it make sense to be aggressive in paying off your debts? It can. It generally (but not always) comes down to comparing the potential return on your investing choices to the *effective* interest rates you're being charged on your loan.

Compare interest rates. If you're paying a higher rate of interest on a debt than you could earn on an investment, it makes sense to pay off that debt as quickly as you can. Such is typically the case with credit cards, where it's rare that interest rates are less than double digits. Making only the minimum required payment is generally a bad idea, because interest and fees can grow faster than you pay down the principal. At the very least you should try to pay more than the minimum —

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Debt and Your Retirement

Most people's vision of retirement not only involves freedom from work but also freedom from debt. A debt-free retirement is a laudable goal, but it's one that has become increasingly difficult for many to achieve. Mortgage, credit card debt, even student loans now follow people into their golden years, and that can have serious consequences for their long-term financial health.

The Debt-Free Retirement Goal

When you retire, you stop actively earning income and start living on your savings. If you're still paying off debt, those payments will be another fixed expense, which means you'll have to draw more from your nest egg and have less to spend on things you truly enjoy. By going into retirement debt free, you'll lower your living expenses,

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Paying Off Debt

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even if you're not trying to be aggressive in paying down the balance.

If you have money left over at the end of the month, you should consider trying to save and paying down debt simultaneously. This is especially true when it comes to tax-advantaged savings plans, like individual retirement accounts (IRAs) and 401(k) plans. Contributions to these are often made on a pretax basis, which adds to the effective total return you receive. If your employer matches your contributions, you should do all you can to contribute to the maximum match before taking an aggressive stance toward reducing your debt load.

Don't forget the power of compounding. The biggest reason to save *and* pay down debt at the same time is that saving, even relatively small amounts, puts time on your side by harnessing the power of compounding. When you reinvest your returns — whether it's interest, dividends, or capital gains — your money makes more money, and you can reach your long-term goals faster.

Be careful about paying off mortgages. Owning a home free of mortgage debt remains a fond dream that influences the decisions many Americans make. It explains why 15-year mortgages seem more appealing to some than 30-year mortgages: not only are the interest rates for 15-year mortgages generally lower, but it takes less time to pay them off, and the accumulated interest you pay is much less.

But it's not necessarily a smart idea to take out a 15-year mortgage because the required monthly payments are generally 20% to 30% higher than the payment on the same principal amount for a 30-year loan. That means that you have less free cash flow to devote to saving in a retirement plan, and if you lose your income for an extended period of time, it's harder to keep up with the payments.

On top of that, mortgage interest is generally tax-deductible. Finally, the interest rates on mortgages are among the lowest consumers face. All of this means that paying off a mortgage more aggressively is one of the last spending options you should consider.

In summary, paying off debt has its advantages, but whether it's the right choice for you depends on your broader financial picture, what kinds of debts you have, what interest rates they carry, and what your saving opportunities are. It can take some careful analysis to make the best decisions. Please call if you'd like to discuss this in more detail.

Is There Such a Thing as Good Debt?

Good debt is basically defined as financing something that will increase your income or net worth, while bad debt is just the opposite. You should try to think of good debt as an investment. You're borrowing money now with the hopes that the asset purchased will increase in value over time.

What you want to do is try to minimize your bad debt and maximize your good debt. When you consider a purchase, think like an investor. Will you make a profit from the purchase? Will it help with your future? Will it help you earn income? If you answer no, then you may want to wait to make the purchase.

Following are examples of good debt:

Education — Taking out a loan for college or technical training is an investment in your future. After years in the workforce, it will most likely pay for itself. Typically, better educated people have greater earning potential and have an easier time finding good-paying opportunities.

Owning a Business — Entrepreneurs who are willing to work hard and have the ambition needed to run a business can turn a small business loan into a successful venture. Hopefully, this investment in yourself will result in a business that is self-sustaining with a good profit.

Purchasing Real Estate — There are several different ways to make money on real estate. The most common is taking a mortgage to purchase a home and then selling it at a profit after many years. Investing in residential real estate by renting out a home or apartment is also good debt that can provide you with ongoing income. And commercial real estate, such as an office building, store, or industrial park, can return good profits and capital gains.

Here are some examples of bad debt:

Vehicles — For many, vehicles are a necessity and an expensive one. When you take a loan to buy a car, the minute you drive off the lot, the car loses a significant portion of its value. Financially, it would make more sense to purchase a used car with cash or finance a smaller amount.

Consumable Goods — We all need clothing to wear, food to eat, gas for our cars, and the occasional get-away trip, but many buy these items with borrowed money instead of cash. Not only are these items probably worth less than what we pay for them, but interest on the debt increases the price substantially.

Credit Cards — When credit cards are used to pay, they are doing nothing to increase your income or your net worth. The interest rates can be incredibly high over other types of consumer loans and the payments are designed to maximize the costs to the consumer. And, if you don't pay your balances in full each month, your debt could quickly get out of hand.

Please call if you'd like to discuss debt in more detail.

Your Retirement

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which will make that nest egg last longer.

Reducing Debt before Retirement

If at all possible, you'll want to eliminate your debt before you retire. Of course, some types of debt are worse than others. High-interest credit card debt can be a significant burden, so you'll want to eliminate it as quickly as possible. Look for areas in your budget where you can cut back and make extra debt payments, or consider a second job to make extra payments. If you have a car loan and are close to retirement, consider selling the car after you quit working, since many people find they no longer need multiple vehicles in retirement.

Becoming debt-free before retirement may mean aligning your mortgage payoff date with your retirement date; you may be able to bring your mortgage payoff date closer by making extra payments. Often, retirees want the peace of mind that comes with knowing they'll own their home when they retire. But that accelerated payoff plan might not be right for everyone. If you have a relatively low-interest mortgage, no other debt, and are already maxing out your retirement savings, you may feel comfortable sticking with your standard repayment plan, especially if you can get more from investing the money that you'd otherwise use to make the extra mortgage payments.

One thing you shouldn't do: take money out of your retirement accounts to pay off credit card or mortgage debt. If you focus all your financial resources on paying off your loans, you run the risk of retiring with inadequate savings. Another potential misstep: prioritizing debt payoff over saving. While you don't want to be saddled with excessive debt, you also don't want to end up cash poor in retirement, without enough money to meet everyday expenses.

Debt in Retirement

Unfortunately, many people still end up near retirement with a significant amount of debt. If that's your situation, you have several options. One is to delay retirement for a few years while you concentrate on paying off debt. Plus, if you continue to work, you're not tapping your nest egg, and it can continue to grow. In addition, if you delay claiming Social Security, your monthly payment will increase by up to 8% a year until you reach age 70.

If you must enter retirement with debt, you may need to pare down your lifestyle — traveling less frequently, moving to a smaller home, or giving up your boat or RV — to reduce debt and minimize the risk of outliving your retirement savings. You could also continue to work part-time or as a consultant. That can bring in extra income, and many people enjoy a more gradual transition to full retirement.

Finally, know that going into retirement with debt poses some other, specific risks. While most creditors can't garnish your Social Security payments, the federal government is an exception. If you owe back taxes, student loans, alimony, child support, or certain other types of payments, you may lose up to 15% of your Social Security benefit.

Interested in learning more about what you can do to retire debt-free before you retire? Please call if you'd like to discuss this in more detail.

How to Avoid Credit Card Dependence

Ask yourself these questions to evaluate your dependence on credit cards:

- Do you rely on credit cards to make it until your next paycheck?
- Does it seem you always have to put unexpected expenses on your credit card?
- Do you think you spend more than you would with cash because your card has rewards or discounts?
- Do the holidays leave you with a mountain of credit card debt?

If you answered yes to these questions, you are probably relying too much on your credit cards. If you are concerned that you are too dependent on your credit cards, there are steps you can take to become credit card independent.

- Put your credit cards somewhere for safekeeping to reduce the temptation to use them as your regular form of payment.
- Become more disciplined with spending by enacting a cash-only policy. While many people use debit cards as a convenient way to pay cash, be careful. Many financial institutions will allow you to overdraft your account when you use a debit card and may charge a large fee for this overdraft privilege.
- Consolidate your balances to the cards that have the lowest interest rates and close the rest of your credit card accounts to reduce the amount of available credit and, thus, the potential amount of debt you could incur. While closing credit cards can have a negative impact on your credit score, it's still better to have a temporary credit score setback than to go deeper into debt if you can't control your spending. To reduce the impact to your score, you should also consider keeping your oldest credit card in addition to a lower interest-rate card.
- Shock yourself into reality by looking at a few important things on your credit card statement, including how much you are paying in interest on an annual basis, how long it will take you to pay off the balance, and how much you will pay in interest if you are only making the minimum monthly payment. This information can be a real eye-opener.

Please call if you'd like to discuss this in more detail.

News and Announcements

From the Thurman Household

Well, my sabbatical is now over. It consisted of lots of research, spreadsheets, reading and writing. However, I didn't get everything done that I wanted. Part of the challenge is that my research, and the 2nd edition of my book, ***The All-Weather Retirement Portfolio*** is going to be published by Forbes! This required, and is still requiring, a lot of work. The book is due out at the end of February, if I can keep on the timeline. I'll keep you posted.

My wife, Pati, just completed a 50k run. For those metrically challenged, that's 31 miles-at one time. Not only that, she won her age group. We won't mention, however, what that is.

My son, Levi, has earned his blue belt in Jiu Jitsu. I'm proud of his effort and perseverance. He's also going to school at SNU for a pre-Physical Therapy degree and working part-time as a PT tech.

Have a great and safe month.

Randy Thurman, CFP®, CPA/PFS

From the Flinton Household

"Behind every great man is a woman rolling her eyes."

~ Jim Carrey

It's that time of year again when our family find ourselves huddled together due to the weather. With the girls getting older (amazing how that happens!) it's been fun to enjoy games, movies, and activities we've not experienced before. Watching ***Father of the Bride*** and ***Steel Magnolias*** as a family was surely a highlight for everyone. Although for me, observing how the girls reacted and took in their first Monopoly game was truly insightful. Samantha was apathetic and spent most of the game reading a book. Emerson,on the other hand, was out for blood from the beginning. It was a good lesson for them to learn about luck, strategy, and the ruthlessness of their dad when it comes to board games!

As I was tucking them in later that evening, Samantha wanted to talk about some specifics about the game and how it relates to real life. It was a lighthearted conversation as her demeanor with this style of game isn't too serious or important. Emerson also wanted to talk about the game, although her question and answer session was more in the vein of how to learn strategy so she could dominate next time around. She was rather tired and expressed to me how the game made her feel, with a countenance that rode the line between anger and disgust. "Dad, I really like being a kid. I just really don't want to grow up…because then you have to pay taxes!"

Andrew Flinton, CFP®

From the Bolander Household

"Peace begins with a smile."

~ Mother Teresa

This year has been unusual in every way, and it's especially hard to see any smiles due to social distancing and face coverings. At the beginning of this year you may recall that I had planned to work at being a better friend and to connect more often. However, that didn't quite work out the way I had envisioned. I have kept in touch with a few friends and family members although I'm more of a face-to-face kind of person, and it's just not the same over the phone or even in-person but with no hugs and hidden smiles.

Yet, there is much to be thankful for, especially for you, our clients and friends. Despite the unusual circumstances, so many of you have embraced phone meetings and some quasi-face-to-face meetings over the internet, and you have continued to refer your family and friends to us. We have a wonderful team here at RIA, and we are honored to serve you. I look forward to the days when we can sit across the table and enjoy coffee or soda and a smile together once again. Until then, please keep safe and be sure to send a smile to someone you are thankful for this Thanksgiving.

Wishing you happiness and peace!

Brenda C. Bolander,
CFP®, CPA/PFS