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Financial Briefs

FALL 2015

Paying Off Debt Isn't Saving

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

Calculating your net worth is simple: total up the value of everything you own, and subtract all of your debt from that.

Net Worth = Assets – Debt

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 do anything to advance your goal of building your wealth. It only helps if you save the amount you are no longer sending 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 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 a debt. And if you have a spouse 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 you have both of these objectives covered. Does it make sense to be aggressive in paying off your debts? It can. It generally 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. Making only the minimum required payment is generally a bad

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Student Loans and Home Ownership

We've all heard the stories about the crushing levels of student loan debt among recent — and not so recent — college grads. Americans now owe more than $1 trillion in education-related debt, with an average loan balance of roughly $30,000 (Source: *U.S. News & World Report*, November 13, 2014).

All that debt is making it difficult for young people to become financially independent and move forward toward major financial milestones. In fact, many experts are concerned that high levels of student loan debt are actually causing people to delay home ownership (Source: The Federal Reserve, 2014). Studies by the Federal Reserve seem to suggest that people with student loans are more likely to put off buying a home until their 30s.

Yet other experts say that while high levels of student loan debt may be one factor in causing young people to delay home ownership, it's not the only one. A tough job market and low wages are big problems as well. So is the fact that young people are delaying key milestones like getting married and having children, which tend to be associated with home ownership. Even those with high levels of debt may not be shut out of home ownership. While big monthly payments and steep debt totals can be an obstacle to buying a house, that's not always the case, especially when big student loan totals are associated with advanced education that leads to higher earnings (like law school or medical school).

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Paying Off Debt

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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.

If you have money left over at the end of the month, you should consider both trying to save and paying down your debt at the same time. This is especially true when it comes to tax-advantaged savings 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.

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, 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. However, 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 you'll 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.

Mortgage interest is also generally tax deductible. Finally, the interest rates on mortgages are among the lowest consumers face. All of this means paying off a mortgage more aggressively is one of the last things you should consider doing with your money.

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

5 Rules for Buying Your First Home

Buying your first home is a big step, both emotionally and financially. Once people decide to buy a house, it's easy to get caught up in all the details. Rushing into a home purchase without paying attention to some basic rules can lead to future trouble. Here are five guidelines to keep in mind when you're buying your first home.

Know How Much You Can Afford

Before you even start looking at listings, sit down and crunch some numbers. You may want that $500,000 dream home; but in reality, you can only afford a $250,000 home. Generally, the rule of thumb is that you shouldn't spend more than 28% of your gross monthly income on your mortgage.

Get Preapproved

Most people don't get preapproved for a mortgage before they start shopping for a home. Just 10% take this extra step, according to some estimates. Yet a preapproval can help smooth the home-buying process, since sellers can be more confident that you'll be able to get a loan and are serious.

Remember, however, that a preapproval isn't a guarantee that you'll get a mortgage — it just confirms how much the lender would be willing to let you borrow.

Find an Agent You Can Trust

Finding a good real estate agent involves more than a simple Internet search. This is the person who will be guiding you through the entire home-buying process, so you want to find someone you trust and with whom you're comfortable. Not only do you want to check into their credentials, but you should also talk to former clients. A referral from a friend, family member, or neighbor may be a good first place to start. Don't hesitate to interview a couple of agents to find the one who's best for you.

When looking for an agent, watch out for signs that he/she might not be a good fit. For example, you probably want to work with an agent who has experience helping other people in your price range and is familiar with the area in which you hope to buy.

Don't Skimp on the Down Payment

The days of no-down-payment homes are largely gone. But there are still loans out there for buyers who don't have big savings, like FHA loans and VA loans. These aren't necessarily a bad deal — in fact, they can be a big help for first-time buyers. But generally, you want to put as much down on your home as you can reasonably afford without jeopardizing your other financial goals. Twenty percent is the number most often recommended.

Show up with a down payment that's less than 20% of a home's value and you'll have to get private mortgage insurance (PMI), which protects your lender in case you default and means a larger monthly mortgage payment for you. However, the FHA recently cut the insurance payments it requires for low-down-payment loans to 0.85%.

Always Get a Home Inspection

A house that looks picture-perfect on the outside could be rotten to the core (literally). Getting a qualified home inspection will help you have the confidence that the home you're buying is a solid investment. If you have an inspection clause in your offer, you can back away from a deal if the inspection reveals problems with the home that the seller is unwilling to fix.

If you're prepared to make a serious offer on a home and the seller wants you to waive the inspection, run, don't walk, away. It could be that there's a serious problem with the property the seller doesn't want you to know about.

Are you ready to buy your first home, but aren't sure where to begin? Please call if you'd like to review your finances, so you can turn your home ownership dreams into reality.

Student Loans

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Whether or not high levels of student debt are affecting the broader housing market, it's likely having at least some impact on individual borrowers and homebuyers. People with high monthly student loan payments may struggle to save up enough for a down payment, especially if their income is relatively low. Also, if they have a mountain of student loans to pay back, they may be hesitant to add a mortgage on top of that, even if they can technically afford it.

People who are overwhelmed by their educational debt — a small but significant share of total borrowers — are in an even worse spot. Student loans are virtually impossible to discharge in bankruptcy. That debt will follow you around for life, even if you're unable to pay. And defaulting on your student loans will wreak havoc on your credit score, making it extremely difficult to buy a house, especially in an environment where lending standards are far higher than they were a decade or so ago. Even if you're diligent about paying that bill every month, mortgage lenders may still think your debt levels are too high relative to your income and deny your application.

In fact, their debt-to-income ratio is one key number that prospective homebuyers need to understand before they even start looking through real estate listings. It's a number that's determined by dividing your total monthly liabilities (including student loans, credit card payments, auto loans, and your anticipated mortgage amount) by your total monthly income. Lenders generally want to see a debt-to-income ratio of 43% or less. More than that, and your loan application is likely to be denied.

Say you earn $4,000 a month, and you have a $300 monthly student loan payment, a $150 monthly car payment, and a $75 monthly payment on your credit card. To buy the home you want, you'll need a mortgage of $250,000, which translates to a monthly payment of about $1,500. Your total monthly debt payments including the mortgage will be $2,025. Divide that by your $4,000 in monthly income and you have a debt-to-income ratio of 51%. That's higher than many mortgage lenders want to see, and you may be denied when you apply for a loan.

But what if you didn't have that student loan payment? Subtract the $300 from your liability and your monthly payments fall to $1,725. That gives you a debt-to-income ratio of 43%, low enough to increase your chances of qualifying for a mortgage.

Of course, financial matters are rarely as simple as in the example outlined above, and a $300 monthly student loan obligation doesn't mean that you won't be able to buy a house. The person above could try to eliminate his/her other debts, save for a larger down payment, earn more money, or look for a cheaper house. But the fact remains: How much you owe today is going to affect how much you are going to be able to borrow in the future.

Should You Own or Rent?

Owning a home is still part of the American dream. Certainly, there are significant financial and tax reasons for owning a home. While you typically only make a down payment of 10% or 20% of the home's cost, you retain all price appreciation on the home. Part of each mortgage payment builds equity in your home. In the beginning, that may only be a small portion of each payment, but significant equity can be accumulated over a period of years. Historically, homes have provided a good hedge against inflation.

There are also significant tax advantages to home ownership. Mortgage interest and property taxes can be deducted on your tax return as itemized deductions, reducing the cost of home ownership. When you sell the home, a significant amount of capital gains can be excluded from taxes. If the home was your primary residence for at least two of the preceding five years, you can exclude $250,000 of gains if you are a single taxpayer and $500,000 of gains if you are married filing a joint return.

But despite these advantages, you should still evaluate whether owning a home makes sense for your particular situation. Some factors to consider include:

- **How long will you live in the home?** Besides the purchase price of the home, you must pay closing costs. There are also costs involved in selling, which typically include the real estate agent's commission. Thus, you'll usually need to live in the home for at least five to seven years to make it a worthwhile financial decision.
- **Can you afford to take on the debt?** Generally, lenders prefer that your total debt payments, including your mortgage and other consumer debts, not exceed 40% of your gross income. Make sure you're comfortable with the amount of debt you are incurring and you'll still have enough disposable income to save for other goals, such as your retirement.
- **Do you have a large enough down payment?** If possible, strive to make a down payment of at least 10% to 20% of the home's purchase price. If your down payment is less than 20%, you'll have to pay private mortgage insurance.
- **Have you considered all costs?** Besides the mortgage payment and property taxes, there are other costs involved with owning a home. You'll be responsible for all utilities, insurance, repairs, and maintenance on the home.

If you'd like to review whether it makes financial sense to own a home, please call.

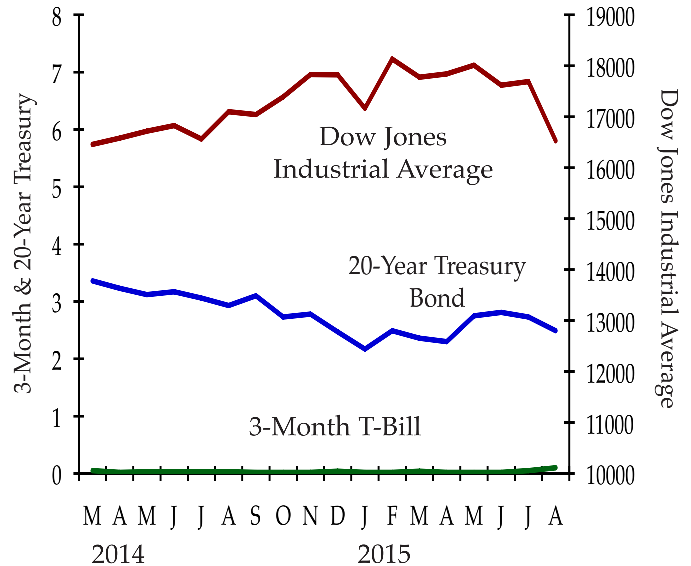
Business Data

Indicator	Jun-15	Jul-15	Aug-15	Dec-14	Aug-14
	Month-end				
Prime rate	3.25	3.25	3.25	3.25	3.25
3-month T-bill yield	0.02	0.05	0.10	0.04	0.03
10-year T-note yield	2.32	2.32	2.12	2.14	2.41
20-year T-bond yield	2.81	2.73	2.49	2.47	2.93
Dow Jones Corp.	3.25	3.31	3.33	3.08	2.72
GDP (adj. annual rate)#	+2.20	+0.60	+3.70	+2.20	+4.60

Indicator	Month-end Jun-15	Month-end Jul-15	Month-end Aug-15	% Change YTD	% Change 12 Mon.
Dow Jones Industrials	17619.51	17689.86	16528.03	-7.3%	-3.3%
Standard & Poor's 500	2063.11	2103.84	1972.18	-4.2%	-1.6%
Nasdaq Composite	4986.87	5128.28	4776.51	0.9%	4.3%
Gold	1171.00	1098.40	1127.00	-6.0%	-12.3%
Unemployment rate@	5.50	5.30	5.30	-8.6%	-14.5%
Consumer price index@	237.80	238.60	238.70	1.1%	0.2%
Index of leading ind.@	122.90	123.60	123.30	16.9%	19.0%

— 4th, 1st, 2nd quarter @ — May, Jun, Jul Sources: *Barron's, Wall Street Journal*
Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield
March 2014 to August 2015



News and Announcements

Do You Have Too Much Debt?

Various rules of thumb exist to help determine when debt levels are excessive. For instance, one rule of thumb states your total debt payments, including your mortgage and credit card bills, should not exceed 36% of your gross monthly income. The problem with rules of thumb, however, is they don't take into account your unique circumstances. Look for these signs that your debt level may be getting too high:

- **You have no money left over at the end of the month.** If you have nothing left to save after paying your bills every month, your debt may be too high. Be especially concerned if you have to dip into savings to pay bills.
- **You've reached your maximum credit limit.** If you've maxed out your credit card limits or are considering obtaining new cards for additional credit, your debt may be getting out of hand. Credit cards should be used as a convenience, not to finance an unaffordable lifestyle.
- **You're only making minimum payments.** Required minimum payments on credit card debt are so low, it can take decades to pay off the debt. It will be difficult to get your debt under control if you are only making minimum payments.
- **You do not have an emergency fund.** Ideally, you should set aside three to six months of living expenses in case of emergencies, such as a job loss, disability, or major home or car repair. If you can't maintain that due to debt payments, your debt level is probably too high.
- **You're not comfortable.** The ultimate test of whether your debt level is too high is your comfort with that debt and the payments that must be made.

If your debt level is too high, take steps now to get it under control. Please call if you'd like help with your debt.

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