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## Rate of return key in paying down debt

By Carolyn Bigda, special to Tribune Newspapers

June 15, 2012

Who says young people aren't good with money?

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Recently, I received an email from a 25-year-old who has been saving "every penny" she's earned since age 16.

Her frugality has paid off. Though she earns $48,000, she's put $62,000 in the bank. She also contributes 10 percent of her salary to a 401(k) and bought a new car almost entirely with cash.

Still, like many 20-somethings, this young woman has college loans to repay: $25,000, with a fixed 6.8 percent interest rate.

The debt load is typical of a recent grad. According to the College Board, students who borrow while attending four-year public universities graduate with an average of $22,000 in education loans. At four-year, nonprofit private schools, the sum is $28,100.

Her question: "Should I continue saving up for my future, with minimum loan payments being made? Or should I pay off my debt?"

We consulted with financial planners. Here's what they had to say.

**Pay off high-rate debt**

First, she should be applauded for getting off to such a good start, said Sheryl Garrett, a financial planner and founder of the Garrett Planning Network, a group of fee-only advisers.

A disciplined savings habit has provided the young grad with ample cash — and choices.

In this case, Garrett, along with other planners, suggests the young woman use her savings to eliminate the education debt. The main reason: With yields on savings accounts at record lows, the interest rate she's paying on her student loans is well above what she's earning on her cash.

"She can't be getting more than 1 percent at the bank," Garrett said. "Given that, I'd recommended paying off the student loans."

Allan Roth, a financial planner in Colorado Springs, Colo., agrees, likening the elimination of the loan

interest to an investment return. "It's a guaranteed, safe, 6.8 percent annual return," he said. "I wish I could find that kind of risk-free return in the market now."

**Then, keep saving**

But planners emphasize that it's important to keep up the savings regimen after the debt is gone.

"She should take the freed-up cash flow and use half of it to bump up her 401(k) contribution and the other half to rebuild her cash reserves," said financial planner Mark Berg.

Another option: Contribute to a Roth IRA and get tax diversification in her retirement savings. Contributions to Roths are taxable, but withdrawals are tax-free in retirement. The reverse is true of traditional retirement accounts.

Berg also said it's worth thinking about other financial goals.

"Saving for a down payment on a home would be a good goal at this age," he said. "Also, saving for the next car purchase is always prudent."

Once she gets rid of her student loans, the young grad will have $37,000 in savings. That's a solid foundation on which to build and a key reason why it makes sense for her to wipe out her student loans now.

"You want to have at least three months' worth of salary in reserve for emergencies," said Bonnie Sewell, a financial planner in Leesburg, Va.

You also want to resist the urge to spend the money that previously went toward debt repayment.

There's nothing wrong with a using a portion of those funds for a well-deserved vacation or other indulgence, Sewell said. But you don't want to spend every last dollar.

"Living below your means is by far the biggest predictor of whether you'll achieve financial independence," Roth said.

So far, this 20-something is well on her way to getting that freedom.

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