5 Critical Finance Concepts to Increase Savings and Reduce Debt

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About the Author

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David has earned the trust and respect of his clients during his career in the financial services industry. His experience allows him to provide the excellent personal service and financial perspective upon which his customers have come to rely. He works closely with clients and has a proven ability to respond and plan for their needs.

As a Certified Financial Planner™ and President of Bridgeview Capital Advisors, Inc., David is responsible for advising clients in the areas of retirement plans and portfolio management. Specializing in financial planning and consulting, David brings together all aspects of his clients' finances while incorporating their goals and objectives, both personal and financial.

After graduating from Cal Poly San Luis Obispo in 1998, David joined the lending division of a well-known national bank where he specialized in consumer credit analysis and finance. In 2000, David steered his focus toward investments and insurance planning. David worked directly with clients and public institutions to establish and promote retirement savings through various qualified plans.

After completing the professional and educational requirements of the Certified Financial Planner Board of Standards, David earned the marks of a Certified Financial Planner™ or CFP®. In this capacity, David focused on high net worth clients and prepared asset allocation analysis, cash flow planning, and insurance strategies. As a Financial Advisor with Bridgeview Capital Advisors, Inc., David provides his services to a broader clientele and customizes the scope of planning for each client.

In his time away from work, David enjoys spending time with his family, golfing and playing guitar. He is also a proud supporter of Shriners Hospitals for Children in Sacramento.

Visit David's blog **The Astute Advisor** at **www.theastuteadvisor.com.** There is so much more to life than money, but still, we are faced with financial decisions at every turn in our lives. Whether you're just starting out, planning the next phase of your career, or already in retirement, there will be something on this blog for you.

5 Critical Finance Concepts to Increase Savings and Reduce Debt

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- Student Loan Debt
- Compound Interest
- Tax-deferred vs. Tax-free
- Start Saving Now!

Contact me today for your FREE consultation!

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1. Credit Card Debt

Credit card debt is the enemy of financial success. Not all debt is created equal and there are no set standards as to what is considered too much debt. What is manageable for one may not be for another. If you want to succeed financially, you need to break the cycle of credit card debt.

To be fair, credit cards aren't the problem. Nor am I suggesting that debt is bad. In fact, taking out a loan or using various types of financing is critical to starting or expanding a business. Even buying a home requires debt. What is critical is how we manage it.

Credit is inherently a good thing but racking up the credit card debt can get ugly quick. The first thing we need to do is change how we perceive credit cards. So from now on, instead of calling them credit cards (which sounds so harmless) we should call them 'debt traps.' This is similar to calling cigarettes 'cancer sticks.' Let's call these things what they are.

Credit cards, I mean debt traps, should be used with caution. My suggestion is that you become the credit card company's worst customer. Their worst customer uses the card and pays off the balance each month. Do you like 0% interest? Well that's what you'll pay when you pay off the card each month. Do you know who is the credit card company's BEST customer? It's the person who racks up the debt and pays the minimum payment each month. The credit card company also loves it when you're late because they can charge a late fee AND jack up your rate.

If you're serious about long term financial success, the first thing you need to do is develop a plan to tackle your credit card debt. Be honest with yourself. If you can't pay off the cards within 12 months given your current income, you'll need to make some serious changes to your budget. If doing it within 12 months isn't possible and you feel you're in too deep, you may need credit counseling which can be a way to help you develop a more comprehensive plan in dealing with the debt.

When your credit card debt is in the rear view mirror you can focus on building up your savings and retirement funds. Getting out from under credit card debt will allow you to devote more funds toward these goals and most importantly will give you peace of mind. Instead of making the credit card companies rich, make yourself rich. Credit card debt is the enemy. Its defeat can bring financial success.

2. Student Loan Debt

Student loan debt is on the rise and the numbers are staggering. Total student debt is approximately $1.2 trillion and is second only to U.S. mortgage debt. This level of debt is not only a burden on students but it is a burden on the economy as a whole.

This type of debt is nearly impossible to discharge in bankruptcy. It is critical to understand that bankruptcy laws have changed. If you find yourself in that unfortunate situation, it is likely that you'll be stuck with your student loan debt. According to an article in The Wall Street Journal on 01/06/2014, fewer than 1,000 people try each year to have student loan debt discharged in bankruptcy.

Student debt is on the rise. A report issued by The Institute for College Access & Success (TICAS) states that in 2012 the average student loan debt was $29,400. The average debt increased at a rate of 6% per year from 2008 through 2012. This is roughly 3 times the rate of inflation and is in line with increases in college costs.

Interest rates will impact borrowers. Interest rates on federal student loans are now more closely aligned with market interest rates. While rates are low now, they may not be in the future. The current rate for undergraduates is 3.86%. New laws have put caps on those rates at 8.25% for future years. If rates were to rise to this level combined with rising debt levels, the impact on borrowers and the economy as a whole would be significant.

Using private loans (non-federal) can be risky. According to TICAS, loans made by banks and private lenders typically have the highest interest rates for those that can least afford them. The report goes on to state that private loans lack flexible repayment options that are often found in federal student loans.

Don't borrow too much. Just because you CAN do something doesn't mean you SHOULD. Banks and financial institutions are all too willing to give students a loan. Don't borrow funds simply because the bank is willing to lend it to you. Before you borrow, think beyond college graduation. There will be other big purchases to make like homes and cars. The more you shell out in student loan payments, the less you can devote toward a mortgage or retirement funds.

As college costs continue to rise, the impact of borrowing is increasingly significant both on the borrower and the economy as a whole. This demonstrates the need to plan for education costs very early on while making economical decisions on how, where and when to pursue an education. Without minimizing the importance of a college education, it isn't worth a lifetime of insurmountable debt.

3. Compound Interest

Don't under estimate the power of compound interest. It can work for you or against you. According to Investopedia the definition of compound interest is: Interest calculated on the initial principal and also on the accumulated interest of previous periods of a deposit or loan. This concept is so powerful Albert Einstein is said to have called compound interest the "eighth wonder of the world" and that "he who understands it, earns it... he who doesn't, pays it."

Most everyone has heard of this concept and it most often comes up when thinking about the growth of savings or investments over the long term. It's important to remember compounding works in reverse and this is where it can work against you.

Most likely, if you take out a mortgage, the interest is compounded monthly. When we're about to make a huge purchase like buying a home, the primary concern is typically the monthly payment and whether or not it fits within our budget. However, even with low interest rates, it can be downright scary when you can see how much interest you will have paid over the course of 30 years.

How much interest will you pay? Let's take the following example: A $250,000 30 year mortgage at 4% will result in a principal and interest payment of $1,193.54 per month. This will cost you $179,673.01 in interest over the 30 years! You will have borrowed $250,000 and paid back $429,673.01. That is a huge number and you can thank compound interest for that.

What can you do about it? Use compound interest to your advantage and make it work for you by making small additional payments to principal. Small steps now can make a huge impact down the road. Make the following additional monthly payments at the start of your loan for 15 years and see what happens:

Additional Payment	Interest Saved	Loan Paid Off
$50	$13,168	19 months early
$75	$19,231	28 months early
$100	$24,976	37 months early

Make sure you check first with your lender regarding their policy on additional payments and how they're applied. There are other considerations too. When you make additional payments they are no longer available to make retirement contributions or other savings which can also utilize compound interest. There are also numerous variations on how and when to apply additional payments to principal for a desired result.

Understanding compound interest and making it work for you can save you thousands and thousands of dollars and help you get out of debt quicker. Be smart like Albert Einstein and make compound interest work for you.

4. Tax-deferred vs. Tax-free

When planning for retirement, it's important to understand how various retirement accounts are taxed. At the end of the day, retirement accounts are either tax-deferred or tax-free.

Tax-deferred

Simply put, this method of taxation means you'll pay the taxes later. In an effort to encourage individuals to save for their retirement, the government provides this tax incentive. Funds you contribute to a retirement account won't be taxed until you withdraw the funds. The most common type of retirement accounts with this feature are IRAs, SIMPLE IRAs, 401(k)s, and 403(b)s to name a few.

There are two main concepts that make this attractive. First, shielding funds from capital gains and dividend taxes will allow more of the funds to remain invested and increase the effects of compounding returns. The greater the number of years until retirement, the greater the benefit of the tax deferral. This is yet another reason to start saving early. Second, when you withdraw funds during retirement, the idea is that you'll owe less in taxes on the distribution. This assumes you're in a lower tax bracket during retirement than you were when you originally made the contribution to the retirement account.

Tax-deferred is not to be confused with tax-deductible. For example, one could make a contribution to an IRA and not be allowed the tax-deduction. However, you would still receive the tax-deferred status on the investment's earnings from capital gains and dividends. It should be noted however, that taking a deduction from income or reducing your salary through a 401(k) or 403(b) will give you the biggest bang for your buck.

Tax-free

Probably the least understood and most under-utilized form of taxation for retirement accounts is the tax-free method. This form of taxation allows one to make contributions to a retirement account and receive the same benefits of tax-deferred accounts while the money is invested. Most notably, these accounts are Roth IRAs and 401(k) and 403(b) plans with Roth features (tax-free). However, there is one huge difference. With a tax-free account, you pay NO taxes when the funds are taken out during retirement. This is in contrast to a tax-deferred account where you pay income tax on whatever you spend from the account.

The key point to understand about tax-free accounts is that they don't offer an immediate tax benefit like deductible IRA contributions and salary contributions to a 401(k), 403(b), or SIMPLE IRA plan. With these tax-deferred plans, you are reducing your income tax liability for the year in which the contributions are made, thus reducing your tax bill. With tax-free accounts like Roth IRAs and company retirement plans with Roth features, contributions are made "after tax" so you don't get an immediate income tax savings.

To make matters a little more complicated, company retirement plans with Roth features (tax-free) will have a combination of tax-deferred AND tax-free. This occurs because a 401(k) that pays matching and/or profit sharing contributions is doing so under the tax-deferred method while YOUR salary contributions are after tax and will be considered the tax-free portion.

Tax-deferred and tax-free are both important components of a strong financial foundation. Understanding these concepts will result in better decisions about your retirement now and into the future.

5. Start Saving Now!

Waiting to start a retirement savings plan can be hazardous to your financial health. The longer you wait, the harder it will be to catch up. If you think it will be difficult coming up with the funds now, consider how hard it will be in the future.

While this example assumes a $1 million nest egg by age 65, this amount may not be appropriate for everyone. For some, it won't be enough.

According to Morningstar, the following monthly amounts are needed to accumulate $1 million by age 65 assuming an annualized 7% compound return:

Age 25: $381 per month to accumulate $1 million by age 65. This is a big number for many 25 year old's especially considering the job market and the level of student debt many graduates are faced with. To put this amount in perspective, it is the about the same amount as the average used car loan payment which is $352 (according to Experian as referenced in an article on CNBC.com)

Age 35: $820 per month to accumulate $1 million by age 65. This is very close to the average monthly house payment of $865 according to an analysis by Realtytrac and reported in HousingWire.com. Of course, depending on where you live, this amount could be much more.

Age 45: $1,920 per month to accumulate $1 million by age 65. This is a little more than the expected monthly expense of $1,532 for tuition, fees, room and board for a public 4-year school (in state) according to CollegeBoard.com.

Age 55: $5,778 per month to accumulate $1 million by age 65. This is equivalent to a gross annual salary of $69,336. This is a huge number and very few could save this much. If this was your salary and you had $0 expenses, it still wouldn't be enough because taxes would take a huge bite.

The level of sacrifice increases with age when it comes to saving for retirement. While many are under the impression that it will be easier to start saving later when your income is higher, the reality is that it becomes much more difficult. Despite the fact that our incomes typically grow, so do our expenses and financial obligations in general.

If you think it's hard saving $381 at age 25, think of how hard it will be trying to save $1,920 at age 45. It is never too late to start saving, but the sooner the better. Starting a retirement savings plan now will make it easier to afford the things you want in the future.

"The most important quality for an investor is temperament, not intellect."

- Warren Buffett

Disclaimers

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