Striking a Balance between Debt, Life and the Pursuit of Financial Freedom

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Tis the season for shopping and buying gifts. It's easy to get pulled in by sales and deals. However, this time of year, it's even more important to try to think long term while you're making these short term purchase decisions. Many times during the holiday season, people end up spending more than they originally anticipated and, in some cases, incur unexpected debt to start the New Year. However, understanding how debt works can hopefully help reverse this startling annual debacle.

Getting your financial house in order

You can't get anywhere in your planning unless your financial house is in order and the first room in that house is debt. Oftentimes with debt you get very unfavorable interest rates charged on the money that you owe. Credit card companies charge so much interest that it's virtually impossible to make more money anywhere else. I can't remember a situation where a client came to our office with a credit card balance and our first order of business wasn't recommending that they pay it off as quickly as possible.

When to borrow vs. when to save

Credit card debt aside, one of the challenges in navigating your personal finances year over year is learning how to balance the when to borrow versus when to save because debt isn't always all that bad if it's done properly. The first area outside of credit card debt you want to address is your mortgage. Right now, the government provides a tax incentive that allows homeowners to deduct some mortgage interest off their income which creates a nice tax savings for some. Yet, most people who borrow don't think about the long-term impact of how much money they're spending in interest when borrowing from a bank and using a mortgage to help them buy the home of their dreams.

Here's an example: You have a $250,000 loan with a 4.25% interest rate and a loan term of 30 years. If you pay that off over 30 years, you're going to pay $206,016 total interest over the life of that loan. When you start to look at these numbers, the reaction should be *wow*.

What you want to do for your mortgage is even take a look at simple techniques like making bi-weekly payments rather than monthly. If you make bi-weekly payments, the total interest that you would pay over the 30 year life of the loan goes down to $171,182 – a total interest savings of $34,143. So, here's a really easy strategy that just saved you tens of thousands of dollars without doing anything dramatically different. You are still paying the same monthly amount, just paying it twice per month. It's easy and you need to contact your mortgage company to see if they can make that program available to you.

Something else you're going to want to do with regards to your mortgage is to think about increasing your monthly payments over and above your regular mortgage. Take that same $250,000 loan. If you add an extra $200 a month to your payments, the total interest you pay would go down to $149,454 – that's $56,562 in savings. It pays to think globally about where you are spending your money every month. Some people spend $200 a month on cigarettes or going out to a fancy monthly dinner. Think about the difference $200 a month could make over a period of time. It could save you money and potentially make your financial objectives more achievable.

Other components of debt – your lifestyle

Many people keep dipping into their savings to bail themselves out of credit card debt that accumulates over the holidays, after a big vacation or after a project they've taken on in their homes. They didn't plan for it in advance and then they lean on their hard earned savings to bail themselves out.

Imagine if you end up having to take $4,000 a year out of your savings to pay this short term credit card debt that you accumulate due to poor planning. Over a 30 year period growing at 7.5%, that $4,000 ends up being $444,617. That $440,000 is money you don't have in your account. It is hard to believe that a few thousand per year can accumulate to that amount, but it does!

Plan for the surprises

There's no fancy planning strategy with regards to debt. You simply need to plan and budget for your expenses and set aside money for things that will come up in the future. That can include saving money for broken appliances or future car payments. Save money for those unexpected items. Also, go ahead and start taking a look at the debts in your life – for example, credit cards, your mortgage and student loans – and start looking at ways you can pay those down quickly and effectively. The best thing you can do to carve out a path for your financial freedom is set a course for long term success. There are no short cuts to achieving your financial freedom. Sure some people hit the lottery. Other people get lucky because they happen to find a job at a company that explodes providing terrific opportunities for income and net worth growth. For most, we need to craft a strategy, live a reasonable lifestyle within our means and enjoy the journey.

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