How to manage your debt and invest for your future

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A successful strategy requires the right balance for you.

Simple math suggests it's wise to pay off your high-interest credit cards before you invest. But what about car loans? Or student or home equity loans? Should you be totally debt-free before you invest?

Finding the right balance between investing for the future and paying down debt requires that you do something few investors typically do: think strategically about debt.

"People fixate on the asset side of their personal balance sheet, devoting their time to looking for the next blockbuster stock," says Nevenka Vrdoljak, director, Investment Analytics, Merrill Lynch. "However, they fail to realize that refinancing their mortgage could save hundreds or even thousands of dollars a year. Or that if they pay off a credit card that charges 15% interest, that's the economic equivalent of earning a 15% investment return."

Vrdoljak proposes taking a more comprehensive approach to managing debt, one that accounts for both the asset and liability sides of your balance sheet, and uses debt strategically to build wealth.

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Good debt, bad debt

Debt can be an effective financial tool. For example you might use a home equity line of credit (HELOC) to cover a short-term unplanned expense without having to tap into your retirement funds. A low-interest loan can also help you pursue a variety of long-term goals, from owning a home or starting a business to paying for college or graduate school.

But it's also important to distinguish between good debt and bad debt. Good debt, such as your mortgage, is tax-advantaged and leverages your assets to help build wealth. Bad debt, like high-interest credit cards, creates a financial drain. So how do you categorize and manage debt that falls in between these extremes?

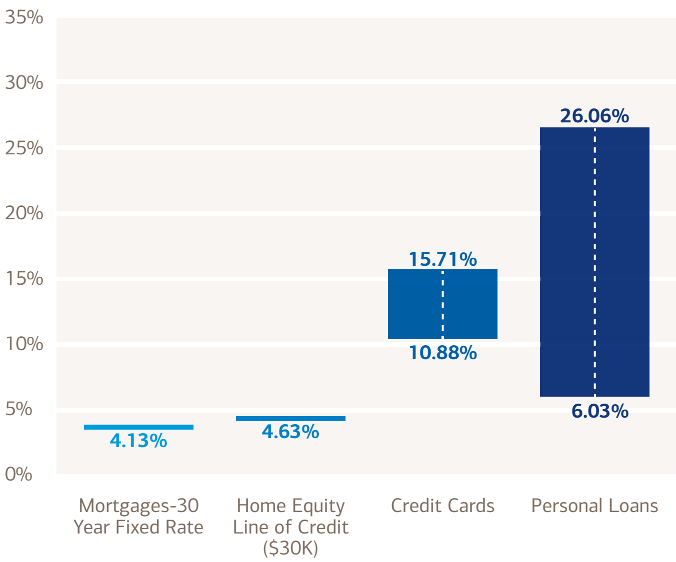
David Laster, director, Investment Analytics, Merrill Lynch, says debt isn't really "good" unless it comes with a plan for paying it off. "The beauty of an amortizing mortgage is that after 15 or 30 years, you're free of the loan. However, it's rare for people to impose a strict debt repayment schedule on themselves for their credit card accounts," he notes.

To keep your debt from moving too far into the "bad" category, Laster and Vrdoljak offer these guidelines:

- **Do your homework.** Interest rates differ widely, particularly with unsecured personal loans and credit cards. So make sure you do your research and negotiate with the lender to ensure you get the best rate and terms, says Vrdoljak. "It's crucial to explore ways you might gain efficiencies with the type of debt you currently hold, whether it's refinancing a mortgage, renegotiating credit card terms, or consolidating your debt."

Lending rates can vary widely

It's important to research before taking on debt. In addition to having higher interest rates than mortgages and HELOCs, unsecured personal loans and credit cards also have rates that can differ dramatically.



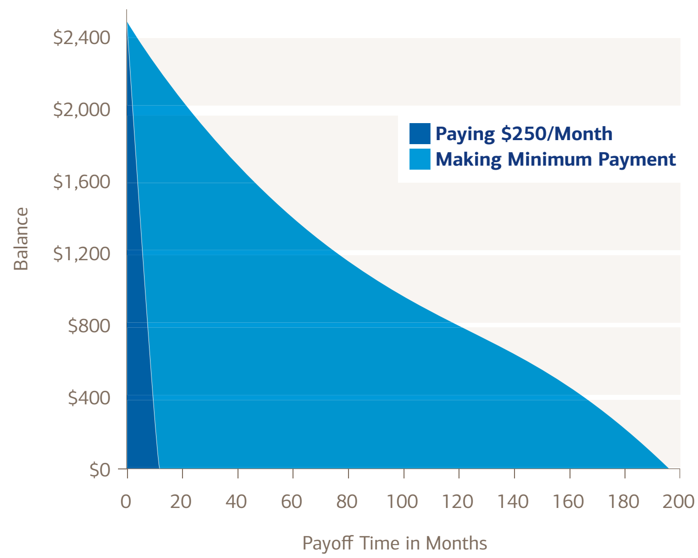
Source: Mortgages, HELOC, and credit cards: Bankrate; Personal loans: LendingClub May 29, 2014.

- **Plan to pay more than the minimum.** Those with credit card balances are often way too easy on themselves, generally choosing to pay only the minimum monthly payment, says Laster. "Research on consumer behavior tells us that many people view a suggested 401(k) deferral rate or a 'minimum payment due' amount on a credit card as a recommendation. But paying the minimum due is definitely not something that you should accept as guidance," he explains. Although many people pay only the minimums out of necessity, Laster advocates paying more whenever possible because it can significantly reduce both the length and cost of your debt.

- **Consider worst-case scenarios.** Laster also suggests that borrowers need to acknowledge the potential risks of taking on additional debt. "Few people think about worst-case scenarios when they use their credit cards," he says. "If interest rates increase or you lose your job, it could be very difficult to pay off your debt."

Make it more than the minimum

The chart below illustrates the value of paying more than the required minimum due on credit card balances. For a balance of $2,500 on a card that charges 12% interest, it takes nearly 16 years to pay off the balance if you pay only the minimum, with $2,140.88 paid in interest. But it takes less than a year to retire the debt if you can pay $250 each month, with only $142.46 paid in interest.



Source: Merrill Lynch Investment Management & Guidance (IMG). For hypothetical purposes only. June 12, 2014.

How much is too much?

The truth is, of course, that even good debt can become overwhelming. Maybe your circumstances change or there's a market downturn. So how much debt is too much?

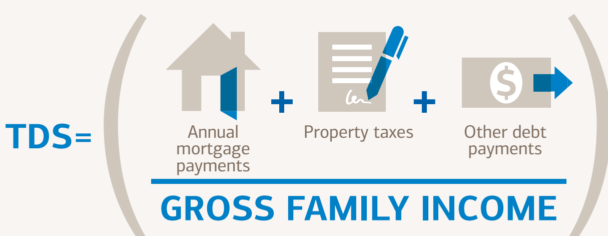
The wealth planning community offers guidelines that can help you decide if you're taking on too much debt, Vrdoljak says. "Your total debt service, which is all of your annual debt — including your mortgage, property taxes, and credit card and personal loan balances — divided by your gross income should be no more than 30%, although some lenders increase that to 40%," she says.

For example Jack and Dee, two working professionals, have a monthly mortgage payment of $1,500 (annual payment of $18,000), property taxes of $5,000, credit card payments totaling $4,000, and a gross family income of $95,000. This would give them a total debt service (TDS) of 28.4% ($27,000/$95,000). Based on the benchmark of 30%, Jack and Dee appear to be carrying an acceptable amount of debt.

Obviously a lower number is better here, but Vrdoljak acknowledges that life stage, income, assets and willingness to take risk also will influence what's appropriate for each individual.

What's an acceptable amount of debt?

The Total Debt Service (TDS) ratio is a rule of thumb financial lenders use to determine whether a potential borrower already has too much debt.



A result less than 30% is generally considered an acceptable level of risk by financial lenders.

Five strategies to get, and stay, debt-free

Whether it's monthly payments that exceed the recommended TDS ratio or even smaller balances that are causing you sleepless nights, Laster says your first step to digging out of debt should be to record on paper everything you owe, including the amount of each loan, its interest rate, and the time horizon for paying it off. "The compound interest you pay over the course of a loan isn't a concept that the mind can intuitively grasp, so it helps to get the numbers on paper," he says. "Sometimes the exercise of making the list alone is enough of a wake-up call to develop a plan to get out of debt."

The good news is that once you have this total picture of your outstanding debt, it's much easier to develop your payment plan, says Michael Liersch, Merrill Lynch's director of Behavioral Economics. Here are the five action steps that Liersch and his Merrill Lynch colleagues recommend to help keep debt under control:

1. **Commit to a goal — and actively pursue it.** You might think automating your credit card payments, much as you do with 401(k) savings, is a good practice. And while it can be, Liersch suggests automation can have its own set of behavioral risks. "Setting it and forgetting it can be useful, but it isn't always the way to go," he explains. "Active engagement can be beneficial, too. With 401(k)s, for example, where contributions are made automatically, there can be a tendency to become more passive. This can lead employees to forget that they need to actively manage their retirement future — like increasing contributions over time, or reallocating assets as retirement gets closer." According to Liersch, you should deliberately write down your debt repayment goals and initial them to signify your commitment. Then, each time you make a payment, you can measure your progress against those goals.

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Your long-term goal should be to become debt-free (with the possible exception of your mortgage) before you reach retirement, says Laster. "Debt can be especially dangerous in retirement because you are living on a fixed income, and your health care expenses could increase," he says. "So there's more urgency as you get closer to retirement age."

2. **Prioritize payoffs.** When deciding what cards or loans to pay off first, Liersch says you can forget high-powered math and focus exclusively on the "character of the debt." He explains: "Take a look at what you owe on credit cards, private student loans, car loans and other personal loans, excluding your mortgage. Then identify the debt with the highest interest rate and pay as much as you can afford each month while making minimum payments elsewhere. If interest rates are similar and you need a tiebreaker, you can choose to pay the debt with the biggest balance or longest time horizon first. The fantastic part about this approach is there are no calculations to be done. You just look at the attributes of your debt, and attack the debt with the highest interest rate first."

   The reason this approach works well, Liersch says, is that people in debt tend to choose ineffective, "feel-good" strategies. "Often people struggling with debt throw money at the credit card with the highest balance, even if it has a low interest rate, because they want to make something big smaller. Or to gain the satisfaction of checking something off their list, they pay off the credit card with the smallest balance, and make only minimum payments on cards with higher interest rates or bigger balances."

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3. **Look for hidden expenses to eliminate.** It's not unusual for people who are trying to reboot their savings to discover that they spend 15% more than they expected, says Liersch. "When you look at your expenses, you may see fees for memberships and services, even extra phones, that you don't use," he says. "At one point you may have made the payments automatic and just forgot about them." The simple exercise of analyzing where your money goes each month can uncover unnecessary expenses that would be better spent reducing your debt. At the very least do this annually, but quarterly is even better.

4. **Get your family on board.** Nobody likes to talk about how much they owe, especially balances on credit cards that charge 20%. But Liersch says discussing your debt situation with your family can help keep you on track to paying it off. "Being transparent about your financial situation is one of the most important steps to improving your financial situation," he says. "Once you admit that keeping up with the Joneses is financed with unsustainable credit, that image is no longer important, and no longer a financial and emotional drain."

5. **Build an emergency fund.** The relief of paying off your debt will be short-lived unless you have an emergency fund, typically a short-term savings account with at least six months of living expenses.

   "Yes, it's important to reduce your liabilities, but it's also important to build your assets as well," says Kevin Glick, assistant vice president, Merrill Edge Financial Solutions Advisor™. "I would never discourage someone from aggressively reducing debt, but putting some money aside as a first priority every month to create an emergency fund is critical to staying solvent. Without that liquid account, every time some unexpected expense comes up, whether it's new tires or a medical bill, you're going to pull out your credit card and go back into debt."

   Of course, setting aside extra money can seem overwhelming if you are paying off large loans and credit card debt at the same time. That's why Glick advises breaking down the task. "Make a commitment to save $1,000 to start," he suggests. "You'll be surprised how fast the account grows from there with regular contributions."

   Another factor to consider when balancing paying off debt and saving for an emergency fund is that if you use all your available funds to pay off your credit cards or other personal debt, lenders may reduce or eliminate your access to credit. Saving to an emergency fund gives you access to funds if you need them.

Where investing fits in

Just as you must balance the desire to pay off your debt with the need to build savings in an emergency account,

What's your plan for the unexpected?

Knowing that you have extra money set aside to take care of a sudden auto repair bill or an emergency home maintenance project without derailing your other financial plans can help you sleep better at night. Still, according to recent U.S. government data,[1] only 38% of Americans have emergency savings to help cushion the blow of a job loss, medical emergency or other unexpected event without digging into retirement savings or going into more debt. Twenty-five percent have no savings at all.

Aside from helping you feel more secure, an emergency fund also can help you avoid making emotionally charged decisions to meet a short-term need that can really hurt you over the long term, says Kevin Glick, assistant vice president, Merrill Edge Financial Solutions Advisor™. For example, he says, some of his clients have been so worried about their mounting debt that they tapped into their 401(k)s to pay off their credit cards. Others used their retirement money to pay off a mortgage, which is one debt that is typically okay to carry into retirement due to its tax advantages and the opportunity to build equity.

"Those mistakes not only resulted in a 10% early withdrawal penalty for those who were younger than retirement age, but the extra income also pushed some into a higher tax bracket," he says. "And the worst part was that they were left with seriously depleted retirement nest eggs."

For more ideas on creating an emergency savings account, including choices for where to invest your cash for easy access, go to **merrilledge.com**.

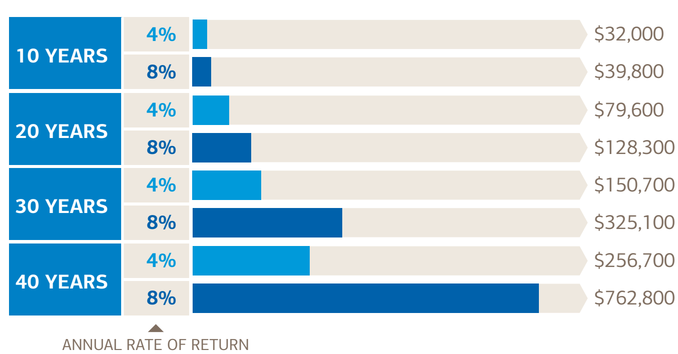
you must also juggle those priorities with your investing goals for the future. "Retirement accounts, like IRAs and 401(k)s, have the potential to grow and compound tax-free for many years," says Christopher Vale, senior vice president, Merrill Edge Product & Strategy. "And contributing to your workplace retirement plan is especially important if your employer offers a company match to your own contributions," he adds. "That's a benefit you absolutely want to take advantage of. You don't want to leave the company's money on the table when it could have the opportunity to grow in your account tax-deferred over a 30- or 40-year working career."

Unfortunately, when tackling the problem of how much to earmark for investing versus reducing debt, people with large, lower-interest loan balances often make the mistake of forgoing contributions to their 401(k)s in favor of paying off their debt more quickly. "If you do the math, you may be better off starting to save and invest a little for retirement too," says Vale. "For example you don't want to be paying off too much more than you owe on low-interest loans if that means you can't contribute at least enough to get the employer's match with your 401(k)," he cautions. "It's definitely a balancing act," Vale says, "but the lower the interest rate on your loan, the better deal it may be to pay off that loan more gradually and invest in your 401(k) plan at the same time."

Investors who focus with tunnel vision on paying off debt often rationalize their decision not to invest for retirement with the mistaken notion that the small contributions they might make to retirement plans won't amount to much anyway. But that's not a good assumption, Vale says.

The impact of saving $50 per week

Contributing a small amount each week could add up.



This chart is intended for hypothetical illustration only, and is not intended to be representative of the past or future performance of any particular investment. It assumes 4% and 8% average annual returns with no withdrawals or distributions, and reinvesting of all dividends and capital gains. Actual rates of return cannot be predicted and will fluctuate. Investor results may be more or less.
Source: Merrill Lynch Wealth Management, June 12, 2014

[1] American Family Financial Statistics compiled from Federal Reserve, U.S. Census Bureau, Internal Revenue Service, as of 12/26/2013

"Not only might your loan be at a lower rate than you could reasonably earn if you invested in the market, but even small contributions to a retirement fund have the potential to grow more than you think over time," insists Vale. For example he says, saving $50 a week may not seem like much. But that's about $2,500 per year. And after 20 years in a tax-deferred account, assuming a hypothetical 4% return, you could have almost $80,000.

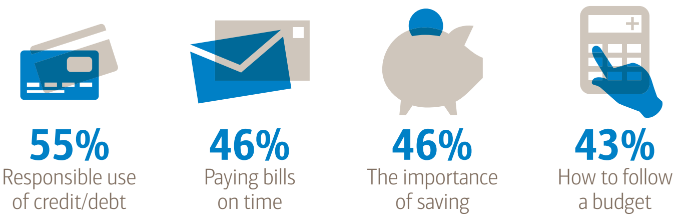
Passing on financial lessons learned

If there's a behavioral silver bullet for managing debt and investing for the future, Liersch says it's communication — particularly between you and your spouse or partner and other family members. And yes, that means you need to talk to your kids about money.

But on that front there is good news: According to the Merrill Edge Report® Fall 2013, more parents are educating their children about taking control of their personal finances. In fact 55% of the study's respondents said responsible use of credit was the most important financial lesson they could teach their children.[2]

Financial lessons learned and passed on

Which of the following financial management lessons are most important to teach your children?



Source: Merrill Edge Report® Fall 2013

That's a welcome trend because, as Liersch points out, communicating your financial intentions across generations can create a strong family commitment to focusing on your goals and avoiding bad debt. "If one of your stated values is financial freedom, it's easier for your kids to understand how extra expenses for non-essentials might not work," he concludes. "You need that support. When your kids buy in, you don't have to make excuses. Not only does that reduce your stress and break the negative cycle, it also lays a good, strong foundation for your children."

How to balance debt with investing

Know where you stand	Get your debts, payoff amounts and interest rates down on paper. (You don't want your total debt payments to be more than 30% of your income.) Make sure the decisions you're making about taking on more debt are in sync with your goals.
Identify good and bad debt	Good debt, such as your mortgage, is tax-advantaged and uses leverage to create the potential for more wealth. High-interest credit card debt can be bad debt because it drains your finances.
Prioritize payments	When paying off personal loans, aggressively target the highest balance with the higher rate and the longest time horizon first, and make the minimum payments on everything else.
Stop the cycle	Establish an emergency savings account with at least six months of living expenses so when unplanned expenses surface, you have easy access to the money you need without having to add to your credit card balances or tap into long-term retirement savings.
Start a conversation	Talk with your family about a realistic budget and you'll be less likely to rely on credit.
Invest in the future	Don't let your focus on debt prevent you from investing in tax-advantaged retirement accounts that can provide the opportunity to grow tax-deferred, with compound interest, over time—especially if your company matches your 401(k) contributions.

[2] Merrill Edge Report® Fall 2013

How Merrill Edge® can help

Merrill Edge offers online resources to help you think strategically about debt and investing.

- Visit the Investor Education section on **merrilledge.com** to read articles on topics such as:
  - Saving and budgeting
  - Managing debt and credit
  - Establishing an emergency fund
  - Creating an investment strategy
- Use the tools and calculators at **merrilledge.com** to track expenses, evaluate goals and measure debt:
  - **Net Worth Estimator™** (login required)
  - **Cash Flow Calculator**
  - **Retirement Evaluator™** (login required)
  - **Cost of Debt Calculator**

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