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Financial Briefs

JANUARY 2024

Paying Off Debt Isn't Saving

Should you 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.

The rational objective for all sound financial planning is to increase your net worth, which is the true measure of your financial health. Calculating your net worth is simple: total up the value of everything you own and subtract from that all of your debt.

Net Worth = Assets – Debt

When you pay off debt, it feels good. And, in fact, it almost always improves one aspect of your financial wellbeing: it lowers your monthly bills, which means you can either spend or save more. But 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 then save the amount you no longer have to send 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 to pay off debt, 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 savings account equal in value to three to six months of your living expenses. So unless you already have enough tucked away in your emergency fund, you should consider if it makes sense to use any free cash to pay off a debt. And if you have a partner 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 (but not always) 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

Continued on page 2

Is There Good Debt?

For the vast majority of people, debt is a fact of life. While people spend most of their lives trying to get out of debt, not all debt is created equal. Good debt is basically defined as financing something that will increase your income or net worth, while bad debt is just the opposite.

You should try to think of good debt as an investment. You're borrowing money now with the hopes that the asset purchased will increase in value over time. It also allows you to buy something now at an affordable price by having the payments spread out over time, as opposed to having to put off a purchase until you have saved enough money.

What you want to do is try to minimize your bad debt and maximize your good debt. When you go to make a purchase, think like an investor. Will you make a profit from the purchase? Will it help with your future? Will it help you earn income? If you answer no to these questions, then you may want to wait to make the purchase until you have saved enough cash.

Following are some examples of good debt:

Education

Taking out a loan for college or technical training is an investment in your future. After a few years in

Continued on page 3

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FR2023-0810-0005

Paying Off Debt

Continued from page 1

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, where it's rare the interest rate is less than double digits. Making only the minimum required payment is generally a bad idea, because interest and fees can grow faster than you pay down the principal. At the very least, then, you should try to pay more than the minimum — even if you're not trying to be aggressive in paying down the balance.

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, like individual retirement accounts (IRAs) and 401(k) plans. Contributions to these are often made on a pre-tax 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 before taking an aggressive stance toward reducing your debt load.

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 — whether it's interest, dividends, or capital gains — 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 many Americans' decisions. It explains why 15-year mortgages seem more appealing to some than 30-year mortgages: not only are the interest rates for 15-year mortgages generally lower, but it takes less time to pay them off, and the accumulated interest you pay is much less.

But 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 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.

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

In summary, paying off debt has its advantages, but whether it's the right thing for you depends on your broader financial picture, what kinds of debts you have, what interest rates they carry, and what your saving opportunities are. It can take some careful analysis to make the best decisions. Please call if you'd like to discuss this in more detail.

How to Avoid Credit Card Dependence

Ask yourself these questions to evaluate your dependence on credit cards:

- Do you rely on credit cards to make it through until your next paycheck?
- Does it seem you always have to put unexpected expenses on your credit card?
- Do you think you spend more than you would with cash because your card has rewards or discounts?
- Do the holidays leave you with a mountain of credit card debt?

If you answered yes to these questions, you are probably relying too much on your credit cards. If you are concerned that you are too dependent on your credit cards, there are steps you can take to become credit card independent.

- Put your credit cards somewhere for safekeeping to reduce the temptation to use them as your regular form of payment.
- Become more disciplined with spending by enacting a cash-only policy. While many people use debit cards as a convenient way to pay cash; be careful, because many financial institutions will allow you to overdraft your account when you use a debit card and may charge a large fee for this overdraft privilege.
- Consolidate your balances to fewer cards that have the lowest interest rates and close the rest of your credit card accounts to reduce the amount of available credit and, thus, the potential amount of debt you could incur. While closing credit cards can have a negative impact on your credit score, it's still better to have a temporary credit score setback than to go deeper into debt if you can't control your spending. To reduce the impact to your score, you should also consider keeping your oldest credit card in addition to a lower interest-rate card.
- Shock yourself into reality by looking at a few important things on your credit card statement including: how much are you paying in interest on an annual basis? How long will it take you to pay off the balance and how much will you pay in interest if you are only making the minimum monthly payment? This information can be a real eye- opener.

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

Good Debt

Continued from page 1

the workforce, it will most likely pay for itself. Typically, better educated people have greater earning potential and have an easier time finding good-paying opportunities. The return on investment of an education over the course of a person's life will likely be in the hundreds of thousands of dollars.

Owning a Business

Entrepreneurs who are willing to work hard and have the ambition needed to run a business can turn a small business loan into a successful venture. Hopefully, this investment in yourself will result in a business that is self-sustaining with a good profit or one that could really take off resulting in significant wealth.

Real Estate

There are several different ways to make money on real estate. The most common is taking a mortgage to purchase a home and then selling it at a profit after many years of residing in the home. Investing in residential real estate by renting out a home or apartment is also good debt that can provide you with ongoing income. And commercial real estate, such as an office building, store, or industrial park can return good profits and capital gains.

There are other types of debt that are bad, because they are used to purchase assets that depreciate. Here are examples of bad debt:

Vehicles

For many, vehicles are a necessity and an expensive one. When you take a loan to buy a car, the minute you drive off the lot, it loses a significant portion of its value. Financially, it would make more sense to purchase a used car with cash or finance a smaller amount of money for a shorter period of time.

Consumable Goods

We all need clothing to wear, food to eat, gas for our cars, and the occasional get-away trip, but many buy these items with borrowed money instead of cash. Not only are these items probably worth less than what we pay for them, but interest on the debt increases the price substantially. That money you're paying in interest could be used more wisely elsewhere. It comes down to learning to live within your means.

Credit Cards

When credit cards are used to pay for anything, they are doing nothing to increase your income or your net worth. The interest rates can be incredibly high over other types of consumer loans, and the payments are designed in a way to maximize the costs to the consumer. And, if you don't pay your balances in full each month, your debt could quickly get out of hand.

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

Ways to Get Out of Debt

The first step to getting out of the debt cycle is to take a realistic view of your current financial situation and recognize that you are carrying too much debt. Once you come to terms with your debt, you can then work on ways to pay it off.

Develop a Spending Plan

Once you have a handle on what you're spending versus how much money you're making, you can develop a budget to help you determine what you can spend, how much goes toward paying down debt, and how much you can save.

Ditch the Credit Cards

If high-interest rate credit cards are the reason you're in a debt spiral, then you have to remove the temptation to stop adding more debt. Use a debit card that is linked to your checking account, so you can better control your spending.

Work on Changing Your Habits

Many times getting out of debt will require that you change your spending habits. Start by making small changes that can really add up to reduce your spending.

Pick Up a Side Job

Think of things you can do to generate more income. Get creative about what you can do to earn more money with your free time.

Reduce Your Borrowing Expenses

While getting another loan is not ideal, it may be necessary to get your debt under control and reduce your borrowing costs. Look for a debt consolidation loan at a lower interest rate than your current debt, which will reduce your monthly interest payments. Also, try to make extra payments that go directly to the loan principal to accelerate the payoff.

How to Stay Out of the Debt Cycle

It's a whole lot easier to stay out of debt than it is to dig yourself out of it, so once you are on stable financial ground, you have to stick with your new disciplined approach to spending.

Live Below Your Means

Just because you can afford it doesn't mean you should buy it. Take a conservative approach to your spending and live below your means to set yourself up for financial success.

Don't Buy Up to the Maximum

When your mortgage lender provides you with the maximum home purchase price you can afford based on your debt to income ratio, don't spend every dime of it. You will also want to estimate the costs of maintaining the home. You may end up using credit cards to pay for these expenses, and then you are heading down the path to more debt.

Be Ready for Emergencies

People sometimes end up in debt due to an unforeseen emergency rather than their everyday spending. In some circumstances, going into debt due to an emergency could be avoided if there were savings to cover the expense. You should save about six months of living expenses to cover unexpected expenses.

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

Business Data

Indicator	Oct-23	Nov-23	Dec-23	Dec-22	Dec-21
	Month-end				
Prime rate	8.50	8.50	8.50	7.50	3.25
3-month T-bill yield	5.33	5.28	5.26	4.35	0.08
10-year T-note yield	4.88	4.37	3.88	3.88	1.52
20-year T-bond yield	5.21	4.72	4.20	4.14	1.94
Dow Jones Corp.	6.34	5.83	5.17	5.54	2.48
GDP (adj. annual rate)#	+2.20	+2.10	+4.90	+2.60	+6.90

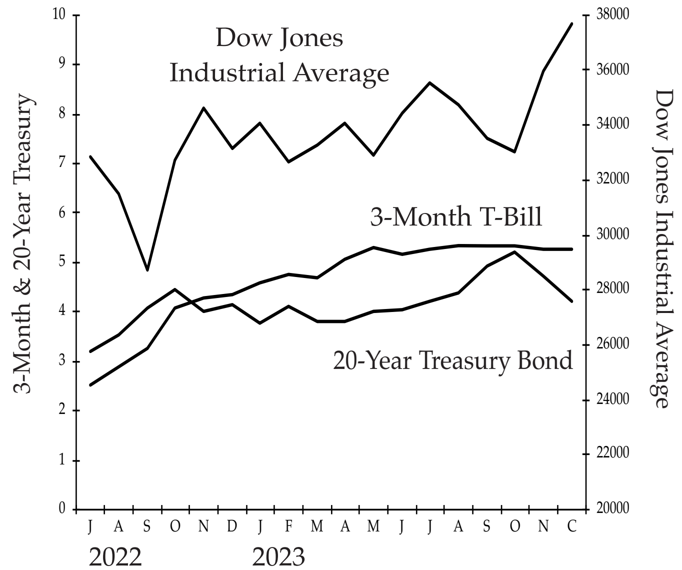
Indicator	Oct-23	Nov-23	Dec-23	2023	2022
	Month-end			% Change	
Dow Jones Industrials	33052.87	35950.89	37689.54	13.7%	-8.8%
S&P 500	4193.80	4567.80	4769.83	24.2%	-19.4%
Nasdaq Composite	12851.24	14226.22	15011.35	43.7%	-33.2%
Gold	1996.90	2035.45	2068.67	14.1%	0.4%
Unemployment rate@	3.80	3.90	3.70	0.0%	-11.9%
Consumer price index@	307.79	307.67	307.05	3.1%	7.1%

— 1st, 2nd, 3rd quarter @ — Sep, Oct, Nov 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

July 2022 to December 2023



News and Announcements

Set Your Own Debt Limits

Credit can be a valuable tool that allows you to purchase major items and pay for them over time. But the availability of credit also makes it easy to incur more debt than you can comfortably repay. Rather than allowing lenders to set credit limits for you, evaluate your financial situation and determine your own limits.

To find out where you stand with consumer debt, which includes all debt except your mortgage, make a list of your debts and monthly payments. Then calculate your debt ratio by dividing your monthly debt payments by your monthly net income. The general guideline is that your debt ratio should not exceed 10% to 15% of your net income, with 20% usually considered the absolute maximum. However, you should consider your own circumstances and decide how much debt you are comfortable with.

Before purchasing something on credit, carefully evaluate whether it makes financial sense to do so. Some questions to ask yourself include:

- Should I wait and save the money so I can pay cash for the item?
- Will the cost of the item increase or decrease in the future?
- Is it really worth paying interest on the item so I can use it now?
- Will I still be within my designated debt limits if I add this new debt payment?
- Will the item still have value after I finish paying for it?

Setting your own debt limit and carefully evaluating whether you should purchase an item on credit should help you keep your debt under control.

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