

LOST OPPORTUNITY COST

Debt can cost more than you think: understanding the Lost Opportunity Cost of debt

It's not always easy to see the real magnitude of how overspending and living in debt erodes wealth. People often focus only on saving, investing, and building wealth. They don't realize that they are often losing much more wealth than they are actually building.

These losses come from paying taxes, fees, certain insurance costs, and monthly lifestyle expenses. Perhaps the most damaging cost is maintaining credit and loan balances to finance things that are going down in value over time, like cars, TVs, furniture, appliances, etc.

When this happens you can lose in three ways. First, you lose the asset value because the asset you bought depreciates. Second, you lose the payments because you agree to financing terms. And third, you lose the use of money on those payments forever.

This is known as lost opportunity cost.

What is Lost Opportunity Cost?

In personal finance, lost opportunity cost can be a powerful and negative force. When you lose a dollar, not only is that dollar gone, but you also lose what that dollar could have earned for you had you been able to keep it.

If you have the opportunity to earn 8% (say 5% after tax) in your investment portfolio, then every dollar you lose is a dollar that never gets to enjoy that 5% net interest.



Auto Loan Example

Let's consider a couple with two cars parked in their driveway. They are nice cars, with all of the latest features that make them a hit when they pull up to a valet stand at the local restaurant.

One car has a monthly payment of \$800 and the other has a payment of \$600. That's \$1,400 each month coming off of their balance sheet to finance cars that go down in value as the odometers go up.

Now, let's further assume that every five years the old cars are traded in for newer models — that cost a bit more each time — and that this continues until this couple retires 25 years later. The loss of wealth surrounding making car payments can be staggering.

If however, this couple could lower their monthly car payments by 50%, they could "recapture" over half of what they were previously losing. This could be accomplished by buying less expensive cars, buying used cars, or simply driving cars longer before trading them in. The result is that they still have adequate transportation, but they are holding on to \$700 each month.

A balanced perspective:

Thinking about your spending in the context of opportunity cost and your long-term financial future can help you determine if your purchase or expense is “worth it.”

To get a sense of the lost opportunity cost of the purchase you’re considering, ask yourself three simple questions:

- What is the true cost of this expense including interest?
- What is the potential for this money if I save or invest it instead?
- Is the item or experience today worth the loss of wealth in the future?

How to reduce the Lost Opportunity Cost of your debt

It’s clear that spending and living in debt can create a substantial lost opportunity cost — but that doesn’t necessarily mean you should scramble to pay off debt as fast as possible.

Here’s why:

Eliminating debt quickly can get in the way of your other financial priorities. If you apply a significant portion of your money toward paying down debt too soon, it could affect your ability to maintain Financial Balance®.

Consider these simple steps to help reduce your debt and the drag of lost opportunity cost:

1. Consolidate your debt.

It may be easier to see the real cost of your debt when you pay your debts in one monthly consolidated payment. And, consolidating your debts into a single loan may allow you to pay less each month, allowing you to apply money to other areas in your financial life where it could make a greater difference.

2. Slow down your debt payments.

By paying down debts aggressively, you may be losing the opportunity to use that money in ways that can potentially benefit you more — today and in the long run.

3. Apply this “found money” to bolster your protection, savings, and investments.

Once you’ve consolidated your debt and slowed down your payments, you may have freed up money that can be used to ensure you’ll have comprehensive protection, help you save 15–20 percent of your gross annual income, and maintain proper levels of liquid savings.

By understanding the impact of the lost opportunity cost of your purchases and expenses and working to reduce debt over time, you’re putting yourself in a position to make the most of your money.

That’s common sense — with an uncommon perspective.

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