THE MONEY MARATHON: SEPTEMBER 2009

DEBT: HOW TO ELIMINATE IT AND STAY OUT OF IT.

In my book, The Money Marathon: 7 Simple Steps to Financial Freedom, I compare debt to a person running a marathon with a 50 pound weight on his back. Running a marathon is hard, but is impossible if a person is weighted down. Winning the race to financial freedom is also nearly impossible with the burden of excess debt. A person can't save and invest meaningful amounts of money effectively if debt is compounding interest in the wrong direction. I tell students that investments growing at 12% can double in value in six years (Rule of 72- Interest Rate divided into 72 tells how quickly money will double). Debt compounding works the same but in reverse. As an example, using the rule of 72, credit card debt at 22.9% can double against a person in 3.14 years. Debt is like running on a treadmill that is moving faster than the person running.

WHAT DEBT IS ACCEPTABLE?

There are only two types of consumer debt than I believe are acceptable. One is using borrowed money to buy a house. Houses appreciate at about 4% per year historically or about 1% over inflation. The current downturn in home prices, caused by speculation and loose lending standards, actually has created a good time to buy. Over time, housing should appreciate at near its historic levels. The second reason to borrow money is to pay for a person's education. It would be better not to have to borrow. But, it if there is no other choice, I believe it is better to borrow to finish than not to finish. Education is an investment in a person's future and will pay on average a $35 return for every dollar spent over the course of a lifetime. Thirty years ago, the income of a person with a college education was 20% above a person with no college. Today that difference is 90%.

WHAT DEBT IS NOT ACCEPTABLE AND HOW DOES A PERSON PAY FOR THESE ITEMS?

I am opposed to borrowing for any other types of consumer debt. (Remember business debt is not consumer debt. Many types of business debt are acceptable).What about borrowing to buy a car, go on vacation, buy appliances, buying a boat etc? The answer is no, no, no, and no for everything else I haven't mentioned. The way to buy those items is to save until a person can pay for them with cash. As an example, if a person has a car valued at $2000 and wants a newer car, I would suggest that person makes a payment to himself until he has enough money to trade up. The average car payment is $500 per month. If a person made this payment to himself for a year he could trade his car plus the $6000 he had saved (12 X $500) for an $8000 car. If the person wants a more expensive car he should save longer.

WHAT ABOUT USING CREDIT CARDS

The rule for credit cards is to never use them unless you plan to and do pay the bill in full and on time before it is due the next month. If a person follows that rule he will never pay interest and it can't compound against him. With monthly interest, monthly late fees of over $30 dollars each month, and over the card limit fees of over $30 each month, it is possible for a one time $1000 charge to a credit card to accumulate another $1000 in interest and fees in a year. If a person can't manage a credit card using the rule above, he should not have a credit card. If credit cards are too big of a temptation, cut them up.

HOW DO I GET OUT OF DEBT?

Rule 1: Decide that getting out of debt is a top priority. Without a commitment to change, it won't happen. Decide that living burdened by debt has to change.

Rule 2: Make a list of all debts which includes payments, interest rates and balances. Then commit to make progress reducing this list of debts by paying either the smallest debt first or the highest interest rate first. To save dollars it makes sense to pay on the debt with the highest interest first. But the important thing is to make progress and it may help to be able to eliminate smaller debts so that a person can continue to see he is making progress. Do whatever works best for a person's particular situation.

Rule 3: Make a budget. A budget is a monthly written plan to decide in advance how a person will spend his money. Most people let their money spend itself and then they wonder what happened and where it went. By deciding in advance with a plan, (budget) a person is prioritizing how the limited resource he has will be spent. For couples it is important that this be done together. If there is a change in the monthly budget both people need to agree and then if they spend more in one area they have to lower another area. In the first month that a couple begins using a budget, they may meet 15- 20 times to discuss changes. But it will get easier each month.

Rule 4: Consider selling items of value that are not needed. If it is important to get out of debt, maybe that boat should be sold? Maybe there are items that can be sold over EBAY? When a person is out of debt he can buy back those items with cash saved. Cars with debt may need to be sold or traded down. It may be acceptable to keep making car payments if a person can pay the car off in two years or less. Otherwise consider trading down to lower the payment.

When a person knows getting out of debt is working is when he starts to look at all of his expenses as choices. As an example, a couple might say to each other let's go out to dinner tonight. But before they go, they might think about what this will cost, let's say $50. Then they might consider that they would rather pay that on their debt. Then they know they are serious and have made getting out of debt a high priority. I am not saying never go out to dinner. I am saying that when getting out of debt is a top priority a couple will choose to pay down debt first over other choices. As a couple make continued progress I actually think it is good to occasionally celebrate progress. Celebrating legitimate progress is a good reason to go out to dinner.

Debt is like a python with a strangle hold on a person. He can't breathe and he can't get away. Over time, it will suffocate him. A person cannot become financially successful and reach his financial goals with too much consumer debt. If a person or couple wants to succeed financial they need to make getting out of debt a top priority and follow the steps above.

Don’t be weighed down by overwhelming debt. Get off the debt treadmill and start running towards financial freedom.

(Remember every investor’s situation is unique and it is important to review your specific situation with a financial professional.)

Ed Douglas is a Certified Financial Planner/Consultant, Chairman Emeritus of Citizens Bancshares and author of two books, “Making a Million With Only $2000-Every Young Person Can Do It” and his new book “The Money Marathon: 7 Simple Steps to Financial Freedom” available at www.eddouglas.com . Ed can be contacted at ed@eddouglas.com or 660-646-2066.