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Financial Briefs

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Debt's Role in Your Financial Plan

As nice as it may seem, achieving debt-free status isn't always the best way to reach your financial goals. Take a look, for example, at mortgage debt. Most people — especially first-time homeowners — can't afford to pay cash for a home, so they borrow some portion of the purchase price. What's more, most mortgage debt is tax deductible, so it's among the cheapest debt you can assume.

On the other hand, you don't have to look any further than the recent history of the real estate market to see how too much mortgage debt can cause significant financial problems.

What Is Smart Debt?

Smart debt is the kind that generates more advantages than disadvantages. Here's how to recognize it:

- **You already have the free cash flow or liquid assets to cover the required monthly payments.** This means that you aren't counting on additional income from the asset you acquire to make the payments. While some people might find this advice too conservative, it's important to remember that the income an asset is supposed to generate can be speculative. If it's rental income, you might not find tenants or may lose the ones already in place. If it's short-term proceeds from flipping a property, the market may not support the higher price you're hoping for. And if it's a new business, the customers might not be there in the numbers you need.
- **The payments don't prevent you from addressing important financial objectives.** Debt that reduces the amount you can save for a child's education or your retirement may not be smart debt.
- **It's to cover the big-ticket items you need to earn a living.** For most people, this means a reliable car. For the self-employed, it can also mean capital equipment, like computers and furniture, or an addition to your house for your business.
- **It's tax deductible.** This generally applies only to mortgage interest, but there are limitations. The IRS doesn't let you take a deduction for mortgage debt beyond $1 million on a first or second home, and that's reduced to $500,000 if you're married but filing separately. It also disallows taking a deduction for interest on home-equity loans totaling more than $100,000.
- **It preserves or improves the value of your home.** Financing major repairs, remodeling, or making your home more efficient with debt can be a smart move, as long as it doesn't violate the principles suggested above.
- **It doesn't push your debt-to-income ratios too high.** Financial

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Paying Off Your Mortgage

There are advantages and disadvantages to paying off your mortgage. On the positive side, any extra money sent with your mortgage payment is applied to the outstanding principal, which can significantly reduce your total interest cost. This reduces your interest expense deduction on your tax return, but you are paying most of the cost anyway. For instance, if you're in the 25% tax bracket, you save 25 cents in taxes for every dollar of interest, but you're still paying the remaining 75 cents.

When paying down principal, you are effectively earning a pretax return equal to your mortgage interest rate, which is a guaranteed return with no risk. Most mortgages allow you to add as much to the

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experts and banks recommend keeping your total monthly debt payments (including rent or mortgage) at or below 40% of your monthly take-home income, and payments that don't keep a roof over your head to a maximum of 20%. Go beyond these limits, and you may find it hard to be approved for a loan when you need it.

- **It doesn't reduce your credit rating.** This comes into play chiefly as a result of credit card borrowing. Your credit rating suffers when your credit card balances come close to your limit. Consumer credit experts say you should aim to keep your balances at less than 35% of your credit limit to keep your FICO scores from being reduced.

Strategies to Reduce Debt

If your debt is out of hand, here are some steps you can take to make it more manageable:

- **Refinance your mortgage.** If you haven't missed any payments and have equity in your home (it's worth at least what you owe), you may be able to reduce your mortgage payments by refinancing. Even if you have to finance closing costs, mortgage rates might be so much lower than your current rate that you still come out ahead. You might even be able to cash out some untapped equity in your home and pay off some unsecured debt — replacing high-interest, nondeductible debt with low-interest, tax-deductible debt.
- **Reduce your spending on nonessential items.** Cut out as much of your monthly budget as possible, like restaurant meals, entertainment, subscriptions, premium TV packages, and expensive mobile phone data plans. Trade a luxury car you're still making payments on for a less-expensive one.
- **Keep a record of every penny you spend.** Incidentals you pay for with cash can add up without you being aware of just how much you're spending. Keeping a diary could help you find more ways to reduce unnecessary spending.
- **Cut up your credit cards.** This makes it nearly impossible to take on any more credit card debt.
- **Pay down high-interest debt first.** Keep making the minimum payments on all of your debts, but find a way to make the biggest payment possible on your highest-interest card or loan first.
- **Negotiate with your lenders.** Call them to request a reduction in your interest rate, a waiver of late fees, or an affordable payment plan.

If your plan hasn't been updated lately to reflect current debt balances or you're not sure whether you're making the best use of borrowed funds to reach your goals, it's time for a thorough review. Please call if you'd like to discuss debt in more detail.

Managing Your Home Investment

Your home is an investment, so you should develop strategies to manage that investment. Some points to consider include:

- **Don't stretch to purchase the most expensive home you can afford.** The reason homes contribute so significantly to many people's net worth is that you retain any price appreciation on the entire home, even though you only put down 10–20% of the purchase price. That fact causes many people to strain their budgets and purchase the largest home they can afford, hoping the increase in the home's value will more than offset the sacrifices made along the way. Before embarking on such a strategy, consider all the risks. If home prices start to fall, you could end up owing more than the home is worth. Also, should your income decline or you lose your job, you may have difficulty paying the mortgage and other housing costs. If your budget is strained to the limit, you might not have money left over to contribute to your 401(k) plan or individual retirement account. It may be a better strategy to purchase a home you can comfortably afford.
- **Don't take equity out of your home in the form of a home-equity loan or a higher mortgage balance.** While lower interest rates allow many homeowners to reduce their monthly mortgage payments, many also opt to take equity out of their homes and stretch mortgage payments over longer periods. One of the main advantages of home ownership is it's a forced savings plan with part of each mortgage payment going toward equity. Resist the urge to use that equity on something else.
- **Make sure you have adequate insurance.** Your homeowners insurance policy should be sufficient to completely rebuild and refurnish your home in the event of a total disaster. Check the limits of your policy every year and increase those limits if needed. You will probably want a guaranteed replacement clause, which pays the entire cost of rebuilding your home.
- **Inventory everything in your home.** You can either write or videotape the inventory. Include everything in your home, systematically working your way around every room so nothing is left out. Keep receipts for larger items with the inventory. The inventory and receipts will help substantiate a claim in the event your home and contents are destroyed.

Paying Off Your Mortgage

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payment as you like, whenever you like, making it an easy way to use excess funds. However, check with your specific lender to determine if prepayment penalties apply.

On the other hand, instead of prepaying your mortgage, you might want to use additional funds for investments with the potential to earn higher returns. Also, once you make the additional mortgage payments, the only way to access that money is to sell your home or take out a home-equity loan, usually at higher rates than the original mortgage.

Consider the following factors before prepaying your mortgage:

- **Are all components of your financial plan in place?** Before prepaying your mortgage, make provisions for things like disability insurance, life insurance, and an emergency reserve fund.
- **Is all your consumer debt paid off?** Consumer debt typically carries interest rates that are higher than your mortgage rate; and interest payments are not typically tax deductible, unless it's a home-equity loan. Thus, you should probably pay off your consumer debt in full before making additional payments on your mortgage.
- **Are you maximizing contributions to qualified retirement plans?** Make sure you are contributing the maximum to your 401(k) plan, especially if your employer matches funds, or are fully funding other qualified plans and individual retirement accounts.
- **Have you investigated other investment alternatives?** Look into other investments whose potential returns may exceed the return from prepaying your mortgage. However, make sure you actually make those investments. You don't want to just spend any money that could have gone toward your mortgage.
- **Are you nearing retirement?** As you approach retirement age, the idea of entering retirement with no debts may make prepaying your mortgage a more attractive alternative. Or you may like the certainty of positive returns that comes from prepaying your mortgage.

If you decide to prepay your mortgage, consider these strategies:

- Switch from a 30-year to a 15-year mortgage. By paying the mortgage off 15 years sooner, you save a significant amount of interest.
- Pay half your mortgage payment every two weeks. Over the course of a year, that equals 26 payments or 13 monthly installments. Check with your lender to make sure this option is offered.
- Add additional amounts to your monthly mortgage payment. This option is the most flexible, since you decide on a monthly basis how much to add to your payment.

Please call if you'd like help deciding whether you should prepay your mortgage.

Review Your Homeowners Insurance

Often, homeowners insurance is purchased with the home and then is not thought about again until a claim is made. But since there is little you can do at that point about your coverage, take time periodically to review your policy. Some items to consider include:

- **Review the adequacy of your policy limits.** Investigate how much it would cost to replace your home and make sure your policy limit will cover that amount. Don't insure your home for its market value — it may cost more or less than that to rebuild your home. And even if your home were totally destroyed, you would still have the land. Try to obtain guaranteed replacement cost coverage, wherein the insurance company pays the cost to rebuild your home even when the cost exceeds the policy. Make sure your policy has an inflation endorsement that adjusts your coverage annually for increases in construction costs.
- **Obtain coverage for special risks.** Basic policies protect you from fire, smoke, windstorms, vandalism, and lightning. The most comprehensive policies cover every peril except those specifically excluded, typically floods, earthquakes, war, and nuclear accidents. If you live near a floodplain or earthquake area, obtain specific coverage for these perils. Find out if your policy will pay to rebuild your home in accordance with local zoning laws and ordinances. An existing home does not have to meet new zoning laws and ordinances, but when you rebuild, you must comply with those laws.
- **Understand what other items are covered by your policy.** Your homeowners policy also typically covers personal property, other structures on your property, landscaping, loss of use when your property is destroyed, and personal liability coverage. Carefully review the limits for all of these items, since you can generally add endorsements if you need additional coverage. Typical policies cover personal property for a maximum of 50% of the coverage on the home, usually paying actual cash value, which deducts depreciation from the amount paid. Try to obtain a replacement cost endorsement, which pays to replace your property and typically raises the limit to 70% of your home's coverage. Pay special attention to limits for items like jewelry, antiques, collectibles, and works of art.

Business Data

	Month-end				
Indicator	**Oct-16**	**Nov-16**	**Dec-16**	**Dec-15**	**Dec-14**
Prime rate	3.50	3.50	3.75	3.50	3.25
3-month T-bill yield	0.35	0.49	0.56	0.26	0.04
10-year T-note yield	1.76	2.26	2.55	2.24	2.14
20-year T-bond yield	2.17	2.66	2.86	2.60	2.47
Dow Jones Corp.	2.76	3.16	3.17	3.43	3.08
GDP (adj. annual rate)#	+0.80	+1.40	+3.50	+1.40	+2.20

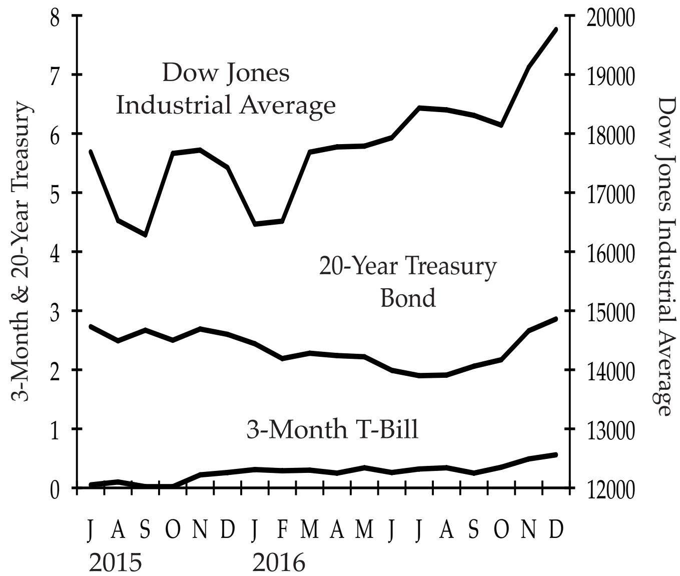
	Month-end			% Change	
Indicator	**Oct-16**	**Nov-16**	**Dec-16**	**2016**	**2015**
Dow Jones Industrials	18142.42	19123.58	19762.60	13.4%	-2.2%
Standard & Poor's 500	2126.15	2198.81	2238.83	9.5%	-0.7%
Nasdaq Composite	5189.13	5323.68	5383.12	7.5%	5.7%
Gold	1272.00	1178.10	1159.10	9.1%	-11.4%
Unemployment rate@	5.00	4.90	4.60	-8.0%	-13.8%
Consumer price index@	241.40	241.70	241.40	1.7%	0.5%
Index of leading ind.@	124.40	124.60	124.60	0.6%	2.8%

— 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 2015 to December 2016



News and Announcements

Dealing with a Spouse's Credit Issues

Combining your finances with your spouse's may also include combining your credit histories. When you apply jointly for credit, both your credit histories will be evaluated. Thus, if one of you has an outstanding credit history and the other has credit problems, it can affect the approval process and the cost of your debt. Some tips to consider when one spouse has a poor credit history include:

- **Don't apply for joint credit.** If your spouse's credit history is very bad, it may pay to leave him/her off the credit application. However, that means your spouse's income won't be considered.
- **Ask a parent or relative to cosign a major loan, such as a mortgage.** Before asking, keep in mind that you are asking that person to take responsibility for the entire loan. If you default, the lender can come after your cosigner. Or, if you are late making payments, that will also be reflected on the cosigner's credit history.
- **Instead of applying for joint credit cards, list your spouse as an authorized user of your cards.** While an authorized user can charge on your credit card, you are responsible for paying the bills. If the account is paid promptly, it will be reported on both credit histories, helping to improve your spouse's credit history. However, if you make delinquent payments, only your credit history suffers, since your spouse can ask to be removed from the card and have the negative information removed from his/her credit history.
- **Use other strategies to improve your spouse's credit history.** Ensure that your spouse makes all payments on a timely basis. Try to pay down as many of his/her credit balances as possible. If your spouse has difficulty obtaining credit, have him/her apply for a secured credit card.

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