



ALBION FINANCIAL GROUP

GUIDING CLIENTS TO A LIFETIME OF GOOD DECISIONS



UTAH SAVES WEEK - SMART MONEY MOVES: PAYING DOWN DEBT IS SAVING

**WRITTEN BY
ADAM HAYNES, FINANCIAL PLANNER**

In a financial landscape where interest rates on savings accounts are enticingly high, the decision between paying down debt or stashing cash becomes more intricate. This article aims to unravel a few of the complexities, arguing that even with the allure of a 5% interest rate in a High-Yield Savings Account, strategically paying down debt can often be a superior financial move. We will delve into the nuances of tax considerations and the importance of setting concrete financial goals to guide this decision-making process.

“Strategically paying down debt can often be a superior financial move.”

THE EMERGENCY FUND

Prior to exploring better potential use-cases for idle cash, a proper emergency fund should be established. It is understood that the purpose of cash in an emergency fund is to provide financial security during uncertain times. For this reason, these funds need to be liquid, and as such, a High-Yield Savings Account is an adequate place to house this cash.

THE TEMPTATION OF HIGH-INTEREST SAVINGS

For funds above and beyond what is needed in an emergency fund, a 5% interest rate on a High-Yield Savings Account can be a tempting prospect, seemingly outpacing the interest paid on certain debts. However, the true impact of this nominal rate needs to be dissected, especially when considering the after-tax reality and the inherent trade-offs.



“One critical factor often overlooked is taxes.”



TAX CONSIDERATIONS AND THE REALITY OF AFTER-TAX RETURNS

One critical factor often overlooked is taxes. Interest earned in savings accounts is subject to ordinary income tax (the highest tax rates individuals can be subject to), which can significantly diminish the apparent superiority and allure of a 5% interest rate. The effective return, or after-tax return, will likely be much lower, potentially making the decision to pay down debt more appealing.

STRATEGIC GOAL SETTING

Rather than being swayed by high interest rates alone, individuals should set clear financial goals to guide their decisions. It comes down to determining a concrete purpose for every dollar in a financial plan. This could include saving for a home, funding education, or securing retirement. Defining a goal for each dollar allows for a clear answer as to how the funds should be used or invested. Rather than chasing the highest interest-bearing savings account in the short-term, it is necessary to shift to a long-term view. With a long-term focus and a goal for every dollar, the decision of what to do with additional funds becomes increasingly clear.

“It comes down to determining a concrete purpose for every dollar in a financial plan.”

PAYING DOWN DEBT

A Closer Look at Mortgage Considerations: Take the example of a 3% mortgage on a home. While the nominal rate appears lower than the 5% savings interest rate, the tax implications must be considered. After accounting for ordinary income taxes (federal, state, and potentially net-investment income tax) on the interest earned in savings, the effective return



may not be significantly higher, if at all (surprisingly, in the highest of personal income tax brackets, the calculation tips the scales in favor of paying down the debt in this scenario). In this light, paying down a low-interest mortgage, even in the current higher interest rate environment, can be a financially prudent move if there is alignment with the overall financial plan.

“Paying down a low-interest mortgage, even in the current higher interest rate environment, can be a financially prudent move.”

LONG-TERM DEBT AS A STRATEGIC ASSET

Even when interest rates on savings appear attractive, individuals with long-term, low-interest debt, such as a mortgage, may find value in paying down this obligation. By strategically reducing debt, they enhance their financial flexibility and free up cash flow to use in pursuit of other goals. For this reason, paying down debt is saving.

“Strategic wisdom lies in the details.”

In the dynamic interplay between high-interest savings and debt repayment, strategic wisdom lies in the details. Nominal interest rates on savings accounts can be alluring, but after-tax considerations and the strategic goals one sets can redefine the narrative. As advocates for financial wisdom and well-being, we urge careful consideration of the overall impact on goals before deciding to invest or pay off debt.



Utah Saves Week is part of America Saves Week, February 27-March 3, 2023.

Albion Financial Group is an SEC registered investment advisor. The information provided is intended solely for educational purposes and should not be construed as an offer or solicitation for the purchase or sale of any particular securities product, service, or investment strategy. Past performance is not indicative of future performance.

Additional information about Albion Financial Group is also available on the SEC's website at www.adviserinfo.sec.gov under CRD number 105957. Albion Financial Group only transacts business in states where it is properly registered, notice filed or excluded or exempted from registration or notice filing requirements.