Paying down debt

What you need to know

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Are you dealing with debt? Debt can help you achieve your goals, such as buying a home or getting an education to improve your income potential, but it can also be a source of stress and put a strain on your finances. Having a plan to tackle your debt can help you get in control, reduce anxiety and even lower costs.

If you have debt, you're not alone. In fact, almost 80% of U.S. households have debt, with many families holding more than one type of debt.[1] If you have debt and it's stressing you or your finances, you might be interested in paying it off. But what if you're still building your financial foundation? How do you balance paying down debt with making progress toward other goals, such as building an emergency fund or saving enough for retirement? If you're wrestling with these questions, this report can help you put together a plan to address your debt more effectively.

1 Source: Federal Reserve, *Changes in U.S. Family Finances from 2019 to 2022,* 2023.

How to tackle your debt	
Prepare your debt	1. Know your debt.
	2. Explore debt optimization strategies.
Pay it down	3. Decide how much to allocate toward debt vs. other goals.
	4. Prioritize your debt.

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What if you're comfortable with your debt?

While this report is mainly for individuals trying to reduce their debt to a comfortable level, these strategies might still be helpful if you aren't stressed about your debt but are looking to manage it more effectively.

What if your debt is too high?

If you're struggling to make minimum debt payments, the strategies here might not be suitable, and you might need to look into other alternatives (e.g., talk to a reputable credit counselor, work with creditors directly to renegotiate payments or consult with a bankruptcy attorney).

1. Know your debt.

Start by understanding how much you owe and what kinds of debt you have. Make a list of all your individual debts, including credit card debt, mortgage, auto loans, student loans, medical debt and "buy now, pay later" loans, among others.

For each individual debt, note:

- Type of debt
- Total amount owed
- Interest rate charged and type (fixed versus variable)
- Whom you owe
- For installment debt, the recurring payment amount and the payoff date
- For revolving debt, the minimum payment



Installment vs. revolving debt

Installment debt is when you receive a fixed amount that you repay over time by making fixed payments (typically monthly). Mortgages and auto loans are examples of installment debt. Revolving debt is when you have an open line of credit that you can draw from as needed (up to an approved limit). You can choose how much of the outstanding balance to pay back every billing period (although minimum payments are generally required). Unpaid balances will generally accrue interest and roll over to the next period. Credit cards are an example of revolving debt.

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Once you have a list of all your debts, add it all up to know the total amount you owe. Also, check your debt-to-income (DTI) ratio, which can give you a sense of how much of your income you're allocating to debt. To calculate your DTI ratio, divide your total monthly debt payments by your gross monthly income. For installment debt, include the required ongoing payments, and for revolving debt, include the minimum payments.

Work toward a DTI ratio below 35% if you have a mortgage or 20% if you don't. Lenders will generally consider you to be safer if your DTI ratio is below these values. The less comfortable you are with debt, the lower DTI ratio you should target.

How do I find my debts?

If you have a hard time keeping track of your debts, a good place to start is your credit report. Your credit report includes a list of your debts along with information such as outstanding balances and payment history. You can request a free copy from each of the credit bureaus. As you review your credit report, pay attention to errors, since they are common. For more information on how to request a credit report and fix errors, visit annualcreditreport.com.

Debt doesn't have to be scary

Learning how much you owe can stir negative emotions, so you may be tempted to delay or avoid reviewing your debts. But ignoring your debt can ultimately make it worse. If you're struggling with this task, you can try certain steps, such as entrusting a loved one to keep you accountable or pairing this activity with something you enjoy (such as a nice treat or activity once you're finished). Knowing your debt can empower you to take control and make progress toward paying it off.



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2. Explore debt optimization strategies.

Once you know how your debt is structured, see if there's an opportunity to reorganize it and make it work better for you. In particular, you might be able to lower and streamline your payments as well as change the type of debt you hold.

There are three strategies you could use to optimize your debt.

You could ...	Which involves ...	Examples
Refinance debt	Paying off an existing debt using new debt (of the same type) that has different terms (e.g., lower rate or longer period).	• Replace a mortgage or auto loan with a new one that has a lower rate. • Transfer credit card debt to a new card with a low introductory rate (balance transfer credit card).
Swap debt	Paying off an existing debt using new debt (of a different type) that has different terms (e.g., lower rate or longer period).	• Use new debt backed by assets (e.g., home equity loan, HELOC or securities-based lending) to pay off unsecured debt, since secured debt can have a lower rate.
Consolidate debt	Paying off multiple existing debts using new debt to combine several payments into one. The new debt could have different terms than the old debt.	• Use a personal loan or secured debt to pay off multiple high-interest debts. • Use a credit card balance transfer to consolidate multiple credit card debts into one.

Optimization ≠ less debt

It's important to understand that while **debt optimization strategies might reduce your interest rate or payment amount, they won't reduce the total amount of debt you owe.** You're simply replacing existing debt with new debt that has different terms. As a result, debt optimization strategies should be accompanied by good debt habits and not used as an opportunity to take on more debt (e.g., after transferring credit card debt to a new loan, using the freed-up space on your credit cards to accumulate new debt).

While these optimization strategies can help you better manage your debt, they might not always work for you. They typically require you to take on new debt, usually with more favorable terms than your existing debt. So, to make the most of these strategies, you'll generally need to have a good credit score. Also, they'll be more or less advantageous based on external factors, such as current interest rates.

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Key considerations and risks

Debt optimization strategies can have costs and come with certain conditions that can offset some of the benefits. When looking into debt optimization strategies, consider the following:

- **Fees.** Applying for new debt or a debt balance transfer generally comes with fees (typically 2%–6% of the balance).
- **Total interest paid.** While extending the terms of your debt can help lower payments, this could result in paying more in total interest (even if your new rate is lower).
- **New terms and conditions.** Favorable terms on the new debt might only last for a limited time. For example, balance transfer credit cards can start with a low introductory rate (as low as 0%) but, after a while, rates typically increase substantially. Also, understand the new risks that might come with changing debt types (e.g., going from a fixed to a variable rate).
- **Impact on credit score.** Applying for new credit can negatively impact your credit score (at least in the short term).

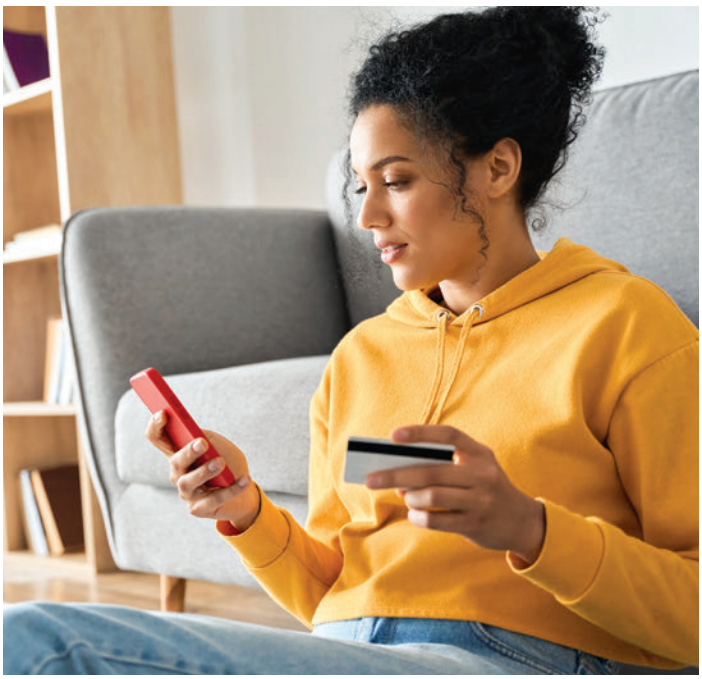
Your financial advisor can help you understand the benefits and costs of debt optimization strategies.

A word of caution: Unsecured vs. secured debt

Beware when trading unsecured debt (e.g., credit cards) for secured debt (e.g., home equity loan or securities-based lending). If you're unable to pay it back, you may lose those assets that you used for the secured debt (e.g., your home).

Tips for optimizing specific types of debt

- Be careful when using a credit card to pay medical debt. While unpaid medical balances generally won't accrue interest, credit card debt will. Also, you'll lose specific protections associated with medical debt (e.g., limits on debt collection efforts).
- If you have federal student loans, you can typically change the repayment option anytime. You can also consolidate multiple student loans and/or refinance them into a private loan. But in both cases, you might lose certain benefits. For more information on optimizing student loans, check out our report on strategies for repaying student loans.



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3. Decide how much to allocate toward debt vs. other goals.

After organizing your debt, determine how much money you'll put toward debt payments. This involves:

- Calculating your required minimum payments
- Determining any additional amount you'd like to put toward debt

Calculate minimum debt payments

Your debts typically have minimum payments (generally monthly). Depending on the type of debt, minimum payments could be a flat amount (e.g., monthly mortgage payment), a percentage of the outstanding balance (e.g., 1% of your credit card balance) or the total interest accrued since the last payment.

If you fail to cover minimum payments, you may be subject to costly fees and penalties, higher interest rates, and your credit score might be negatively impacted. For debt secured by assets, you could be at risk of losing these assets. As a result, **you should always make minimum payments across all your debts.** In fact, you should consider minimum debt payments as necessary expenses in your budget.



Determine extra payments

If you only make minimum payments, you'll hold debt for longer and pay more in interest. For some types of debt (such as credit cards), it might take a relatively long time to pay it down if you only pay the minimum. As a result, you might want to put more funds toward your debt. Paying off your debt faster can also help improve your cash flow, increase your credit score and reduce stress.

To determine how much extra money you should put toward your debt:

- Start by going over your budget (or creating one if you don't have one) and calculate any extra funds after covering your total expenses (including minimum debt payments).
- Then, think about how you'd like to allocate this surplus between paying down debt and saving for your other goals. Remember, every dollar used to pay down debt is a dollar you won't be able to save.

The importance of budgeting

After reviewing your budget, you might conclude that you'd like a larger surplus to put toward debt and other goals. If that's the case, revisit your budget and make adjustments. To learn more about how to review your budget, check out our report on budgeting.

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While you're building your financial stability, it's important that you balance paying down debt with making progress toward building an emergency fund and saving for retirement. In other words, while paying off debt faster might sound tempting, it might not be the best move if you don't have a fully funded emergency fund or aren't saving enough for retirement.

The following chart shows our recommended approach to balancing multiple goals by setting specific milestones. For more details about how to balance tackling debt with other goals, check out our report, "Starting your financial journey."

	Milestone 1	Milestone 2	Milestone 3
Emergency savings	$500 to 1 month of total expenses	1.5 – 2 months of total expenses	3 – 6 months of total expenses
Investing for retirement	Employer match (HSA, then retirement)	10% – 15% gross income (including employer match)	The amount necessary to get on track for your retirement goal
Debt reduction	Pay high-interest debt (>8%)	Debt-to-income (DTI) <35% with a mortgage or 20% without; pay down highest interest rate first	Consider paying off any debt that causes stress

Tips

- Periodically review the amount you're allocating toward your debt versus other goals, particularly as your priorities and/or available funds change (e.g., you get a raise, buy a home, etc.).
- You can also use this approach to allocate one-time additional income, such as a tax refund or bonus, to your financial goals.

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4. Prioritize your debt.

The final step is deciding how you'll allocate extra payments across your debts. When it comes to prioritizing debt, there are two main methods to consider: the avalanche method and the snowball method.

	Avalanche method	Snowball method
Approach	Pay debt with the ***highest interest rate*** first	Pay debt with the ***lowest balance*** first
Benefit	Minimize interest payments	Build momentum by reducing the number of debts quicker
Trade-off	Can be harder to stay motivated or see progress (particularly, if the higher-interest debt is large)	Pay more in interest

We generally recommend focusing on paying down high-interest-rate debt first (such as credit card debt) following the avalanche method. In particular, pay debt with the highest ***after-tax*** interest rate first, since some interest, like mortgage interest, may be tax deductible. We favor this approach because it helps minimize interest paid. Also, higher-interest-rate debt tends to be revolving, which usually has a larger weight on your credit score. If two debts have a similar interest rate, pay off the one with the smaller balance first.



Alternative: Combine both approaches

While we advise starting with the highest-interest debt, paying off small balances can be motivating. So, if getting rid of debt with lower balances will help you get started, you can combine both methods. In particular, focus on small debts first (e.g., those with a few hundred or couple thousand dollars), starting with those with a higher interest rate. Once these smaller debts are paid off, tackle your remaining debts from highest to lowest rate.

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The following example shows how the different methods can be used in practice and their trade-offs.

Example: Avalanche vs. snowball vs. hybrid methods

Let's assume you have the following debts:

- Credit card A with **$7,500** balance, **30%** rate and minimum payment of $125
- Credit card B with **$800** balance, **25%** rate and minimum payment of $50
- Personal loan with a remaining balance of **$6,000**, a **15%** rate and a monthly payment of $121
- Auto loan with a remaining balance of **$1,800**, a **7%** rate and a monthly payment of $151

After getting a raise, you decide to start making extra debt payments of $250 a month in addition to minimum payments. Which debts would you allocate those funds to first under each method? How would that affect the cost and repayment time frame?

Avalanche method			Hybrid method			Snowball method		
Type	Amount	Rate	Type	Amount	Rate	Type	Amount	Rate
Credit card A	$7,500	30%	Credit card B	$800	25%	Credit card B	$800	25%
Credit card B	$800	25%	Auto loan	$1,800	7%	Auto loan	$1,800	7%
Personal loan	$6,000	15%	Credit card A	$7,500	30%	Personal loan	$6,000	15%
Auto loan	$1,800	7%	Personal loan	$6,000	15%	Credit card A	$7,500	30%

Avalanche method	Hybrid method	Snowball method
How long will it take you to pay your debts?		
3.5 years	4.1 years	5.6 years
How much will you pay in interest?		
$5,600	$7,600	$12,500
How many debts will you have after one year?		
4	2	2

Source: Edward Jones. This hypothetical example is for illustrative purposes only. It assumes that, once a debt is paid off, the required minimum payment is redirected to other goals and expenses. If instead the funds were used to make additional debt payments, interest payments would be lower and the repayment period shorter under each approach. Additionally, the difference between the three approaches would be smaller.

As the example shows, the avalanche method results in less interest paid and debts being paid off faster. In this case, you'd save $2,000 in interest, and your debts would be paid about six months sooner compared to a hybrid approach. That's why we generally recommend using the avalanche method. This example also illustrates the appeal of considering a hybrid approach. With the avalanche method, all four debts would still be outstanding after one year. But with a hybrid approach, you'll only have two debts remaining. These small wins could help you build momentum. Also, paying off some debts sooner and removing required minimum payments can have the additional benefit of improving your DTI ratio faster.

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Tip: Once you've determined how much you want to put toward each of your debts, set up automatic payments so you don't miss any payments.

You've achieved financial stability. Now what?

Once you've built your financial stability (i.e., you've fully funded your emergency fund, you're on track for retirement and you've paid off any burdensome debt), you still might want to make extra debt payments. Paying off debt can save you on interest charges — but at the cost of missing out on investing the money and potentially earning a market return that could be higher than the rate on your debt. Also, you might want to weigh the value of getting rid of your debt faster versus reaching your other goals sooner (e.g., retiring earlier).

The following chart shows an example of the financial trade-off between paying down debt versus investing. As you can see, if the after-tax rate on your debt is higher than the expected market return, it would be more financially advantageous to allocate extra payments toward debt rather than investing (and vice versa).

Example: Pay down debt vs. invest

Using extra $250 to pay 30-year, $300,000 loan faster or invest

	Loan with a 4% interest rate		Loan with a 7% interest rate	
	Pay down debt	**Invest at 6%**	**Pay down debt**	**Invest at 6%**
Interest paid	($156,000)	($216,000)	($283,000)	($419,000)
Return on investment ***(after 30 years)***	$37,000	$161,000	$66,000	$161,000
Net impact	($119,000)	($55,000)	($217,000)	($258,000)

Source: Edward Jones estimates. Assumes that you either (i) make extra debt payments of $250 until the loan is paid off and, afterward, you invest an amount equal to the debt payments plus the $250 for the remaining term of the loan or (ii) you don't make extra debt payments and invest $250 a month for 30 years. The rate of return is 6% per year and the loan interest rate is either 4% or 7% per year. This hypothetical example is for illustrative purposes only and does not reflect the performance of a specific investment. Values rounded to the nearest $1,000.

Whether you have multiple liabilities or just a few, dealing with debt can feel overwhelming. Having a roadmap to tackle your debt can give you clarity on your next moves and help you get where you want to go. Work with your financial advisor to create a strategy to pay down your debt that works for you and your goals.

This report is for educational purposes only and should not be interpreted as specific advice. Financial decisions should be based on each individual's unique situation.

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