Should you use extra cash to invest or pay off debt? Here are some options

KEY POINTS

- Whether it's a bonus, tax refund, stimulus check or severance package, coming into money spurs the question of whether to pay off debt or invest with it.
- No matter what the source of the money is, you should give careful consideration to the decision.
- There are good reasons for either decision. You could also opt to do a little bit of both.

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A frequent question that I get asked as a financial advisor revolves around paying off debt versus investing when the opportunity arises.

Typically, someone has some extra money as the result of a bonus, tax refund or some other windfall.

However, as we have worked our way through the Covid-19 pandemic, the questions have oftentimes been spurred after someone has received a severance package.

No matter what the source of the money is, you should give careful consideration to the decision of paying off the debt or investing.

There are many financial experts who recommend first paying off debt.

There are good arguments for this, for both financial and non-financial reasons. Financially, the debt is paid and you are no longer paying interest — and those are good things.

There are also psychological and emotional benefits, as well. Mortgage-burning parties used to be a big deal. These parties were meant to be a celebration of becoming true owners of a property, free and clear of the responsibility and risk of the property being encumbered.

Homeowners didn't have to worry about what would happen if they lost their job or some other economic misfortune arose. They could sleep a little easier at night knowing that, if nothing else, "I've got a roof over my head."

Now, on the flipside, a school of thought suggests that if your after-tax return on investments is greater than your after-tax cost of your debt, then you should invest the money.

A simple example works like this: You owe a debt that comes with an interest rate of 4%. We will assume that the interest is deductible.

Now let's assume investment returns of 8%. If you are in a marginal tax bracket of 22%, that makes the effective cost of your debt 3.12%, as compared to an after-tax return on investment of 6.24%.

In this scenario, it makes sense to invest the funds and pay the minimum on your debt.

Clearly there is the risk of comparing a certain debt cost versus an uncertain investment return, so be very careful if you take this approach.

Now, there's a third option in the payoff-debt-versus-invest debate, and it can be summed up with a quote from Yogi Berra, a brilliant baseball player and manager. Yogi was also famous for his comically wise sayings, which are known as "Yogi-isms." One of his more famous quips reminds of that third option: "When you come to a fork in the road, take it."

The decision to pay off debt or invest doesn't have to be an either-or decision. Why not try to do both?

Often this option allows someone to have their cake and eat it, too.

You save money on the interest expense, but you also get the money invested. This is a particularly good option when there aren't enough funds to completely erase the debt.

Let's be honest, for many people investing is more "fun" than saving or reducing interest expense no matter what the math suggests. There is also the additional benefit of getting into the habit of investing rather than putting it off until some point in the future.

No matter which option you choose, it's important take the time to think it through, make a plan and then execute it.

In another words, follow the road map that makes sense for you because, as Yogi said: "If you don't know where you're going, you'll end up someplace else."

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