Heading west will only add to high debt

Money Manager/by Karin Price Muelle – www.businesstoday.com

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Sherry, a 24-year-old public relations rep, is planning on big changes over the next few months. She came to the Herald hoping to get her mounting credit card debt under control before making a big move across the country, to San Francisco.

Today, Sherry, who rents an apartment in Greater Boston, earns $40,000 per year, and she hopes whatever job she finds across the country will pay about the same. After investigating living expenses in the area she's considering, she figures the cost of living will be similar to Boston.

But the move will cost some big cash. Sherry estimates moving expenses, including a deposit on an apartment and some new furnishings, will cost about $3,200 - money that Sherry doesn't have.

After paying her monthly bills, her checking account usually has a balance of about $300. She also has a savings account worth $250, to which she deposits $80 per paycheck. But because Sherry likes to travel in her spare time, she never accumulates very much of a surplus in the account.

``Traveling is my hobby,'' Sherry says. ``I put myself on a budget of $200 a month, but I've been exceeding that.''

Not only is Sherry cash-poor, she's also fighting credit card debt - which she adds to when her travel expenses surpass her budget.

She has a balance of $9,000 on one card, which is racking up interest at 11.99 percent. That rate was negotiated down from 14 percent a few years ago.

She also has $2,500 on one card at a low 1.9 percent rate, but that will go up to a rate of 12.5 percent.

She's planning on charging most of her moving costs, which will only add to her debt. She sends payments of between $400 and $500 each month to her creditors, but her balances continue to climb.

``I keep trying to pay them off, but I can't do it while still charging every month,'' Sherry says.

Sherry is also paying down her college loans: $221 per month on a Stafford loan and $71 per month on a Perkins loan. Plus she owes her parents $12,000 they loaned her for a car, but she's not making any payments at this time. She's planning to pay down her other debt first, she says.

Add all that debt to her monthly expenses, and Sherry is running a deficit every month. To ease the cash shortage, Sherry charges more on her credit cards, which she knows puts her in a never-ending circle of growing debt.

Though Sherry is facing a cash crunch now, she's also very aware that she hasn't yet started planning for retirement. She wants to start a retirement plan by her 25th birthday. But she knows if she changes jobs, her employer-sponsored options will probably be limited. She missed out on her previous employer's 401(k) plan because she wasn't in the job for a full year before she quit, and her current employer's plan has the same one-year service requirement.

``I might not be at this company for year, so I keep missing out,'' she says.

Solution

Go on strict spending diet

Sherry's problem is simple to diagnose, but the treatment is easier said than done. She has to either earn more or spend less so she can pay off her debt before she even considers a long-term savings plan.

Art von der Linden, a certified financial planner with Wingate Financial Group Inc., of Lexington, says Sherry has to get on a strict spending diet, and she has to make a real effort not to add new charges to her credit cards.

``The plastic is so easy to use, but you build debt that you cannot service,'' he says. ``It's a spiral down the drain.''

But that doesn't mean Sherry's situation is hopeless, von der Linden says. Sherry just needs to find the discipline to control her spending.

After taxes, Sherry takes home about $28,800 per year, but her annual spending exceeds that income by about $3,000, which is added to her credit cards.

A look at Sherry's annual tax refunds shows there's a little extra cash to be found today. She receives about $600 back from the IRS each year after filing her taxes. Instead of getting a refund, von der Linden recommends Sherry adjust her withholding so that she can benefit from that cash throughout the year, instead of giving an interest-free loan to the Internal Revenue Service.

There's not a lot of fat in Sherry's housing costs. Sherry shares her apartment with two roommates, paying monthly rent of $485 per month, and utilities of about $85 per month. She'd be hard-pressed to find a cheaper apartment.

The next place to look for cash is by cutting back Sherry's discretionary expenses, he says. Sherry spends about $250 per month on dining out and another $250 per month on travel as a hobby. These funds could instead be put towards taking a chunk out of her credit card debt.

``She should curtail one or both expenses - preferably both - until the credit card debt is under control,'' von der Linden says.

If she continues to pay about $500 towards each of her two credit cards, it will take 27 months to pay the debt - assuming she doesn't add to the balance. She'll pay $1,650 in interest over that time.

If she cuts back on her dining out and travel costs and diverts that cash to pay the credit cards, she could pay them off in 13 months. The stepped-up payments would also save Sherry about $864 in interest payments.

Next, Sherry should lock up her credit cards and use cash only, until she better balances her budget. Then she should start shopping for low-interest charge cards and transfer her high-interest balances, hopefully slowing the growth of her interest charges.

Sherry expressed concern about penalties that some cards charge to accept transferred balances, but von der Linden says the penalty for not shifting the debt to lower interest cards is worse.

If Sherry makes the move to California, she'll be adding a few thousand dollars more to her cards, von der Linden notes, so it's especially vital that Sherry slow the interest charges as soon as possible. After the big-ticket move, she needs to start using only cash.

As for Sherry's hope to start a retirement plan by her 25th birthday, Sherry will be eligible for her current employer's 401(k) plan in November on her one-year anniversary of service. The plan offers a host of funds from The Vanguard Group, and her employer will match $0.50 on every dollar contributed up to 6 percent of her salary. But von der Linden thinks it's not a realistic goal to start the plan - even if she remains with this employer - because all of Sherry's extra cash should go towards paying off debt.

``It's nirvana to start retirement savings now because she'd have money compounding tax-deferred for a very long time,'' von der Linden says. ``But historically the stock market earns 11 percent a year while her credit card debt is charging more in interest - that's a losing proposition.''

At age 24, von der Linden says Sherry has plenty of time to start a savings plan once she reduces her debt.

He's glad to see she's motivated to get out from under the debt before she gets older, as the interest payments over the long term would really be damaging to her financial well-being.

``She's very early in her life, and it's good to learn these lessons before you get too far in the hole,'' he says.