By Priya Rama

Debt-Free vs Retirement Savings Which to Prioritise?

Most Malaysians prefer to be debt-free rather than focussing on retirement funds. But is this right?

One aspect of wealth planning is managing debts. Asians, particularly Malaysians, often have the mindset of prioritising debt payment over savings for retirement. Any extra cash at the end of the day is used to pay off existing debts rather than investing into a retirement plan.

Smart Investor spoke to a few prominent financial experts on what should be prioritised – being debt-free or saving for retirement.

KENNEY KHEW, LICENSED FINANCIAL PLANNER PHILLIP WEALTH PLANNERS SDN BHD

Kenney Kew

Managing both our debts and savings is important because it increases our net worth eventually.

However, I personally would give more importance to retirement savings than reducing mortgage debt, especially now when inflation rate is pretty high. Furthermore, planning for the next 25 to 30 years is more important than focusing on debts that have already incurred.

One way to manage mortgage debt is by purchasing the Mortgage Reducing Term Assurance (MRTA) from banks. The MRTA is usually incorporated in the mortgage debt or monthly housing instalment to mitigate anything untoward happening to the primary borrower, namely accidents, death, total permanent disability and critical illness.

If this happens, the insurance company will pay a compensation to the bank to fully settle the mortgage loan.

However, if your Debt Service Ratio (annual loan payment/ annual take home pay) is greater than 35% and Debt to Asset Ratio (total liability/total assets) is greater than 50%, you might want to consider settling your debts first.

YONG CHU EU, LICENSED FINANCIAL PLANNER FIN FREEDOM SDN BHD

Yong Chu Eu

Both are equally important. Instead of choosing to prioritise one over the other, we should try balancing the scale – meaning settle our debts and have adequate retirement savings.

If you're debt-free upon retirement, which is highly recommended, but lack savings, you will be having a tough time managing even your daily expenses.

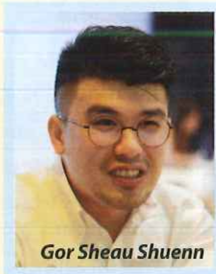
Likewise, if you have adequate savings, and still have a high level of debt upon retirement, most of your wealth will be used to settle those debts. This is why I always stress on simultaneous management of debt and savings.

Most Malaysians are conservative. They prefer to utilise their free cash flow to clear off debts, only then think of investing for retirement. But this is not a good idea as they will have lesser time in compounding their wealth.

The best way is to service your debts on a monthly basis according to the loan requirements. (Take note that your total debts should not be more than 40% of your monthly salary.)

Invest the extra cash into an investment vehicle that you're familiar with, but make sure that the returns are higher than the loan interest rate. (for example, investment return is 7% and mortgage interest rate is 5%)

GOR SHEAU SHUENN, LICENSED FINANCIAL PLANNER BLUEPRINT PLANNING SDN BHD


Gor Sheau Shuenn

Reducing mortgage debt is recommended if it's for self-occupancy because we want to have a debt-free home to live in upon retirement.

However, if it's investment property, just follow the loan repayment schedule and cover the commitment with rental income. Furthermore, the interest on loan are allowable tax expenses, which could be used to reduce chargeable income.

Nevertheless, saving for retirement is equally important. Retirement cashflow should focus on living necessities instead of loan repayment.

If you put all your money into paying off mortgage loan, eventually, you would have a house to stay, but no money to fund for basic living needs. What would you do then?

Of course, investment property can be disposed off anytime for capital gains and parked under retirement fund. But the question is whether you would be able to liquidate the property immediately.

Therefore, I would like to introduce the 50/30/20 budgeting thumb rule:

- 50% of your take-home pay should be used to pay for mortgage, home insurance and maintenance, hire-purchase loan, car insurance and maintenance, and other bigger commitment.
- 30% of your take-home pay should be used to pay for groceries, dining out, entertainment, and other family and personal expenses.
- 20% of your take-home pay should be used for savings, out of which 50% should be kept for retirement and the balance 50% for other financial goals and emergency purpose. This is on top of your EPF savings.

For instance, assuming you are 25 years old today, with the ability to invest RM500 every month into an investment instrument which gives you a return of 7%. In 10 years' time, or by the time you're 35, you will be able to save RM86,500, and RM260,500 by 45.

Apply the Rule of 72 every 10 years, and you would be able to double up your capital by 7% per annum. By the time you reach 65, you would already have RM1 million, even if you have stopped investing at 45 years old.

STEVE LIM, CHIEF LEARNING OFFICER AFFIN HWANG ASSET MANAGEMENT

Steve Lim

I think it depends a lot on an individual's cost of debt versus investment returns. If I make say 12% returns from my investment in the long run, I would rather put more attention to retirement savings than paying off my debts that's costing me 4% per annum.

Of course, you can quickly pay off your debts if you decide otherwise, but you're only going to save 4%, and give away differential returns of about 6-8% on retirement savings.

As Asians, we have a debt-free mentality. But debt is very cheap in this environment right now. Everyone is getting very low interest rates, thus, if you can accumulate a return of 10% on your investment, it would be better to focus efforts on the latter, than settling a debt that is very cheap.

The only time an individual needs to focus on debt is if he is a conservative investor, where he is invested predominantly in fixed income instruments which gives him a return of 5-6% per annum. With a 4% cost of debt, he would be quite indifferent as to whether he should pay off his debts or invest for retirement.

Understand your debts first before managing them. For instance, concentrate on settling short-term debts like credit card and car loans rather than mortgage loan. It's wise to keep your short-term debt low as the repercussions of non-payment can be quite damaging.

Housing loans, on the other hand, are long term, and if you have a savings buffer of 6 months to a year, you should be able to pay off the instalment if you lose your job.

In fact, a home loan can only become a non-performing loan (NPL) after a year, so you shouldn't be too worked up over a long-term debt, as you still have time.

TAN KIM BOOK, LICENSED FINANCIAL PLANNER PHILIP WEALTH PLANNERS SDN BHD

Tan Kim Book

For an individual who would like to plan for effective wealth accumulations for retirement and distributions, we would first have to take a look at his personal financial statement.

If the cost of mortgage is higher than the rate of return on your investment, then I would advise you reduce your mortgage debt, which is logically and mathematically very effective as this can reduce the instalment tenure and save the mortgage cost.

However, you need to have the discipline to save more for your retirement after reducing your mortgage debts. Sometimes, you might have the discipline, but alas, time and compound interest may not be on your side.

On the other hand, if the rate of return on your investment is higher than the cost of mortgage, there is no hurry to reduce your mortgage debts. For instance, let's assume that the cost of your mortgage is 4.5%, and the rate of return on your investment is 8%.

Instead consider to channel your surplus into the Employment Provident Fund (EPF) or a Private Retirement Scheme (PRS), and allow time and compound interest to work for you.

An important fact that many of us aren't aware of is that we shouldn't withdraw the savings in our EPF Account 2 facility, either monthly or lump sum, for paying mortgage instalments or early settlement, if the EPF return is higher than the mortgage cost.

KEVIN NEOH, LICENSED FINANCIAL PLANNER VKA WEALTH PLANNERS SDN BHD

Kevin Neoh

I would say both are equally important. Debt management is also part of the key component towards a sound retirement planning, for if we have debts on our shoulders, we can never truly retire as we still have to service the loan when we stop working.

But if one has to take precedence over the other, then it is important to note that usually, our mortgage has a tenure that is as long as our time horizon towards retirement.

If one repays more to reduce the mortgage and to redeem the property from the financier earlier than the tenure stated in the loan agreement, no doubt there will be extra cash in hand and also a property that is free from incumbencies.

However, what happens when the person runs out of retirement fund? Does he have to sell his property then? If yes, where will this person stay after that?

Hence, it is important to prepare for a retirement fund while we are still working. In short, just follow your mortgage repayment schedule and save the extra cashflow towards building a retirement fund!