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Take Steps to Get Out of Debt

By Margaret O'Meara, CFP®, AIFA®

Whether you're buying coffee and the morning paper at the convenience store, paying for a getaway vacation cruise, or settling your tax bill with Uncle Sam, it's all too easy to pull out your plastic. For many of us, credit cards have become a little too convenient. In fact, many Americans spend 1.25 times what they make in a year, trapping them in an ever-widening spiral of massive debt.

According to the Federal Reserve Board's *Survey of Consumer Finances for 2004*, the median credit card balance (for those carrying a balance on credit cards) rose to \$2,200 or 10.0% from 2001. In the same time frame, the mean rose 15.9% to \$5,100. Also, notably, of the 74.9% of families with credit cards in 2004, 58.0% had a balance at the time of the Fed's survey. Of course, it's crucial not to be lulled into a sense of complacency about your outstanding debt just because so many people are in debt. Sure, misery loves company, but think back to your mother's wisdom when she asked, "If everyone jumped off the bridge would you, too?"

If you've dug yourself deep into debt, these five steps can help you to climb out:

- **Take stock of your situation.** Sure, you have that pit in your stomach when you pull your bills out of the mailbox, but are you in serious trouble? Now is the best time to find out. Summon the strength to list how much you owe, to whom, and at what interest rate. How much is too much? These questions can help you decide:
 - Do I make only minimum payments?

- Do I routinely skip payments or make late payments?
- Have I reached the credit limit on one or more credit cards?

If you answered yes to one of these questions, you'll have something to gain by reading on.

- **Create a realistic budget.** The simple truth is that to get out of debt, you have to spend less than what you earn. First, list your income from all sources. Then, list your fixed expenses such as mortgage payments, rent, and/or car payments. For the next several months, keep track of every dime you spend on variable expenses like clothing, entertainment, and recreation. It's likely you'll arrive at the painful conclusion that you will need to do what you can to trim some fixed expenses and do without some extras such as dining out.

During the period that you are paying down your debt, carry around only the set amount of cash you can spend each week. Leave your debit and credit cards at home. It's easier to improve your spending decisions when you see the cash leaving your wallet rather than swiping your card through a machine. You might also consider putting your credit cards on ice – literally. If you keep them frozen in your freezer, you can thaw them out for use in an emergency, but the time it takes you to defrost them might be long enough to squelch your desire for that big screen television or new outfit.

- **Shop around for lower interest rates and consolidate your balances.** Particularly, if you have a strong credit rating, it's worth shopping around for a lower interest rate. You might start with a visit to www.cardweb.com. Also, keep in mind that while taking advantage of those promotions for 0% introductory rates would alleviate the immediate pressure on your cash flow, often the rate is only good for one year. What's more, invest the time to read the fine print carefully and evaluate the offer in terms of new annual fees, balance transfer charges, and the credit company's ability to increase your rate as long as they give you written notice.

Note that while consolidating your debt to a single card makes bill paying easier, if it's likely you'll use more than 30% of the one card's available credit line, you might want to reconsider your move as it could lower your credit score. (The higher percentage of your credit limit that you use, the greater you are seen as a credit risk.) Also, you might decide to hang onto the credit card you've had the longest because the amount of time you've been granted credit is a plus in your column when figuring your credit score. If that card has an astronomical interest rate, use it every now and then for small purchases and pay it off in full when you get the bill.

- **Develop a payment plan and stick to it.** It's tough to get out of debt without a plan of attack. List all your credit cards with the highest interest rate on top. Make minimum payments on all cards, but direct any extra cash – bonuses, product rebates, rolled coins, yard sale proceeds – to paying off the card at the top. If you need motivation to make more than minimum payments, check out Bankrate.com's calculator at www.bankrate.com/aol/calc/MinPayment.asp. By showing you how your minimum payments simply flow into a compound interest sinkhole, the calculator illustrates what that new living room furniture really costs. You might also benefit from a little investor psychology. That is, if you have a card with a relatively small balance, even if the interest rate is not your highest, perhaps targeting it for first payoff will boost your confidence and enable you to exercise more discipline in paying down your other cards. You can also harness the power of peer pressure. If you share your goal of being debt-free with your friends, you'll be less likely to resort to plastic when you are with them. Also, remember that with universal default, one late payment or accidentally going over your credit limit on one card can increase not only your interest rate on that card, but on other cards issued by different companies.
- **Consider professional help.** You've seen advertisements from numerous credit counseling organizations that say they can help, but some charge high fees. Others insist on a debt management plan that requires you to make payments to them to disperse to your creditors. For more information, the Federal Trade (FTC) publishes a series of free publications on credit issues. They are available at www.ftc.gov/credit or by calling 877-382-4357.

Of course, the real trick in digging out of debt is to develop a financial plan that enables you to live debt-free in the future. Here, your financial advisor will have plenty of suggestions to offer but, really, the best advice is so simple that last season it was the punch line of a *Saturday Night Live* skit: ***"If you can't afford it, don't buy it."***

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