M&G Insights

M&G Investments

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Should you invest or pay off your debt?

The cost of living has increased quite dramatically over the past year, with annual inflation in South Africa currently running at 7.5% (as at the end of September 2022). And interest rates have risen almost as sharply – the prime lending rate is now at 9.75% from 7.25% at the beginning of 2022.

In fact, when compared to just 12 months prior, inflation was sitting at a much more palatable 5.0%, still within the SARB's 3%-6% target range. The sharp increase in prices and interest rates over the past year has made the cost of living increasingly more challenging for many South Africans. It's unsurprising then, that according to TransUnion, the country's outstanding credit card debt amounted to a total of R139 billion, as at the end of the second quarter of 2022. The question of whether to use any disposable money that you may have to accelerate your loan repayments, or to invest, can be a challenging one. In this article, we take a closer look at three key factors that you should consider when deciding on which option is best for you.

1. Understand your options
You've probably heard the statement before, that the best 'investment' you can make is to pay off your debt as quickly as

possible. The theory behind this is relatively simple: the money that you save on interest by accelerating your debt repayments is likely to be more than the return you would get from an investment with a similar risk profile and investment horizon.

While this makes sense in theory, there are certain instances when it doesn’t. The key to understanding which option is best for you is to start by looking at the respective interest rates for each option. In other words, you’ll need to compare the interest rate charged for servicing your debt, relative to the potential rate of return from your investment. If the interest rate on your debt is more than the potential rate of return on your investment, then you might consider paying off your debt first (and vice versa).

2. Where you are in the cycle?

Before you make your decision, it’s important to know where you are in your debt cycle and how your debt repayments have been structured. It’s usually the case that debt repayments are designed so that the interest amount gets paid off first (during the first half of the term), and the loan amount (also referred to as the capital amount) gets paid off second.

So, if you are close to the end of your repayment term, it’s likely that you would have already paid off most of your interest. This means that even if the interest rate on your debt is greater than the potential return on your investment, choosing to invest your extra cash may be the better option compared to accelerating your debt repayments.

3. Start with debts that have the highest interest rate

If you do decide to accelerate your debt repayments, a good starting point is to begin with the debt that has the highest interest rate and work your way down from there. This is because the higher the interest rate on your debt, the more interest you’ll end up paying. Another factor to consider is whether the interest rate on your loan is fixed or linked. Interest rates that are linked to prime (which is the base rate that banks charge customers with good credit scores), will go up and down as the SARB adjusts its repo rate (which is the base rate that the reserve bank lends money to commercial banks). South

Africa is currently in a rate-hiking cycle, which means that if your loan is linked, the rate that you are currently paying on your debt will increase in line with the SARB's interest rate hikes. This means that the amount of money that you pay to service your debt currently, could increase significantly in the future.

To sum up, hopefully, the above points have provided some food for thought when deciding on which option to choose regarding your debt and investments. However, we recognise that knowing when to accelerate your debt repayments or invest your extra cash can be a complicated undertaking, which is why we strongly recommend enlisting the services of a good independent financial adviser to help you structure a solution that's right for you.

To find out more, please feel free to contact our Client Services Team on **0860 105 775** or email us at info@mandg.co.za.