Pay Down Loan or Invest – Video Transcript

If you have extra money available, you might wonder whether it's better to pay down an existing loan, such as a student loan, credit-card balance, or mortgage, or invest those extra funds instead.

The answer involves analyzing how those extra dollars can be put to work for you.

Here's how to do that.

Compare the interest rate on your loan to the rate of return you might earn by investing your extra funds. The first variable is known, the second is only a guess.

When you make extra payments on a loan, you are essentially earning a rate of return equal to the interest rate on the loan.

For example, if you have an auto loan with a 6% interest rate, applying extra money toward that debt is similar to "earning" a 6% return.

If you think you can earn a higher rate of return by investing your extra funds instead, then investing might be the better option.

Of course, when investing, no one can predict a future rate of return with certainty.

Generally speaking, if the interest rate on your current loan is relatively low, the potential long-term return you might earn by investing could outweigh the benefits of paying off your loan early.

On the other hand, if you have limited years to invest and the interest rate on your loan is comparable to the rate you might earn from investing, then paying off your loan early might be more satisfying.

Before you choose either option, though, make sure you're taking full advantage of any retirement plan match offered by your employer — this is free money. If you aren't contributing enough to get the full match, then consider directing any extra funds here first.

All investing involves risk, including the possible loss of principal, and there can be no guarantee that any investing strategy will be successful. Investments seeking to achieve higher rates of return also involve a higher degree of risk.