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Good News on the Credit Card Front!

By Ed Hynes, CFA

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Good news – consumers are paying off more of their credit card debt on time. A recent analysis in The Wall Street Journal reported consumers are paying off their credit card debts more quickly than they used to. This is really positive because clearing up credit card debt is one of the first actions investors should take to get their financial houses in order.

Why is it so important to pay down credit cards? Because the interest rates charged on credit card debt are astronomically high. Right now consumers are charged an average of almost 18 percent.

Luckily, consumers are waking up to this problem and in March paid off 20.6 percent of their credit card debt. This is up from 17.9 percent last year and the shift has occurred for a couple of reasons.

First, a new law forced credit card companies to raise their minimum payments. Previously, the minimum payment often just covered fees and interest costs; and the outstanding balance would never go down. Now the minimum payment must include at least some repayment of principal, in addition to these other costs.

The second reason for quicker payments is many people have consolidated their credit card debt by using home equity lines of credit and are vowing never to get trapped again. In fact, the number one reason for taking a home equity loan is to consolidate debts. Obviously, this does not solve the problem, but it helps. The significantly lower interest rates and the tax-deductibility of interest expenses on these loans give borrowers a better chance.

The Journal's report was not all good news, as total household debt continues increase. The silver lining here is that consumers are managing their debts better. High-cost consumer debt composed of both credit cards and auto leases made up 5.7 percent of household debt at the end of last year. This is down from 6.4 percent five years earlier.

One result of the faster credit card payments are lower profits for the credit card issuers. Profits on credit cards come mainly from the interest they charge on outstanding balances. For example, Citigroup's U.S. card business experienced a 6% drop in revenue in the 1st quarter.

Another issue effecting banks' credit card profits is the intense competition for customers. The banks are negatively impacted when their customers leave for lower rates elsewhere and they hurt their own bottom lines when they use the same tactic to fight back.

One interesting question is should investors pay off their credit card balances before they start saving for retirement? Not always. For employees with matching 401(k) plans, go for the match first. If the match is one for one - that is an immediate 100 percent return on your money, not bad.

Once workers fully utilize their employer's matches, the next place to invest is in their credit card debt. If they are being charged 18 percent, paying down the debt is the same as finding another investment that will pay 18 percent, guaranteed. And I do not know of any investments with that kind of return.

What should consumers do if they have credit card debt and don't have any way to pay it off now? Consider shifting your balances to other cards. For instance, qualifying credit card holders can shift their balances to any number of banks offering low or zero-percent interest rates for a period of time.

I encourage this strategy, but advise you to proceed carefully. Read the fine print before signing on the dotted line. A couple of things can go wrong with this approach. For instance, after the introductory rate expires, make sure the new rate you will pay is not higher than the one you are currently paying. You might plan now to change cards every year, but due to circumstances out of your control, you could be stuck with the new company for a long time. There is no guarantee other deals will be offered or that you will continue to qualify for them.

In summary, let's keep up the good work and avoid high cost credit card debt. It is hard to get ahead when shelling out 18% for interest costs.

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