Dealing with Debt

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"Annual income, twenty pounds; annual expenditure, nineteen pounds; result, happiness. Annual income, twenty pounds; annual expenditure, twenty-one pounds; result, misery."
— Wilkins Micawber in *David Copperfield*

Debt has a bad reputation. It is prevalent, no one wants it, and everyone who has it wants to get rid of it. Everyone wants to be debt-free.

There is, however, another way to look at debt. Debt is a financial tool to meet your personal and financial goals. For example, according to the Association of American Medical Colleges the median level of medical student debt was $180,000 in 2014. While we'd all agree that this level of debt is high, it has allowed most of us to meet our personal goal of becoming a physician.

"Don't wait until a crisis hits to get your debt in order."

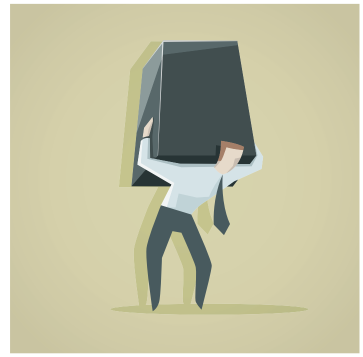
Dealing with Debt Wisely

Banks and financial institutions see physicians as low-risk and are willing to loan us a lot of money, which can be good or bad. If you are an emergency physician, you can probably get a loan to buy a $100,000 luxury car, and while this might be fun, it is probably not wise. The same thing goes for a jumbo mortgage.

Every time you are considering a loan, you should ask yourself if what you are about to purchase is worth it. Will that fancy car or extra-large house truly bring you happiness? Or does it just bring a ton of overhead, increased expenses, and four extra rooms you'll need to buy furniture for.

As I've discussed in prior columns, the book *The Millionaire Next Door* by Stanley and Danko was a longitudinal study of millionaires. This study showed that most millionaires don't drive expensive cars. In fact, most drive "normal" cars or buy them used. In addition, most don't live in large houses in expensive neighborhoods. Their study showed that physicians are notorious for buying these items to live up to society's expectations. Doctors are supposed to drive luxury cars and live in expensive neighborhoods, right? This is also why they found that physicians under accumulate wealth and have much a lower net worth than their income would predict.

Do yourself a favor and buy a smaller house, drive a less expensive car, and avoid a boat. You don't want to own the boat, you want to be best friends with the owner of the boat. Skip the vacation home. You can probably rent an equivalent home for much less than it would cost to buy it, and in 2013 the Nobel Prize in Economics was given to Robert J. Shiller, who showed that housing prices barely outpace inflation over the long haul, making real estate a less attractive investment.



While the ultimate goal is to get to the point where you can pay cash for cars and other major purchases, you will likely take out loans for some period of time when a major need arises. Here are some financial rules of thumb to keep you from getting in debt beyond what you can handle:

- Monthly debt payments (excluding your mortgage) should be <20% of your monthly income.
- Your housing costs should be <30% of your income.

No matter what debt you accumulate, make sure you always make your payments on time. The #1 factor that goes into calculating your credit score is your ability to make timely payments on your debt, and your credit score will determine the interest rate you are charged on nearly every loan you ever take. One late $50 payment could cost your thousands of dollars on a mortgage, for example.

Credit Cards

"Keeping a balance on your credit card is about the worst financial move you can make."
— Burton G. Malkiel, Chair of Economics, Princeton University
Author of *A Random Walk Down Wall Street*

The quote above says it all. If you are going to use a credit card for the convenience, always pay off the entire balance every month because the interest rates they charge can be very high. If you can't control your credit card debt, cut them up, cancel them, or only have one that you use in special circumstances. If you have to have credit card debt, make sure you ask your credit card company to lower the rate or transfer the debt to a low rate card. Check credit.com, cardtrak.com, or lowcards.com for a list of low rate cards.

Good Debt?

In addition to helping you achieve financial goals that are important to you, debt can be used to limit the amount of your own investments that must be in cash equivalents. Having easy access to credit can provide a nice backstop in case of a sudden need for cash.

If you have equity in your home, a home equity line of credit can serve this purpose. Their interest rates are usually low and the interest is often tax deductible, further lowering the cost of borrowing. Home equity lines of credit (and other lines of credit as well) should be set up in advance, not after you lose your job and are a credit risk. Beware of fees your lender may charge and see if you can find one that will waive them for a slightly higher interest rate. A slightly higher interest rate isn't that big of a deal as you hope to never use this line of credit anyway.

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Student Loans

Many readers will have significant student loans. If you are a resident or fellow, contact your loan servicer to see if you are eligible for deferment of your loans until your salary rises. If you are looking to simplify your loans, investigate student loan consolidation by checking loanconsolidation.ed.gov.

Probably the most important step that residents can take to pay off their student loans is to avoid jumping straight into the "doctor lifestyle" as soon as they graduate residency. If you continue to live like a resident until your student loans are paid off, it shouldn't take more than a few years to get rid of them, after which you can splurge a little and enjoy your income free of student loans. This is easy to type and hard to do, but just a few years of "roughing it" can wipe out your student loans.

Paying Off Debt

When you pay off debt, you are earning an after-tax return equivalent to the interest rate you are being charged. For example, if you pay off credit card debt with an 18% interest rate, this is the equivalent of earning a guaranteed 18% return on your investment tax-free. With the long-term rate of return for the stock market averaging just under 10%, you can see that paying off high-rate debt is often a better move than investing in the stock market. In other words, it makes no sense to pay the minimum on high-interest debt like credit cards while investing in the stock market. Pay off your high interest debt first.

The one exception to this is if you get an employer match on your retirement account contributions. If you get a 50% match, that is an immediate 50% return on your investment, so contribute to your retirement account up to the maximum that your employer matches, then pay off high interest debt.

If you have multiple loans, pay off the one with the highest interest rate first. In addition, see if you can stretch out the payments for your low interest loans over a longer period of time, lowering your monthly payments and freeing up cash to pay off your higher interest debts faster. For example, if you have credit card debt with a 14% interest rate, a car loan with an 8% rate, and a mortgage with a 5% rate, pay off the credit card first, then the car loan, and then the mortgage.

Keep in mind that in general it doesn't make sense to pay off debt when the interest rate is lower than the after-tax rate you could earn on an investment. If you want a number, I would pay off high-interest debt (rates greater than 6-8%) such as credit cards, car loans, and private educational loans. If the rate is less than 6%, as with most mortgages nowadays, it probably makes more sense to invest the money in mutual funds and pay off the debt as slowly as possible.

Another move to consider is to take out a home equity loan to pay off high interest debt. You get a lump sum with a fixed interest rate that is often lower than your current debt and pay it off over 5-15 years. In most cases the interest you pay is tax deductible. Keep in mind that you could lose your house if you default on this type of lean, and beware of any up-front fees that you need to factor into your calculations.

Conclusion

Don't wait until a crisis hits (divorce, job loss, disability, or a lawsuit) to get your debt in order. If you have major problems with debt and need help, seek a fee-only financial planner with experience with high-income individuals who can help you restructure and manage your debt.

If you have ideas for future columns or have other resources you'd like to share, email me at jschofer@gmail.com.

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