Managing your debt

By David Keator, Keator Group

Many investors track their assets closely — checking the Dow, following certain companies and consulting with a financial advisor. But what about the often overlooked liabilities side of the balance sheet?

There are lots of pieces to the “balance sheet” puzzle. Amazing value can be brought by addressing the debt side of an individual’s personal balance sheet. It’s just as important as the investment side.

Affluent investors, in particular, have access to a wide variety of creative lending options — the home equity line of credit and collateralized securities are considered to be chief among them. What one often finds is that clients don’t necessarily have too much debt; it’s just organized poorly. People are not taking advantage of more appropriate borrowing options. There’s debt — and then there’s debt.

Consumption vs. conservation

The difference between debt types is generally a matter of consumption versus conservation.

“Borrowing for consumption is usually not a good idea,” says Mary Sexton, former director of lending services of Wachovia Securities.

“You’re using a home equity line of credit to buy shoes? You’re accessing leverage to maintain a lifestyle you can’t currently afford? That’s borrowing for consumption. We want people to learn you should not borrow for consumptive purposes.”

Debt can be used most wisely for conservation purposes.

“These are larger expenses you just can’t fund from current cash flow, such as a big tuition bill,” Sexton says.

“It’s critical when thinking of incurring debt to consider how it will impact your investment decisions.”

With that college tuition bill, for example, it wouldn’t make sense to disrupt your long-term investment plan for a short-term need. Instead, Sexton advises, you could consider a home equity line of credit, or you may elect to borrow against your securities.

Smart debt management

To work with debt strategically, first, clearly identify your overall goals and establish priorities. Then look at all your assets and liabilities and figure out your cash needs going forward.

It’s also important to determine your suitability for borrowing and, just as with investing, set your risk tolerance level.

When you acquire debt using an adjustable interest rate, you must think about interest-rate risk. If you are borrowing in a rising-interest-rate environment using adjustable rates and the prime goes up 500 basis points (5 percent), would you have the ability to pay off the loan to reduce your risk? You need to consider the implications of borrowing. At the end of the day, you need to be able to sleep at night. Of course, basic principles of money management hold true when dealing with interest rates, whether you are working with good debt or bad debt — you want to earn more money than you pay out.

The key is to borrow at the lowest available rate while maximizing your investment returns. You wouldn’t want to borrow on a credit card charging a double-digit interest rate while investing in a money-market fund paying below 5 percent, for example.

Selecting a borrowing method is key to smart debt management. Consider these possibilities:

1. Most home equity lines of credit are variable-rate forms of credit, meaning that the APR may increase or decrease after consummation based on changes to the index (in this example, the prime rate as published in The Wall Street Journal, Eastern Edition, was 5.25 percent on March 3, 2011) and in accordance with the terms of the Home Equity Line of Credit Agreement. The borrower may have to pay closing costs. Adequate homeowner’s insurance is usually required, and flood hazard insurance may be required. If the borrower chooses an interest-only repayment option in a state where that option is available, a balloon repayment will result.

2. Please consult your tax advisor regarding tax deductibility.

3. Margin borrowing adds risk to your investments and is not suitable for all investors. If the market value of the eligible securities in your margin account declines, you may be required to deposit more money or eligible securities in order to maintain your line of credit, or we may be forced to sell securities held in your account.

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References

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