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:

- Credit cards are OK, but only if you pay off the balance. There are highly sophisticated, affluent investors who are carrying $40,000 credit-card balances and don’t have a home equity line of credit. That may not be the best thing to do, depending on your situation.

- A home equity line of credit works well for investors who need immediate liquidity — and even those who don’t. A home equity line is flexible, you only draw on it as you need it during the draw period. It can offer relatively low risk, may be priced at a currently low prime rate or prime plus or minus a margin and may be tax-deductible.

It could be one of the best borrowing options available if you take into consideration your short-term, long-term and interim cash flow needs. And you never know when you’re going to need liquidity — you want the ability to access it in life-altering events. There could be a medical emergency, a divorce, widowhood. You want that line in place beforehand.

Borrowing against securities is another option. This strategy provides low-rate financing, prime or prime plus or minus a margin, by using the client’s stocks, bonds and even savings accounts and certificates of deposit as collateral. Investors can continue to trade their securities and earn on their investments while they are collateralized.

The bottom line: Consult a qualified financial advisor to help you make sure you’re considering all the borrowing options available to you. It could make a dramatic difference in your future financial life.

Disclosure

All loans and lines of credit are generally subject to credit approval, verification and collateral evaluation in accordance with the lender’s underwriting standards. Not all products are available in all states. Other restrictions may apply.

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References

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 3.25 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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