PROTECT YOUR POT OF GOLD FROM BAD ADVICE

THE END OF THE RAINBOW

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Pay Down Debt or Invest?

10 GUIDING PRINCIPLES

by JAMES M. DAHLE, MD, FACEP

Question. ***I am a new attending for a private employer and owe a lot of money. I have the following debts:***

- ***$400,000 5/1 adjustable-rate mortgage at 3.5 percent***
- ***$60,000 student loan at 7.9 percent fixed***
- ***$80,000 student loan at 6.8 percent fixed***
- ***$40,000 student loan at 5.4 percent fixed***
- ***$20,000 student loan at 4.5 percent variable***
- ***$20,000 seven-year car loan at 5 percent fixed***
- ***$11,000 on a credit card at 11 percent***
- ***$8,000 on a credit card at 15 percent***

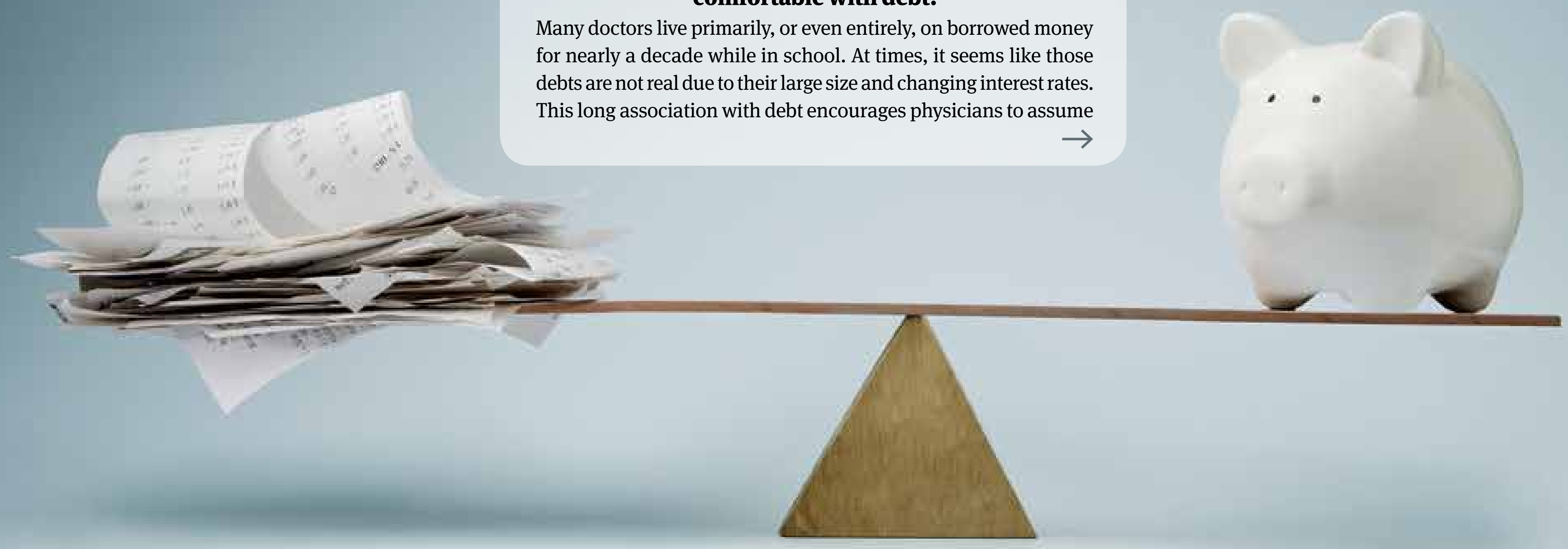
I would also like to get started investing. My employer offers a pretty standard 401(k) and will match the first $6,000 that I invest. My stay-at-home spouse and I are also excited about starting backdoor Roth IRAs. How can we decide when to pay back loans and when to invest?

A. This is a complex problem and one to which there is no definite right answer. The correct answer for you will depend on a lot of factors, such as current interest rates, total debt in relation to your income, expected return on investments, the fixed versus variable nature of your loans, job security, your tax situation, your asset protection plan, and your comfort level with debt. There are, however, some guiding principles you can apply when making such decisions.

1

Physicians, in general, are entirely too comfortable with debt.

Many doctors live primarily, or even entirely, on borrowed money for nearly a decade while in school. At times, it seems like those debts are not real due to their large size and changing interest rates. This long association with debt encourages physicians to assume →



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that owing hundreds of thousands of dollars is somehow OK. It isn't. Although there are exceptions, most of the time paying off debt will improve your financial situation as much or more than anything else you are likely to do. Buying depreciating items, such as automobiles, on credit is a "rookie mistake." Likewise, credit cards aren't for credit. Those who find themselves routinely carrying balances on them would be better served using a debit card or even cash. Paying down debt not only improves your cash flow but is far better than the usual alternative—spending the money.

2

Improve debt when possible.

Some debt is more easily managed than other debt. If you can convert a debt that is nondeductible, high-interest, variable, and/or short-term into a debt that is tax-deductible, low-interest, fixed, and/or long-term, it's usually a good idea to do so. If going for student loan forgiveness isn't right for you, refinancing your student loans at a lower rate is a good idea. Given all the 0 percent credit card offers out there, it seems silly to carry 15 percent interest on credit card debt. If you still have a mortgage greater than 5 percent, refinancing should be priority before you lose your opportunity.

3

Always consider the after-tax interest rate on your debt.

When your debt is completely deductible, use the after-tax interest rate to make comparisons. As a general rule, student loan interest is deductible as a resident but not as an attending. Conversely, mortgage interest may not be deductible as a resident due to the standard deduction being more than your itemized deductions, but it generally is as an attending. Auto and credit card loans are generally not deductible. If your marginal tax rate is 28 percent federal and 5 percent state, a fully deductible 5 percent mortgage has an after-tax interest rate of 5 percent x (100 percent – 28 percent – 5 percent) = 3.35 percent.

4

Variable-rate loans are riskier than fixed-rate loans.

If interest rates rise, variable-rate loans can become very burdensome. So when deciding whether to pay down a variable loan versus an equivalent fixed loan, choose the variable one. That doesn't mean variable-rate loans are a bad tool. Rather than paying the lender extra to run the interest rate risk, you're taking it on yourself, and that will usually get you a lower rate. The shorter the time period before you can pay off the loan, the less risk you are taking.

5

Always consider the effects of inflation on your debt.

I once had a student loan with very attractive terms. I borrowed $5,000 in 1993 at 8 percent interest. However, the interest did not accumulate nor did I have to make payments while I was in college, medical school, residency, or the military. When I left the military in 2010 (17 years after I took out the original loan), I still owed $5,000. However, thanks to inflation, $5,000 in 2010 was not worth nearly as much as it was in 1993. It was as if I had borrowed $5,000 and paid back just $3,000. Inflation is good for borrowers, as long as the interest rates are fixed, because the loans are paid back with depreciated dollars.

6

Paying down debt can increase your risk to creditors.

Sometimes, carrying debt can provide asset protection. Some states, such as Texas and Florida, have large homestead exemptions, meaning a creditor cannot take your house very easily. In other states, the exemption is very small. Because home equity may not be very well-protected in those states, paying down a mortgage instead of investing in a better-protected asset may increase your risk to creditors. Likewise, an automobile whose value is equal to the loan on it is not particularly attractive to a creditor. Keep in mind that asset protection considerations often run counter to investing considerations in situations such as these (ie, that asset protection will cost you money).

7

A 401(k) match is part of your salary.

Always make sure you contribute enough to your 401(k) to get the entire match from your employer. Failing to do this is simply leaving money on the table. Getting any available match is generally the single best investment available to you.

8

Paying off high-interest debt is a great investment.

Paying down a 15 percent loan is the exact equivalent of making an investment that pays a guaranteed 15 percent. Investments like that are exceedingly rare, so if you have one available to you, take advantage of it. An investment growing at 15 percent will quadruple in value in less than a decade, and remember that compound interest works both ways.

9

Maximizing retirement accounts is preferable to paying down low- and moderate-rate debt.

There are very real benefits to maximizing contributions to retirement accounts. This tax-protected "space" in 401(k)s, Roth IRAs, and similar accounts is gone forever if you do not max it out each year. These accounts lower your overall lifetime tax bill, protect your money from creditors in most states, and allow your money to grow faster than it would otherwise. While paying off a debt at 4–8 percent may be preferable to investing in a taxable account, a retirement account contribution is usually better than both options. The cutoff between where investing is better than paying off debt is inexact at best and relies on a lot of factors, including your comfort level with debt, the expected return on your portfolio, and the availability of additional retirement account contributions. However, few would argue that you should invest while carrying debt with an interest rate greater than 8 percent. Likewise, paying off low interest rate debt is less attractive than investing, especially within a retirement account.

10

Becoming debt-free is more behavior than math.

Mathematically speaking, the best way to pay off debt is to choose the debt with the highest interest rate and pay it off first while paying the minimum due on the debts with lower interest. However, people are much more likely to stick with a debt-reduction plan if they feel they are building momentum as they go. The best way to build momentum is to pay off the smallest debts first. In the end, either method is fine, but pick the one you can stick with.

USING THESE PRINCIPLES, I CAN NOW MAKE SOME GENERAL RECOMMENDATIONS.

- Live similarly to the way you did as a resident for a couple of years so you have the cash flow to pay down your debts within two to five years while still maximizing retirement account contributions.
- Be sure to contribute enough to your 401(k) to get the entire match.
- Pay off those credit cards as soon as possible.
- Stop buying cars on credit. Once the car loan is paid off, continue to make car payments into a savings account so you can pay cash for your next car.
- Stop using credit cards for credit.
- Consider refinancing student loans with a private bank.
- Consider refinancing your mortgage into a fixed-rate mortgage to protect you from rising interest rates.
- Decide on what order to pay off the students loans, either smallest first or highest interest rate first. If interest rates rise, move the variable rate student loan to the top of the list.

This tax-protected "space" in 401(k)s, Roth IRAs, and similar accounts is gone forever if you do not max it out each year. These accounts lower your overall lifetime tax bill, protect your money from creditors in most states, and allow your money to grow faster than it would otherwise.