Deleveraging Your Life

Leverage. It's a wonderful thing. Real estate investors and homeowners use it all the time to magnify their returns. However, leverage works both ways. It increases returns by increasing risk. What is the risk? The risk that you cannot service the debt.

Regular readers know I'm not a huge fan of debt. I'm not quite as rabid as the Dave Ramsey types (although even he makes an allowance for 15% of income toward retirement and saving for college before paying off a mortgage), but I certainly lean in that direction. I quoted Mormon Leader J. Reuben Clark (1938) in my book:

> *Interest never sleeps nor sickens nor dies; it never goes to the hospital; it works on Sundays and holidays; it never takes a vacation; it never visits nor travels; it takes no pleasure; it is never laid off work nor discharged from employment; it never works on reduced hours; it never has short crops nor droughts; it never pays taxes; it buys no food; it wears no clothes; it is unhoused and without home and so has no repairs, no replacements, no shingling, plumbing, painting, or whitewashing; it has neither wife, children, father, mother, nor kinfolk to watch over and care for; it has no expense of living; it has neither weddings nor*

births nor deaths; it has no love, no sympathy; it is as hard and soulless as a granite cliff. Once in debt, interest is your companion every minute of the day and night; you cannot shun it or slip away from it; you cannot dismiss it; it yields neither to entreaties, demands, or orders; and whenever you get in its way or cross its course or fail to meet its demands, it crushes you.

Deleveraging Before Retirement

I've been surprised to learn that 80.2% of "near-retirees" carry household debt, including $103K in mortgage debt and $18K in consumer debt. That includes all those middle-class schmucks, right? Nope. For those in the top 1/3 of income, it's $200K in mortgage debt. We're doing the same thing, just with larger numbers. 30% of households over 70 have mortgage debt. That seems like a terrible idea to me. I think it's idiotic to go into retirement with any consumer debt at all or any mortgage debt on your primary residence. In fact, I don't even think it's a great idea to retire owing any significant amount on your investment properties. Here's why:

#1 Security

Retirement finances aren't just about being secure, they're about feeling secure, and people feel more secure when they own the house they live in. No one can raise the rent. No one can take it away from you (assuming you pay the taxes, and even that takes forever before the government steps in throughout most localities.)

#2 Tying Up Income

It takes hard-won income to service debt. Every dollar spent on interest, or even principal, is money that can't be spent touring the world, spoiling the grandkids, or buying some sweet new skis. You worked hard to get that retirement income, whether it comes from a pension, Social Security, a SPIA, or your portfolio. Consider a mortgage you have $30K left on but are paying $1000 a month toward. Using the 4% rule, we can see that this $30K debt is tying up the income from $300,000 of your portfolio. Better to just pay off the $30K.

Deleveraging While Young

Besides retirees, there is another group that can really benefit from "deleveraging their life" by paying down debt. These are the folks that are relatively young and owe either massive amounts of debt (think physician-style student loans) or high-interest debt (think about the poor schmucks on the borrowing side of 23% peer to peer loans or who carry credit card debt month to month.)

These folks are taking on a massive amount of financial risk. I am now routinely hearing from physician couples who owe upwards of $900K. Many current medical and dental students expect to owe more than $400K upon completion of training. $900K at 8% paid off over 10 years requires payments of more than $11K, after-tax, per month. Assuming a 33% combined tax bracket, we're talking about $200K of annual gross income just going to service the student loan debt. Let's hope they're not both pediatricians who have never heard of PSLF! If just one doc becomes disabled or wants to stay home with the kids or whatever, they're going to be living a subsistence lifestyle until that debt is paid off.

The Author deleveraging his life by getting closer to the ground while rappelling from Eichhorn's Pinnacle, Tuolumne Meadows

Even small amounts of high-interest debt can have similar effects. A $50,000 credit card debt at 29.9% requires the payment of $15,000 in interest a year! After tax, that's more than the monthly income of the average physician.

If you're in either of these situations, you need to deleverage – lest some tiny hiccup come into your life and cause you to go bankrupt or get foreclosed on. (Nobody talks about it in the doctor's lounge, but both of those happen to physicians all the time. Hint-look around for the guy who's running a full clinic, playing hospitalist 4 nights a week, and looks like he's about to collapse. That's the guy.)

Sometimes it's not just the student loans. It's $200K of student loans (not terrible by itself, especially once refinanced), plus the $600K mortgage, plus the $80K boat loan, plus the $50K car loan, plus the $250K mortgage on the little cabin. In the end, it's all the same. Interest must be paid.

Deleveraging at Market Highs

There is another time in life when deleveraging may be a good idea besides before retirement and shortly out of training. That's when asset prices are relatively high by historical valuations. Although we've technically had two very brief bear markets in the US stock market since 2009, nobody actually remembers them. Ignoring them, stocks have been going up for over a decade now at an average rate well above expected returns. Similarly, real estate values have climbed dramatically in most areas of the country since 2010. Bond yields continue to be near all-time lows. Rather than taking on ever more equity risk (small value, emerging markets, etc), leveraging up your real estate portfolio, or reaching for yield in the bond market, perhaps now is a great time to take the low, but guaranteed, return available to anyone carrying debt.

Mathematically, you can always make an argument that it's smarter to carry debt. I know it as well as anyone. I used to have a 2.75% 15 year fixed mortgage (perhaps 1.55% after-tax). We carried it for a year or two longer than we needed to because any reasonable student of financial history will concede that it's unlikely that our long-term portfolio returns will be less than 1.55%. But 1.55% would have beat the socks off my portfolio return for 2008! We eventually paid it off anyway back in 2017.

The other issue with low-interest debt is that we start forgetting it is there. We look at the math…of course, I can beat 2%, or 5%, or whatever with my investing. But we don't, because we don't invest it at all. Instead, we spend it. And a 2% return always beats the negative return you get from a BMW, a boat, or a new wardrobe. We gradually become accustomed to that 2% debt such that we carry it for a long, long time. Meanwhile, we work 2 or 3 extra calls or shifts a month to pay for that.

My Life and Your Life

When this post was originally published in 2014, I said this:

> *Personally, I've got a debt at 5.35% on an investment property. After-tax, that's probably at least 3.3%. Meanwhile, I've got money invested in the G Fund paying 2.375% and a TIPS Fund with a negative real yield (probably a nominal yield of 1.82% or so). Paying down my debt is like buying a bond yielding a guaranteed 3.3% that won't be impacted by rising rates! Not spectacular, but certainly attractive compared to current bond yields and possibly compared to stock yields in the event of a market downturn. Timing the market? Perhaps. Hedging my bets without having to even touch my investments? Seems a more appropriate description.*

If I was considering paying down debt more rapidly than required at that time, and I'm one of the least leveraged physicians I know, perhaps you ought to consider it as well.

Now I'm not saying you have to live like a resident until your home is paid off. Moderation in all things. But it will ALWAYS seem like there is something better to do with your money than pay off debt, whether it is investing or spending. Once you realize that, you may find a little more motivation to use your extra cash to deleverage your life before retirement, when you're buried by debt, and at market highs.

What do you think? How do you decide when to pay extra on your debts? How much are you willing to bet your portfolio will outperform paying off your mortgage (or your students loan) over the next 1, 2, or 5 years? Comment below!