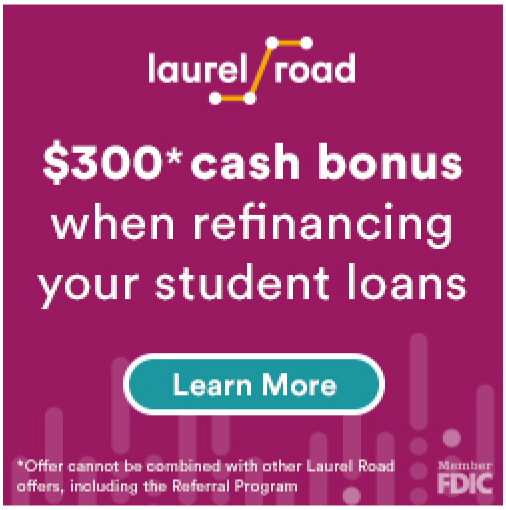
Investing Versus Debt Pay-off

Perhaps the most common question I get by email, in the blog comments, and on the forum basically boils down to "Should I pay off my debt or should I invest?" I've addressed it years ago on the blog, earlier this year on the blog, and hit it hard in The White Coat Investor: A Doctor's Guide to Personal Finance and Investing," but I just keep getting it over and over again, so I know it is important to you. I hope to give very concrete guidelines where possible and outline the issues to consider when that isn't possible. Let's start with the very obvious.

1 Don't Leave Part of Your Salary On The Table



If your employer gives you a match in a retirement account like a 401(k) or 403(b), then be sure to get it. Not getting it is like rejecting part of your salary. So even if you have terrible, nasty debts, I would still contribute enough to get your full match. Think about it. If you get a 100% match on the first 3% of salary (let's say that's $6K) you contribute to the 401(k) then you get an extra $6K. Assuming immediate vesting, even if you turned around and pulled all that money out of the 401(k) and sent it to your lender, you would only pay $1200 in penalties in addition to the taxes you would pay either way. So you're $4,800 ahead.

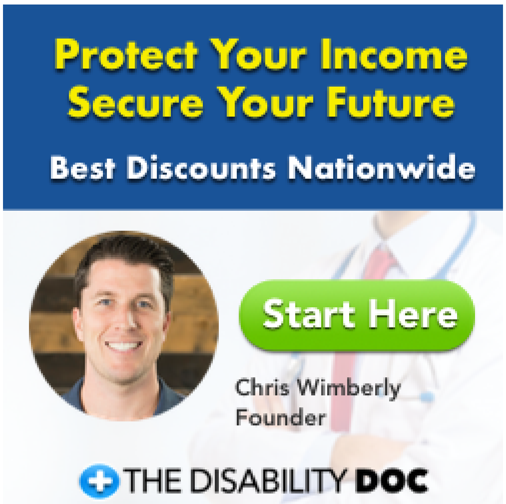
2 Don't Pay Off Loans Someone Else Will Pay Off

If you are doing "The PSLF Thing" (meaning you made lots of tiny IBR/PAYE/REPAYE payments during residency or fellowship and are now employed full-time by a 501(c)3 anticipating tax-free forgiveness after 120 monthly payments), then don't send in extra money to your student loan lender. If you're worried Public Service Loan Forgiveness will go away, then let that worry motivate you to spend less money so you can divert a large percentage of your income toward building wealth. I've traditionally advised people to keep a "side fund" in a taxable account that can then be directed toward the student loans if PSLF gets changed and you're not grandfathered in. However, it doesn't make much sense to invest in taxable if you still have tax-protected space like a 401(k) or Backdoor Roth IRA available to you. So I'd probably put it there. Sure, it's not going to allow you to instantly pay off those student loans in the event of PSLF catastrophe, but you'll end up wealthier for preferentially using the tax-protected account.

3 Stop Digging

Here's another somewhat obvious point. When you realize you're in a deep hole (debt), stop digging! I can't believe how many people are wondering how to get their student loans paid off while still borrowing money to buy other stuff. If it isn't a modest house or a practice you probably shouldn't be buying it on borrowed money. That includes cars, vacations, living expenses, boats, pets, or anything else. Professional school will make you debt-numb. Wake up to its wealth-destroying effects on your life! Do you have $400K in student loans? Then you're likely one of the poorest people in the world. The guy living under the bridge is richer than you. His net worth is $0. You should be driving a beater and living somewhere that feels very middle-class.

4 High-Interest Rate Debt Is A Great Investment



If you have high-interest debt, chances are good that you're not going to be able to find an investment that will make that much money. You don't borrow money at 20% in order to invest because the risks you would have to take to attempt to beat that return are substantial. Thus, if you have debt at 20%, you should be paying it off as a major priority. And by major priority, I mean instead of eating. It probably wouldn't hurt you to lose 10 or 20 lbs anyway, would it? In fact, you can probably lower that figure quite a bit. If you've got 8%+ debt, you're probably better off paying that down instead of doing anything else with your money. That's a guaranteed 8% investment. I wish I could find more of those.

Now that we've got those hard and fast rules out of the way, we can move on to some of the more subtle aspects of this question. Let's look at some of the aspects to consider as you decide how to allocate your disposable income between investments and extra debt payments.

5 How Long Do You Want To Be In Debt?

Personally, I think you ought to have your education paid for within 2-5 years of completing your training. You're really not done with med school until you've paid for it. If you go much beyond 5 years, it will feel like a noose around your neck. I mean, you could have had the military pay for it and you would have been done in 4 years. In order to be out of debt that quickly, you're going to have to direct a substantial portion of your income to it. Calculate out how much that is, and allocate that much toward the debt. Invest the rest.

But what if that doesn't allow you to max out all the accounts you want to max out? Tough cookies. Take more money from your lifestyle spending (i.e. Live Like A Resident), not from your debt pay down money. That's not negotiable. You're getting out of debt in 2-5 years, come hell or high water. Now, if you want to keep your student loans for 5 years in order to max out some retirement accounts when you could get out of debt in 2 without maxing them out, that's okay with me. But dragging your loans out for 15 years? You're going to regret that. Those who lived like a resident when you should have will be financially independent by the time you pay for your school. How are you going to save for your kids' schooling when you haven't paid for yours yet?

Once your student loans are gone, you can ask yourself the same question about your mortgage. Do you really want to be paying for that stack of bricks for 15-30 years? Figure out when you want to be done paying and make payments large enough to be done by then. Don't assume you'll be able to make big huge payments later (although there's a good chance you will, thanks to inflation, but certainly no guarantee.)

6 It Isn’t Just About Comparing Rates of Return

Some people make this topic way too simple. They say, “If your investment is going to earn more than the interest rate of your student loans, then you should carry the loans and invest.” That ignores way too much. It ignores risk. It ignores the effects of taxes. And it ignores other important financial issues like asset protection, estate planning, and insurance costs.

The author’s son demonstrates how risk is generally something you manage, not eliminate at the Utah Olympic Park

Risk

If you can get 8% investing and have 7% loans, you should invest, right? No. Because that 7% is risk-free. And if you want a risk-free investment, you’re looking at only getting

1-2%. If you adjust for risk, paying off those loans is going to be the right choice. Now if you're comparing an expected 8% return to a guaranteed 2% return, well, that's a little easier argument to make.

Another important consideration with risk is your need to take it. If you're a 55-year-old doctor with a net worth of $100K, you have substantial need to take risk (including leverage risk) if you expect to retire with anything close to your accustomed standard of living. If you're a 45-year-old doctor with a net worth of $4 Million, you can afford the luxury of being debt-free. This consideration had a substantial effect on our decision to pay off our very low-interest rate mortgage in less than 7 years.

Taxes

Some types of debt are tax-deductible. And some types of investments are taxable at various rates. In order to compare apples to apples, you have to tax-adjust both sides of the comparison. You have to know your marginal tax rates (and there is likely more than one). If your marginal rate on ordinary income is 35% (you can figure this out with tax software), and your debt interest is fully deductible (you can figure this out with tax software too), then a 4% debt is is really a (1-35%)*4% = 2.6% debt. If your investment return is taxed at your marginal tax rate and earns 6%, then after-tax it is really 3.9%. If your investment return is taxed at a 15% long-term capital gains rate, then that 6% return is really 5.1%. Your marginal tax rate on the investment could be even lower if you are able to defer some of those gains (such as with a tax-efficient stock mutual fund) or if you have offsetting depreciation (such as with a real estate investment.) And it would be zero if you're investing in a tax-protected account. Now make your comparison.

In addition to those simple calculations, we also have to consider the other tax benefits of retirement accounts. For the typical attending physician in his peak earnings years, that mostly means a tax-deferred account like a 401(k). A typical physician should expect a tax arbitrage between his marginal rate at contribution and his effective withdrawal tax rate. 35% and 15% would not be unusual. That has the effect of boosting your investment return significantly as you basically started with a free 20% return in the account. In addition, that money isn't taxed as it grows. That tax-protected growth may boost your return by another 0.5-2% per year. And if you leave it to a young heir, it can be [stretched](#) for more than a century. That tax benefit is awfully hard to pass up in order to get out of debt a few months earlier. Similar principles hold for a tax-free account like a Roth IRA, minus the tax arbitrage.

For the new attending physician, keep in mind you may be able to delay retirement account contributions. Instead of contributing to the 401(k) or HSA in August, you could pay down debt in August and contribute in December. You have until April of next year to get your IRA, SEP-IRA, and employer individual 401(k) contributions in. Yes, you lose the benefit of having that money start compounding in a tax-protected way right away, but at least you don't lose that tax-protected "space" forever.

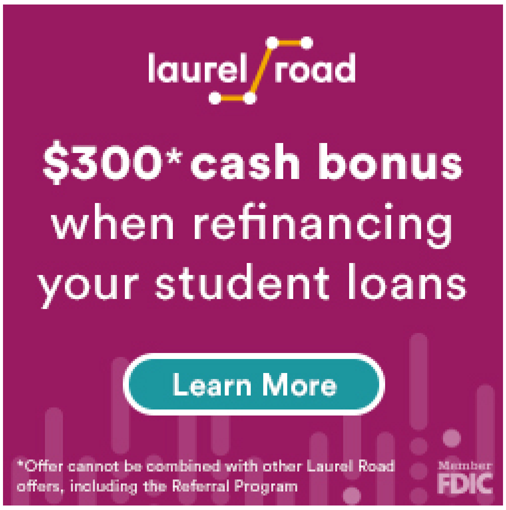
Clearly, it makes a lot more sense to carry debt in order to invest in a tax-protected account than to invest in a taxable account. When you're maxing out all your tax-protected accounts, that's a good time to take a look at the debts you have left and see if throwing some money at them would be wise. A 401(k) is a lot more valuable than most people think it is, and it is most valuable for high-income professionals.

Asset Protection

You should be familiar with the asset protection laws in your state, as it can have a serious effect on this decision. For example, in Texas and Florida, you have strong homestead laws. So it can make a lot of sense to pay down a mortgage as that money is protected from creditors. In my state of Utah, not so smart as only $40K of home equity is protected. But our retirement accounts get 100% protection. So where a doc in Texas might choose to pay down his mortgage, a doc in Utah could, just as logically, choose to invest in his cash balance plan instead, even if expected returns were similar.

You can be assured that your creditors aren't going to take your student loans away from you, but money you use to pay them down also can't be taken away from you, and since they're not going away in bankruptcy, paying them off instead of investing in taxable is a smart asset protection move. Bear in mind that asset protection isn't nearly as important as most docs think it is. The risk of having a significant above policy limits judgment that isn't reduced on appeal is incredibly small.

Estate Planning



Retirement accounts are very useful for estate planning. By properly designating beneficiaries, that money doesn't have to go through probate. Of course, if you expect to die any time soon, you probably don't want to pay your student loans off, as they are generally forgiven at death (if you've refinanced, be sure to read the fine print to see if they're assessed against the value of your estate.) Similar issues exist with disability as most student loans are forgiven in the event of permanent disability.

Cash Flow and Insurance

One of the best benefits of paying off debt is that your cash flow needs are lower. That allows you to carry less life and disability insurance to protect that cash flow. That could be worth hundreds or thousands per month. Now that we've paid off our mortgage, if I died, Katie wouldn't have to come up with that $2,800 a month mortgage payment to stay in the house. She would only have to come up with $300 for property taxes and $100 for property insurance. Big difference.

7 If Unsure, Split the Difference

As you can see, sometimes an invest vs pay off debt dilemma is very straightforward to resolve. And other times it is complex, murky, and dependent even on your emotional feelings about debt. In those times when you're truly unsure what to do, and discussion with those closest to you doesn’t help, just split the difference. Send some of the money into your mortgage or student loan lender and invest the rest and realize that you’re choosing between two very good things to do. Which you do matters far less than the percentage of your income going toward building wealth instead of being spent.

What do you think? What else should be taken into consideration when choosing whether to pay off debt or invest? How do you make these decisions? Comment below!