

The Good, the Bad, and the Ugly: What No One Tells You About Debt

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The average age Americans learn how to balance a checkbook is 28¹. Age 28! If Americans are not taught about basic finance in high school or college, then how can they possibly be ready to evaluate what debt is necessary, budget for it, and have a plan to pay it off without impairing and impeding their financial future? If we don't educate our clients and their children about the benefits and pitfalls with debt, then we are failing them.

Most Americans are introduced to the concept of taking on debt from those who peddle it. You get student loan offers in order to help pay for college. You get credit card offers while in college despite having no meaningful (or any!) income. Then, there is your first car purchase or lease, and eventually many go on to purchase a home, and so on. How can we ask our children to make informed choices when the only information fed to them about debt is from lenders? Is this not the ultimate "fox guarding the hen house" scenario? Well, let's change that starting now.

The Good

Good debt has a purpose and should benefit you now and in the future. Borrowing money in a good way simply means you are buying a capital asset with both a present and future value, and you are financing that purchase with a loan. The best examples would be buying a home or a car. I can even make a case for reasonably sized student loans, but I will discuss that in more detail below.

Another example of good debt can be found in local, state and federal government. If a government builds a school, a bridge, a hospital or a dam, then they are spreading the cost of that capital asset out over time while the benefits should continue well after the debt (bonds) are paid off. Society gets an asset that can be used today, tomorrow and well into the future, as well as indirect benefits such as home appreciation in that community. Good debt invests in the future and builds equity for an individual or a society alike.

The Bad

For individuals, bad debt occurs out of unawareness, lack of discipline or misfortune. Let's leave aside misfortune as it is out of your control. Most bad debt occurs when you finance a want versus a need. Put another way, any time you spend more than you can afford, you are acquiring bad debt. Bad debt typically gets you into debt trouble slowly and without you even realizing it. You take on credit card debt in college with no context around how hard it is to pay off debt with a 15.99% interest rate (or higher). That one nice item of clothing, the quick weekend getaway and the "oh let's just grab a bite"—it adds up, and suddenly the lenders have "gotcha" because you can't pay the full balance each month. Banks and auto companies love to lend you money because they make handsome profits. You can read more in depth about the [effects of compound interest](#) and [leasing versus buying a car](#) in previous pieces on the BCM blog.

In government, bad debt occurs when a government entity spends beyond its means just to provide current services. If tax revenue is \$100, and the operating budget is \$110, \$10 must be financed. This means future tax payers must pay the interest and principal for previous spending they have not benefitted from. Societally, it is the most selfish thing we can do for our future neighbors, friends and family. Why do we do it? Some decisions are hard to make. Politicians are known to defer tough choices and "kick the can down the road", and won't commit to any definitive long-term solutions if it makes them unpopular while they're in office.

The Ugly

Overall, bad debt sacrifices the future in that we ask the future to pay for today's fun without any long-term benefit. A fancy vacation now may be fun and "amazing", but if you spend beyond your means, that vacation could become a burden that prevents you from realizing other, more important goals. At best, it could delay a future car or home purchase. Perhaps that vacation means the difference between a beater car and a new one. Perhaps due to your debt, you can only afford a home in a

lesser school district for your kids...or no home at all. Or the burden of this debt, including any late or missed payments, harms your credit score so lenders will not grant you good debt at reasonable rates. Yes, this may be harsh to read...but sometimes the truth is hard to hear. Bad debt creates nothing but a burden on your future self and your future lifestyle.

Bad debt usually is accompanied by disproportionate ramifications. Americans today have ~\$1.03 trillion in credit card debt, with an average of \$15,654 per household!² While banks are currently paying you less than 1% on your cash held with them, the credit cards typically charge you 12%-18%. This debt is typically unsecured by any asset and thus the rates charged are higher than any debt that is secured by an asset, such as a house. If you go over your limit or miss a payment, your rate will quickly leap, sometimes to over 30%—not to mention the damage to your credit score. So those who struggle or get into trouble end up getting charged the most! If you pay just the minimum amount due, we have seen situations when the repayment of that debt would take over 30 years. And don't forget the teasers...Borrow \$1,000 for some furniture interest free for a year. This is a great strategy if you execute a plan to pay it off on time, but if not, that 30% interest rate means your furniture just went from \$1,000 to 1,300 and will go much higher if you don't pay it off! Could you use this money elsewhere in your life? If you'd like to see how long it will take to pay off a balance or how much interest you'll have to pay over the course of your loan please click below:

www.creditkarma.com/calculators/debtrepayment

So here are some suggestions for overcoming bad debt. You only need two credit cards, i.e. an American Express® and either Visa or Mastercard®. These are accepted virtually everywhere a credit or debit cards are accepted. Shop for a card that gives you benefits you can use (cash back, points towards travel, free merchandise, etc.) Cut up and close any store cards or other cards if you have more than two, especially if you carry a balance. Store cards typically have much higher interest rates and you are being taken advantage of under the guise of convenience or some teaser discount. Don't fall for it. Pay your full credit card balance off each month, don't just make the minimum payment. Don't finance smaller items like furniture or an appliance unless absolutely necessary. Save until you can pay up front or the lenders will bilk you with the rates noted above.

If you do have credit card debt, the fastest way to get out is this: pay the minimum on every card except the card with the highest rate. Put all available cash towards this card. When it is paid off, switch the payments to the card with the next highest rate and proceed until your balance is \$0. Another trick for those with superb discipline: find a card with no interest due for the first year and transfer your balance to this card, taking advantage of the zero interest while you pay off the entire balance. Just remember to do so before the year is up to avoid the interest returning to your statement and nullifying the advantages of the balance transfer process altogether.

Think about it this way—investing in stocks like those in the S&P 500® Index has historically given you returns around 10% over most timeframes. If you avoid paying a bank this amount in interest, it saves you the same as you could potentially earn from investing in stocks over the long term!

The Ugliest—Student Loan Debt

I saved this for last and afforded it an entire segment of this piece because student loan debt is a different beast. As I mentioned earlier, depending on the size of the loan, I could argue either way whether a student's loans are good debt or bad debt. So let's dig a little deeper into this.

Today Americans have over \$1.5 trillion in student loan debt.³ Societally, we are burdening a generation with so much debt, so early, that we are stifling economic growth and dooming millions to relative poverty...poverty they think they are avoiding by earning their degree(s) in the first place. The average student spends \$25,290/year for a four year in-state public undergraduate degree and \$50,900/year on a private four year degree.⁴ Depending on the degree and university, graduate degrees can cost over \$60,000/year!⁵ Beyond scholarships and grants, today's excessive educational costs can ruin a student's future. Again, without impartial information or education provided to students on debt, with no explanation as to the costs of the debt and how long it will take to repay it, we let the lenders, including our own government, take advantage of us.

Please understand that student loan debt is secured by you and all your future income. If you cannot pay off your student loan debt, it never goes away, even if you declare bankruptcy. Student loan lenders can garnish your Social Security payments to recover the debt from you. Did they tell you this when you were applying? Did they tell you this when you were deciding your major, probable career path, and potential future earnings?

At what point does student loan debt turn from good to bad? The answer is simple math after you research what you can expect to earn with your degree.

Let me use an extreme example with a medical degree. In 2017-2018, the average cost of attendance for medical school was \$60,543/year.⁶ With 6% inflation over four years, this will total ~\$272,000. Let's assume no undergraduate or other debt, \$272,000 at 6% interest over 15 years will cost ~\$27,400/year in principal and interest. The Doctor will have to pay ordinary income taxes on their salary before putting any money towards their loans. Using a state tax rate of 5% and an estimated Federal effective tax rate of 35% as a proxy, this means that ~\$45,700 of that Doctor's annual income will be required to pay off the loan. If a pediatrician can be expected to earn \$202,000 per year⁷, then is this student loan debt worth the expense? Perhaps if the aspiring doctor learned this information up front and could choose a higher-paying discipline, such as becoming an orthopedic surgeon, it would make more sense.

If you are an undergraduate and you plan to take on a career that might pay you \$50,000/year to start (the average starting salary of a 2017 college graduate⁸), does taking on \$100,000 of debt make sense? How about \$200,000? College students today are facing ridiculously high college costs, and must be informed to decide in advance if their degree has the potential to afford them a better lifestyle. In many cases, it could actually subjugate them to a future of relative poverty and indebtedness. How will your student loan debt affect your future? When you need to buy that car to get you to work, will you be able to afford both payments? If you want to borrow \$500,000, at 4%, to buy a house, will you be able to afford it? Will the bank even grant you a loan at a reasonable rate if you have a large amount of student loan debt, let alone a car loan and/or credit card balance?

While consumerism drives much of the U.S. economy, we must, like everything else, use debt in moderation and with purpose. We must also ensure that we all know the difference between good debt and bad debt, and that we all have full knowledge of the ramifications of debt on our future lives. At the end of the day, distinguishing good debt from bad debt and evaluating the growth potential of each purchase you make is crucial to securing your financial future. What if, instead of acquiring bad debt by purchasing things you want but don't need, you invested at least some of your hard earned money (plus the money saved by avoiding interest and fees) instead? Imagine the possibilities!

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Sources and Disclosures:

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¹ Dr. David Kelly, PH.D., CFA. Insights and Economic Update on the Markets. March 2, 2018.

²⁻³ United States National Debt Clock. Federal Reserve. Real time, accessed 3/2018. <http://www.usdebtclock.org/>

⁴ The College Board. Average Estimated Undergraduate Budgets, 2017-18.

<https://trends.collegeboard.org/college-pricing/figures-tables/average-estimated-undergraduate-budgets-2017-18>

⁵ The Best Master's Degrees, FinAid. How much does a master's degree cost?

<https://www.bestmastersdegrees.com/best-masters-degrees-faq/how-much-does-a-masters-degree-cost>

⁶ Association of American Medical Colleges. Tuition and Student Fees Report, 2012-2013 through 2017-2018. October 2017.

<https://www.aamc.org/data/tuitionandstudentfees/>

⁷ Medscape. Medscape Pediatrician Compensation Report 2017. April 12, 2017.

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⁸ Time. New College Grads Could Be Looking at the Highest Starting Salaries Ever. May 2017.

<http://time.com/money/4777074/college-grad-pay-2017-average-salary/>

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