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### Understanding Debt

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Asset allocation is one of the most important tools of successful financial management. One aspect of asset allocation that is often overlooked is debt management. When we consider how to allocate savings into stock and bond investments, we should also consider paying down debt.

Almost everyone borrows money. Most of us have credit cards and many have mortgages. To include these debts in the asset allocation process you need to know the after-tax interest cost of each one. Once you have this information, you can compare debts to your other investment choices such as stocks and bonds.

The after-tax cost of credit card debt is fairly easy to understand. There are no tax benefits from credit card interest charges so the after-tax cost is whatever rate you are paying to the bank. For example, if you are paying 15%, that is your after-tax cost of credit card debt. If you pay off this debt, it is the same as earning 15% after-tax, guaranteed. Where else are you going to find that kind of return?

The cost of mortgage debt is more complicated because the deduction of qualified mortgage interest costs reduces your taxable income and this causes your taxes to fall. Let's look at two examples, first in dollars and then in percentages. In dollar terms, the tax savings roughly equal the interest cost times the taxpayer's marginal tax rate. For example, if your interest costs are \$6,000 and your marginal tax rate is 25%, the tax savings are \$1,500 - your net interest cost drops from \$6,000 to \$4,500.

We can look at mortgage interest rates in a similar fashion to calculate an after-tax rate. By multiplying the mortgage's interest rate, let's say 6%, times the marginal tax rate of 25%, we see that the investor saved 1.5% in interest. Taking the 6% interest rate and reducing it by the savings of 1.5% results in an after-tax interest rate of 4.5%.

The after-tax rate on the mortgage debt, in this case 4.5%, is one of the factors investors should use when deciding to invest in stocks and bonds or pay down debt. If you expect to earn more than 4.5% after-tax, you should probably invest your money and leave the debt outstanding. On the other hand, if you expect to earn less than 4.5%, paying down some debt might be a good idea.

Every investor is different, so be careful with these calculations. For instance, if you do not itemize your deductions there is no tax benefit from holding a mortgage. The same

goes for people with little or no taxable income. For some taxpayers another potential hitch is the Alternative Minimum Tax (AMT).

Many homeowners probably overestimate the tax benefits of mortgages. One common mistake is applying the tax savings to their entire mortgage payment rather than just the interest portion. Especially in the early years of a mortgage, many of us assume our mortgage payments are 100% interest and no principal. However, with a 30-year 6% mortgage, 82% of the first year's payments are interest. This drops to 70% in the tenth year and below 50% by the 19<sup>th</sup> year.

I also get the feeling many investors fixate on paying Uncle Sam less rather than looking at how much you have left. Stay focused on growing your net worth, which is not always the same as paying Uncle Sam less.

Should investors always pay down debt that costs more than the returns they are earning on their investments? Well, not always. Keeping some financial flexibility is one reason you may not want to use all your money to pay off your debts. In an emergency, it is easier to raise cash by selling investments than it is to take out a new mortgage. This is especially true if the emergency involves your being sick or unemployed, as a new mortgage may not be available under those circumstances.

A further consideration is the tax laws that work against an investor paying off their mortgage and getting a new one at a later date. In this case, interest costs on the new mortgage are not tax deductible.

In summary, smart investors incorporate debt management into their asset allocation process. They examine the after-tax cost of their debt and seriously consider paying down debt that costs more than they earn on their investments.

*Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at [farmcreeksecurities.com](http://farmcreeksecurities.com). Before putting money in any investment, investors should carefully consider their investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal.*

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