

Managing Debt: The Glass Half Full

by *Edi Alvarez, MSc, CFP®*



There are two ways to look at any obligation—one regards it as the glass half full, the other as the glass half empty. Working hard to provide for your family, for example, can be a source of great pride and accomplishment. This is the sort of obligation that (even in the worst circumstance) ought never be regarded as a burden (the glass half full). Debt is also a form of obligation, and yet when speaking of it there is a tendency to focus on the negative, treating debt as if it were the sword of Damocles ready to impale us (the glass half empty). Debt, like work, does indeed have its positive aspect. For example, debt allows us to enjoy a comfortable home or to drive a safe car while simultaneously helping to build a strong financial track record. The convenience of buying on credit is obvious. Employing debt as a hedge against inflation allows purchases today that may perform well over time (investing in education or real estate are the better known examples). In short, effectively managed debt can help us achieve our goals and to build wealth.

Except for the fortunate few, debt is simply too important and too omnipresent to leave to guesswork. Debt needs to be monitored and managed. Moreover, the traditional definition of debt merits revision. Debt is defined as an obligation to pay or perform something, a liability. Through a questionnaire of AWIS members it is evident that we are conscientious about financial obligations to third parties yet tend to defer obligations to ourselves. **An adequate emergency fund and regular contributions toward retirement ought to be as much a part of our debt consideration as those monthly credit card bills.** Those who believe that they are “debt free” because they maintain a positive cash flow should review how they define debt and think seriously about including paying themselves as part of their debt load.

Scientists tend to accumulate debt a little differently than others, although the inducements are much the same. They pile up student loans as they add one degree on top of another, endure low paying fellowships, postpone full earnings, and relocate more often than many other career streams. Typically, the result is a reduced financial cushion and deferred asset growth until much later in life. Like most everyone else, scientists are subject to unexpected job loss, illness, emergency home and car repairs or dependant care demands. Feedback from AWIS members reveals that frugal attitudes throughout our long education does make us very good at managing cash flow and even masters at “robbing Peter to pay Paul.” For one AWIS member, the expected position did not materialize (upon graduation) adding costs to retrain for a different discipline before taming her initial educational expense. In another case, the final position yielded lower compensation which forced her to carry a very large debt load long into her future. In both cases, these women adjusted their finances and will leverage their education into higher paying jobs, but it will all take longer than expected and in turn, postpone saving for retirement. In yet another scenario, several members’ health care costs prevented or compromised their ability to grow their wealth. I was reminded that there is no continuation of health care (i.e. no COBRA) after graduation.

What follows are a few of the important tools and considerations for managing debt.

First, debt is, more or less, a question of what you make of it. It is neither good nor bad. It can help you build wealth as readily as lose it. Assuming you wish to build wealth, a good first step is to regularly review the numbers – make them real. Combine your income, spending habits and debt all into one document. Don't just try to balance it out in your head. Writing it down will help you to appreciate the relationship between these three vital aspects of your finances. Even better, break your income down into the various sources (pay-stub, self-employed, retirement income, etc.), itemize your fixed expenses (childcare, utilities, taxes) separately from your discretionary expenses (debt to self, travel, entertainment, clothing), and then itemize each of your formal debts (car loan, mortgage, credit card, home equity line of credit). In a separate column, list your assets according to how "liquid" they are, i.e., the most accessible compared to the least accessible. This exercise, if conducted regularly, will give you the clearest possible "snapshot" of how your finances are organized and take you beyond making purchase decisions based solely on the cash you have available in your checkbook.

You can use debt ratios to monitor the potential for debt crises. Ideally, you should aim for an overall debt ratio (total liabilities to total assets) of 33% and a debt-to-service coverage ratio of 3 (meaning, you earn \$3.00 in take-home pay for every \$1 required to repay debt). Although the inducements to purchase your own home are great, you would be well advised to consider the risk you are taking when, for example, you commit to a mortgage that (on its own) saps more than 50% of your take-home pay. A sometimes unnoticed but critical trade-off occurs in such cases. Typically, retirement funding and/or the maintenance of an adequate emergency fund are sacrificed. In the worst scenarios unrealistic debt levels can lead to problems in a relationship and/or financial devastation when unforeseen events arise. Track your debt ratios and lower your debt to prevent problems before they occur. There are times when renting or a less expensive option may just make better sense.

The next step is to focus on your expenses and determine if they are appropriate and properly allocated. Are you spending on entertainment while ignoring retirement? Focus on what is consuming the largest part of your take-home pay down to the smallest component. There shouldn't be any surprises. You may find ways to reduce your bills, with a little effort. Do you have sufficient emergency funds to cover you during an emergency? (An average young person needs about 6 months of expenses plus enough to cover insurance deductibles.) Are you saving enough for retirement? (The amount needed depends on the retirement plan and how much is available, but early in your career it can be around 15% of your income if the company has a retirement pension.) Have you saved for estimated taxes? (If you have a stipend or are self employed verify if you need to pay estimated taxes.) Is your total debt growing? If so, evaluate how you can best reduce the debt. Be honest with what is causing the debt and address it or seek help. For existing debt, look for alternative ways to pay for it.

When reducing debt consider the type of debt separately. Educational debt exists in many forms but may fall under a criterion that could be forgiven if you participate in certain programs (1). Consumer debt should be reduced since it does not help to build capital or wealth ("unproductive debt"). This type of debt usually includes credit cards and even car loans. Don't make the mistake of paying off the largest amount first on your credit card debt. Go after those with the highest interest rates and highest fees first, paying just the minimum on others. Make a list of all of your credit cards including cost (APR), account number, contact telephone, date due, and current balance – make an action plan on how you'll pay them off. Check this list regularly and

use it to monitor your credit card debt. For some, paying down car loans can take priority since missing even one payment may result in repossession. If default is on the horizon, you are often better off selling the car on your own and using the receipts to pay off the loan – avoiding additional costs and a negative mark on your credit history. If you don't have unproductive debt another approach is to pay off educational personal loans that are at high rates.

Started early, good debt practices can make future purchases less expensive. In fact, I encourage you to have credit cards as soon as you qualify, but use them only to make planned purchases that will be paid monthly. To avoid any mistakes, place all of your loans on automatic minimum payment. If you keep a balance remember to negotiate the lowest rate and to revolve it by paying it off completely before adding new debt. Long term relationships with credit providers is advantageous to your credit history, as is a successful history with different types of debt – credit cards (“unsecured loans”) and bank loans (“secured loans” – is debt backed by property such as a house or car) provide additional value to your credit history. Do not let your reported debt exceed 50% of your available credit, which means that you should not close credit cards or lower your available credit until you have all of your cards at zero balance. Finally, review your credit card history regularly and correct errors immediately. These are good credit practices that you can implement immediately.

If your FICO score (see www.myfico.com) is good to “great” and you suddenly find yourself carrying debt, a single phone call to your credit card provider may reduce your interest rate and make available other incentives. Be wary of offers to consolidate debt. Never consolidate your unsecured debt with your secured debt without fully understanding all the potential tradeoffs – in some states debt consolidation that includes refinancing your mortgage can convert your mortgage from “non recourse” to a “recourse loan,” severely restricting your options in times of financial distress. Refinancing your mortgage is one way to control your debt should you find yourself falling behind on payments, but consider the expense as well as the fact that refinancing will not resolve the problems that got you into trouble. If your lender will not work with you to refinance, don't hesitate, contact the local office of the Department of Housing and Urban Development or the housing authority in your state to help you find a legitimate housing counseling agency.

Filing for bankruptcy is an option in dire cases, but should never be considered anything but a last resort. Don't let yourself ever get to that point. Set yourself the following debt management goals:

- Obtain the lowest possible cost for debt
- Pay, at least, the required minimum amounts on all debts – track your debt ratios and act before your debt-to-service ratio drops too low
- Pay off high interest loans and credit cards first and pay the minimum on all other unsecured debt
- Review your numbers every month with an eye to dropping expenses and identifying mounting debt
- Do not carry more than 50% of available credit in debt

- Conduct a formal review of your finances at least once per year including debt and credit history; follow-up with a plan of action

Finally, some additional words of wisdom from fellow AWIS members about debt and finances. Several AWIS members recommend strongly that you live as frugally as possible and not carry debt during your training but that you save regularly (even \$25 a month) and build your credit history. Several members suggested that taking hold of your finances while doing your science will add a dose of reality to your academic work and remind you that there is indeed a light at the end of the educational tunnel that will require earning and managing money. Finally, many who are at or nearing retirement recommend strongly saving for emergencies and retirement sooner rather than later: “Do it!” “Make it a habit.” Years from now, when the (inevitable) emergency arises or you enter retirement you will be glad for their advice.

For my part, I would recommend that you pay regularly into accounts for your retirement and emergency, just as you would your water bill. As incredible as it may seem, most people will automatically adjust their lifestyles to accommodate the additional expense. If you manage your debt properly you’ll come to view your debt as the glass half full.

===== # # # =====

Thanks to everyone who shared their personal experiences. Your continued feedback helps to make the *Money Matters* column relevant.

References

(1) Programs that help pay down student debt include:

1. NIH program: <http://www.lrp.nih.gov/>
Teach for America or AmericCorp: <http://www.teachforamerica.org>
2. Low income area teaching: <http://www.finaid.org/loans/forgiveness.phtml>
3. Military FinAid with the Army National Guard:
http://usmilitary.about.com/lr/military_college_loan_repayment_program/220435/1/
4. Public interest or nonprofit positions may also have debt forgiveness loans with National Association of Public Lawyers or Equal Justice Works:
<http://www.equaljusticeworks.org/resources/student-debt-relief/public-service-loan-forgiveness>

© 2010 Edi Alvarez. All rights reserved.

www.aikapa.com