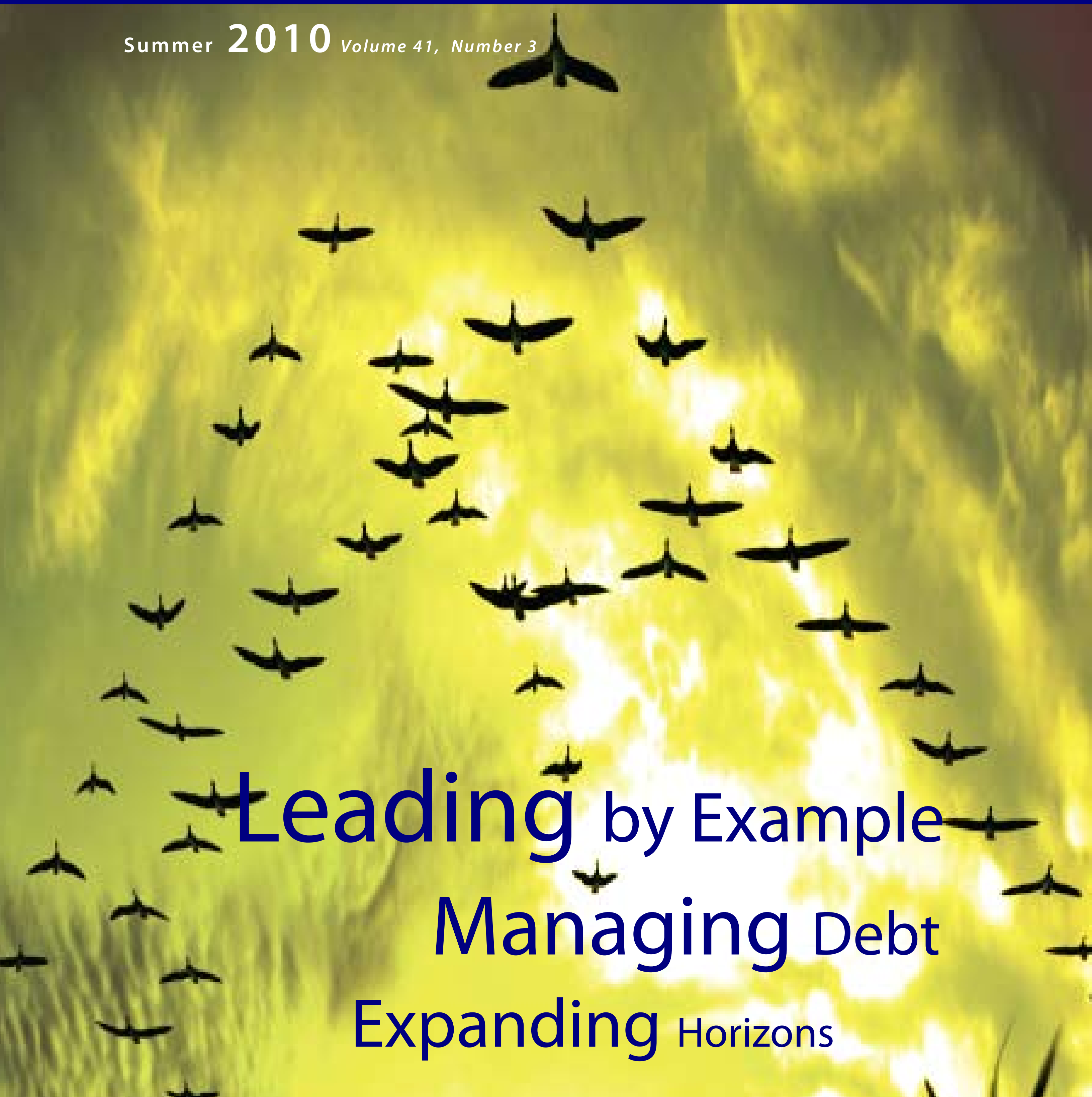
AWIS

ASSOCIATION FOR WOMEN IN SCIENCE

Summer 2010 *Volume 41, Number 3*



Leading by Example

Managing Debt

Expanding Horizons

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Features

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Managing Debt:

Mastering the Upside of Financial Obligation

By Edi Alvarez

There are two sides to any obligation—an upside and a downside. Although there is a natural tendency to focus on the downside, we don't do ourselves any great favor by always thinking about obligation in such pessimistic terms. Working hard to provide for one's family or caring for an aging parent, for example, are obligations that can be a source of great pride and accomplishment, and with any luck, never much of a burden.

Debt (in other words, "financial liability") is also a form of obligation. When speaking of debt we invariably focus on the negative, treating it as if it were a dark cloud hanging over our heads. But debt, like work, does indeed have its positive facet; you might say its "silver lining." For example, debt, (and I really must emphasize, when responsibly managed), allows us to enjoy a comfortable home or a safe car. Making purchases today that have the potential to perform well over time, such as investing in education or real estate, are amongst the most well known examples of employing debt as a hedge against inflation. Incurring a reasonable level of debt and then scrupulously paying it off is a simple and smart way to build a strong financial track record, ultimately providing access to inexpensive credit and ownership of valued assets.

If managed correctly debt can, in short, help us achieve our goals and build wealth. Unfortunately, too many individuals learn to manage debt by trial and error. They become jaded by negative experience and will likely never leverage it to their benefit. Except for the fortunate few, debt is simply too important and too omnipresent to leave to guesswork. It needs to be carefully monitored and managed.

A recent questionnaire of AWIS members reveals that as a group, we are conscientious about financial obligations to third parties. In essence, those who responded are a fiscally responsible bunch, inclined to not overspend and to pay bills in a timely fashion. That said, the questionnaire also revealed something else. A sizeable percentage of respondents do not maintain an adequate emergency fund (85%) or make regular contributions toward retirement (70%). In other words, they are putting other expenses first and, consciously or not, opting to defer the financial obligation they have to themselves. The maintenance of an adequate emergency fund and regular contributions toward retirement ought to be as much a part of everyone's debt consideration as those monthly credit card bills. If you consider yourself "debt free" and financially on track consider what you include in your debt definition.

It is important to understand that scientists tend to accumulate debt a little differently than others. 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. Unfortunately, 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." How might debt play out? For one AWIS member, the expected position did not materialize upon graduation, adding costs to retrain for a different discipline before paying her initial educational expense. In another case, the final position yielded lower compensation which forced her to carry a very large debt load (though at low interest) 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 compromised their ability to grow their wealth. It was a reminder that many must self fund health care (i.e., no COBRA) after graduation.

Debt is, more or less, a question of what you make of it. It can help you build wealth as readily as lose it. What follows are a few of the important tools and considerations for managing debt.

Review the Numbers

Combine your income, expenses 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), itemize your fixed expenses (childcare, utilities, taxes) separately from your discretionary expenses (debt to self, travel, entertainment), and then itemize each of your formal debts (car loan, mortgage, credit card). Then list your assets.

Track Your Debt Ratios

You can use debt ratios to monitor and prevent a debt crisis. Aim for an overall debt ratio (total liabilities to total assets) of 30% 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). Consider the risk you are taking when, for example, you commit to a mortgage that drains more than 50% of your take-home pay. You may be sacrificing your retirement funding and/or the maintenance of an adequate emergency fund. Unrealistic debt levels are often at the root of relationships and/or financial devastation when unforeseen events arise.

Examine Your Expenses

The next step is to focus on your expenses. Are you spending on gadgets while ignoring retirement? Identify what is consuming the largest piece of your income and continue breaking it down to the smallest component. There shouldn't be any surprises. Over time this process may help you identify how to reduce expenses.

Key considerations:

- Do you have sufficient funds to cover you during an emergency? An average young person needs about 6 months of expenses plus enough to cover health insurance deductibles.
- Are you saving enough for retirement? Early in your career it can be around 15% of your income (this is often true if you also have a retirement pension).
- Have you saved for estimated taxes? If you have a stipend or are self employed make sure you save for 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.

Debt incurred for education exists in many forms. Some have very low interest rate repayment programs and may be best leveraged over time. Other education debt may fall under regulation that could forgive your debt if you participate in certain programs (1), and a third type (at high interest rates) is really just another form of consumer debt. Consumer debt (e.g., credit cards and car loans) should be reduced since it does not help to build capital or wealth (it is "unproductive" debt). Pay off loans with the highest interest rates and highest fees first. For some, paying down car loans can take priority since missing even one payment may result in immediate repossession. If default is on the horizon, consider selling the car and using the receipts to pay off the loan.

Keep in mind good debt practices can make future purchases less expensive. If possible, place all of your loans on automatic minimum payment. If you keep a balance on your credit card, remember to negotiate the lowest rate and to revolve.

Regularly Check Your Credit History

Long term relationships with credit providers is advantageous to your credit history, as is a successful history with different types of debt, e.g. credit cards ("unsecured loans") and bank loans ("secured loans," or debt backed by property such as a car). Review your credit card history regularly and correct errors immediately.

Understand the Tradeoffs

Never consolidate your unsecured debt with your secured debt without fully understanding the potential tradeoffs – in some cases debt consolidation can be a great solution and in others it can severely restricting your options in times of financial distress. Should you find yourself falling behind on payments, consider the expense as well as what you can do to prevent incurring new debt.

Filing for bankruptcy is an option only in dire cases. 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 debt
- Review your numbers every month with an eye to dropping expenses and identifying mounting debt – don't ignore the warning signs
- Do not carry more than 50% of available credit in debt
- Save each month into your emergency or rainy day fund
- Make an annual review part of your finances including debt and credit history; follow-up with a plan of action

Several AWIS members strongly recommend that you live as frugally as possible and not carry debt during your training. Save regularly (even $25 a month) and build your credit history. "Make it a habit," while doing your science, adding a dose of reality to your academic work.

I 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. Debt is not a dirty word. If you manage your debt properly it will help you grow your wealth.

Thanks to everyone who shared their personal experiences. Your continued feedback helps to make the Money Matters column relevant and of value to all. ■

References

1. Programs that help pay down student debt include:

- NIH program: http://www.lrp.nih.gov/

Teach for America or AmericCorp: http://www.teachforamerica.org

- Low income area teaching: http://www.finaid.org/loans/forgiveness.phtml
- Military FinAid with the Army National Guard: http://usmilitary.about.com/lr/military_college_loan_repayment_program/220435/1/
- 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