Adam Smith Advisors

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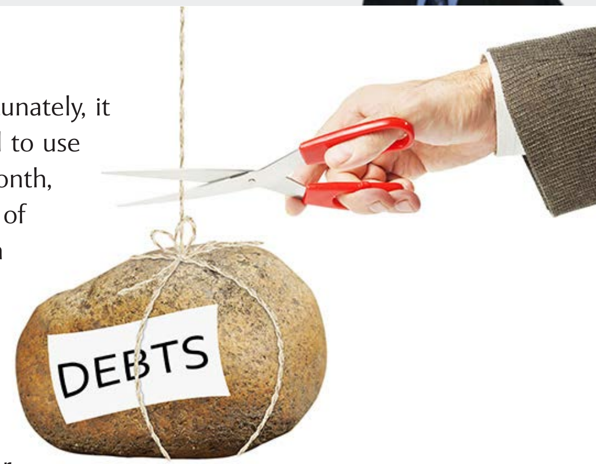
ADAM SMITH INSIGHTS: *Published by Keith Tufte, President of Adam Smith Advisors, LLC, with insights on investing and wealth management.*

INVESTING QUOTE OF THE MONTH:
"There are no shortcuts when it comes to getting out of debt." — Dave Ramsey

GET OUT OF DEBT, STAY OUT OF DEBT



One of the keys to financial success is keeping your debt under control. Unfortunately, it seems the American way is to buy whatever you want, whenever you want, and to use credit to make it happen. Many people spend all the money they make each month, plus 10% by using credit. You can buy the McMansion, the boat, and a couple of BMWs right now all using debt if you want to. Go ahead, take the luxury vacation and put it all on the credit card. The U.S. national debt, student loan debt, and many other types of debt are at all-time highs. Did we not learn anything from the great recession of 2009?

We recommend keeping your debt to a minimum, and using debt only as a means to buy your home, for college if you are smart about it, and possibly for your first car. Many people use debt to live above their means. If you are using debt to buy things on a regular basis, and are not paying off your credit cards each month, you are likely living above your means. We are a bit old fashioned, and think people should save up ahead of time and pay cash for what you want to buy, rather than buying it now with credit and paying the debt back later. By doing it this way, you often find out that you didn't need it as much as you first thought (or don't need it at all), or you can be happy with a cheaper version. The sad thing about debt is that it all must be paid back eventually, with interest, and paying it all back can become a difficult and seemingly never-ending nightmare for many people.

Credit card debt is the worst. It usually carries the highest interest rate (often 12%-20%+), and it is not tax deductible. The minimum payment indicated on your monthly credit card bill is laughably too small to pay off the debt in a timely manner. Credit card debt is usually the first debt you should pay down if you are in too deep with debt. You should start by paying down the highest interest rate card first. Work to eliminate all your credit card debt, and then pay your credit card off in full every month. Set it up to pay off the credit card balance automatically each month from your bank account so you don't ever forget or miss a payment. Reduce the number of credit cards you own to just one or two if you can.

Student loan debt is a crisis in the making. It has spiked due to the skyrocketing cost of college. Many students take out large college loans, and they don't think enough about what type of income or job their major might result in. College is a huge investment, and students/parents should think ahead of time about what type of return on investment they will be getting and who will be paying for it. Going to a very expensive $65,000/year private college and majoring in sociology may not be the best return on investment. Many students graduate with $30,000-$100,000+ in student loans, and some end up with lower paying jobs that do not require a college degree. They will be paying off their student loans for decades. Graduating from college with heavy student loans is forcing many young people to delay buying their first home for 10+ years, or from being able to start saving for other goals such as retirement. One good rule of thumb is to try to keep your total student debt below your projected first year salary upon graduation, based on the average starting salary from your college with your major. It is extremely difficult to get out of paying your student loans, even using personal bankruptcy.

Home mortgage debt is tax deductible for many people, and is a good use of debt if used properly. If you can't afford to put 10%-20% down on your home, you probably can't afford the house and you should stay where you are and/or keep renting.

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There are still many people who are “upside down” on their homes, where they owe more on their home than it is worth after selling costs and the real estate commission. Those people are really stuck, especially if it is a home they can no longer afford due to job loss, lower income, divorce, etc. They can’t afford to stay, and can’t afford to sell.

“Investing” in residential real estate has produced weak returns (about in line with overall inflation) over the long-term on average. You should think of your home as a nice place to live, not necessarily a great future investment. Just because the bank says you can afford the house, doesn’t mean you should spend that much. Only buy the house you can easily afford. Residential real estate has significant monthly overhead costs beyond the mortgage payment such as property taxes, insurance, utilities, maintenance, repairs, etc.

We generally recommend people go with a 15 or 30 year fixed interest rate mortgage, so their payments are predictable and less risky. We also recommend our clients have a plan to pay off their mortgage completely by the time they retire. It is more difficult to enjoy retirement if you still have a mortgage hanging over your head.

Auto loans can come with relatively low interest rates, but they often allow people to buy a more expensive car than they should. Many people think only about the monthly payment that they can afford, rather than the all-in cost of the car over its lifetime including depreciation. Some people never get away from the car payment because as soon as they pay it off (over 5+ years) they go buy a newer and nicer car with a new car loan. They have never experienced the joy (and savings) of driving a completely paid off car. If you can save up the money ahead of time and pay cash for your next car you could save yourself a lot of money and stress. Car leases are often complicated, and complicated financial deals are typically designed to favor the seller, not the buyer.

“Paying down your debt could get you an immediate return of 7%-20%+ on your money”

What should you do if you find yourself way over your head in debt? Come up with a plan to reduce your debt. Make a list of all your debts in terms of dollar size and interest rate. Pay off the highest interest rate debt first. Make short-term specific goals about how much debt you are committed to paying off and by when. Watch your spending, and only buy what you need. Pay off one loan at a time, reduce the number of credit cards, and celebrate small victories along the way. Paying down your debt could get you an immediate return of 7%-20%+ on your money, perhaps better than you could do with investing the money. Can you downsize your house/apartment, sell assets (cabin, second home, boat), or downsize your cars? Can you get a job if you are not working? Track your credit score using CreditKarma (a free service), or the national credit bureau reports you can get for free once a year. Don’t take on new debt. Don’t give up and keep making forward progress.

Getting your total monthly debt payments down to very low levels or to zero greatly reduces your overall financial risk, relives a great amount of stress, and positions you for a successful financial future and retirement. Would you rather look wealthy, or be wealthy? It is difficult to do both. If you haven’t done so already, get out of debt and stay out of debt. Let us know if we can help.

Adam Smith Advisors, LLC (ASA) provides unique wealth management services for a select group of client families to help give them peace of mind. Author Keith Tufte, (CIO of ASA) has over 25 years of successful investment management experience as a Wall Street Analyst, Mutual Fund Portfolio Manager, Director of Equity Research for a major mutual fund firm, Hedge Fund Portfolio Manager, and Wealth Management Advisor. Please FORWARD this e-mail to friends/relatives/business associates that you think may have an interest. Please see our website at http://www.cherrytree.com.

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