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UNIT TRUST CORPORATION

ADVISORY SERVICES DEPARTMENT

Newsletter

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BALANCING INVESTING WITH DEBT

One of the most common questions that investors seek to answer is whether to utilise excess cash to reduce debt or, conversely, use it to invest in the future while continuing steady debt repayments. On one hand, paying off your debt means reduced stress, lower risks, and a greater ability to withstand unexpected emergencies. Alternatively, investing allows you to accumulate wealth and build a reserve that can protect you and your family; it can also provide you with a source of passive income.

It is therefore understandable why many investors face the dilemma of where to place their focus. Should you bite the bullet and eliminate lingering debt, or increase your savings rate via investments?

In a perfect world, the answer would be to have zero debt but, unfortunately, for many people debt is a necessary part of life. This is even more essential in the business world as loans, lines of credit or even a company credit card can help meet your monthly expenses or even finance capital expenditure and expansion. However, too much debt can stifle cash flow and may be detrimental to your business. Additionally, the less you owe, the more available funds you have to reinvest.

It is not an easy decision to determine how you should balance your debt with investing and the answer varies depending on the circumstance, but you need to take into consideration your current debt, your investment options as well as your cash flow situation and risk tolerance.

Good Debt vs Bad Debt

Firstly, you need to understand the type of debt you are dealing with – is it considered good or bad? Good debt helps you to generate income and increases your net worth. It can also enable you to more effectively manage your finances. Mortgages, borrowing to fund your education as well as loans to buy things that save you time and money usually fall into this category. Despite the fact that these loans may set you back initially, you will end up much better off in the long run.

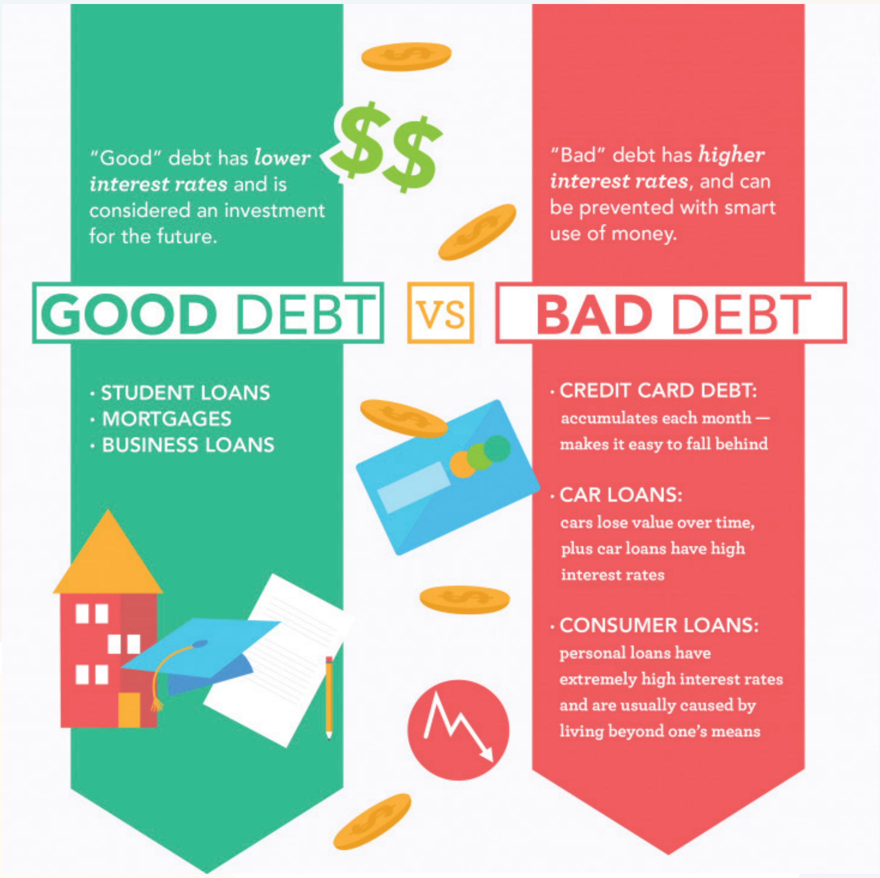
On the other hand, bad debt is considered anything that decreases in value as soon as you buy it or has no potential to generate income in the future. Unfortunately, this tends to be the category that most debt falls into. Car loans and the interest on credit cards are prime examples of bad debt.

Pay attention to interest rates

Another critical element to consider how to apportion your money between debt and investments is interest rates. For debt, the lower the interest rate the better. However, it is not always possible to borrow at low rates. So, where do you draw the line? What interest rate would be considered too high and thereby classify your loan as high interest debt?

It is all relative and as usual depends on the scenario, but many experts suggest that if the interest rate at which you are borrowing is higher than the returns generated from your investments, then you are taking on high interest debt. These are the types of loans that you should aim to repay as quickly as possible as extra payments towards these types of loans, in essence, represent a better return than any of your current investments.

On the other end of the spectrum, there is low interest debt which has low enough interest rates that it makes more sense to use any additional income to invest instead of trying to repay it early. In order to eliminate this type of debt, you will be required to use long-term capital and by doing so, you will be robbing yourself as the gains you would have benefited from investing, especially with compound interest, outweighs your repayment amount.



Source: moneybanker.com

Debt reducing methods

After classifying your debt, you now would have a greater understanding of which ones you should eliminate first and thereby increase the funds available for investment. The following are different methods you can use to reduce your debt burden.

- **Balance-matching method**
  Studies have shown that many people use what's known as "balance-matching," in which the amount they pay per loan is proportional to the total amount owed.

- **The Avalanche Method**
  Mathematically, the most effective way to eliminate debt is to use the avalanche method in which you rank your debt from highest to lowest by interest rate. After you pay the monthly instalment on each, you dedicate any additional funds to the loan with the highest interest rate.

- **The Snowball Method**
  In this method, you prioritise your smallest debts first, regardless of interest rate. Rank your debts from smallest to largest and pay the monthly instalment on all, except the smallest. For that one, dedicate as much cash as possible each month until it is repaid. Then repeat the process and move on to the second-smallest debt.

  The idea behind this method is that you will gain momentum by watching your debts disappear – as you would watching a snowball grow bigger and bigger – which will in turn motivate you to continue eliminating your debts one by one.

The Cash Flow Consideration

Interest rates are extremely important when determining which debt you should eliminate first, but it is just one factor. Having cash at hand to meet your day-to-day expenses is also an important consideration. This is even more essential for business as having available cash could mean the difference between being able to meet all your financial obligations so that the business can keep operating, or not, and your company ceasing to exist.

For example, if you currently have $10,000 in debt which is split into the following two loans:

- Loan 1: $3,000 at a rate of 7% with a monthly payment of $100
- Loan 2: $7,000 at a rate of 8% rate with a monthly payment of $75

One of your previous investments have matured and you received $10,000 and you are considering eliminating all your debt. Unfortunately, due to your current cash flow restrictions, you determine that, you can only afford to repay one loan at the moment.

If you were only considering interest rates, the $7,000 loan would of course be the wiser choice given that it has the higher rate. However, given the fact that the main concern at the moment is availability of cash, you need to take into consideration the cash flow yields and pay off the loan with the greatest cash flow yield, so you would have more available cash each month.

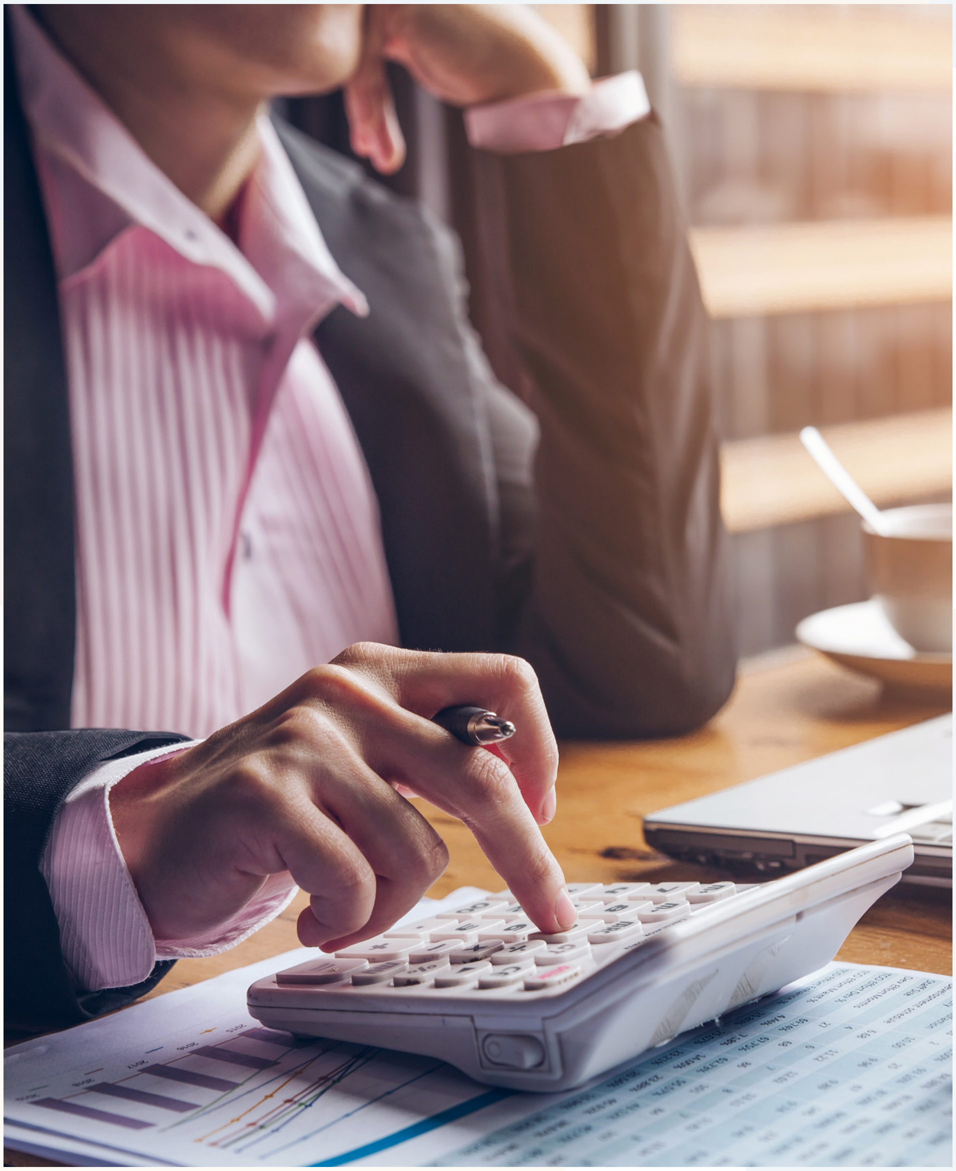
Cash flow yield for a year is calculated as follows:

$$\text{Cash Flow Yield} = \frac{\textit{Monthly instalment* 12}}{\textit{Loan amount}}$$

The Cash flow yields for the two loans are as follows:

- Loan 1= $\frac{100*12}{\$3,000} = 40\%$
- Loan 2 = $\frac{75*12}{\$7,000} = 13\%$

Therefore, you could repay Loan 1. The $100 that previously apportioned to loan payments can now be used to meet other obligations or funnelled into an investment. Additionally, the remaining $7,000 can be used to grow your business or set aside as a cushion for business emergencies.



Redirect your debt payments into your investments

After you have made any debt reductions, you should have some additional income that you can use to invest. In order to determine which investments will be best suited to you, you will need to determine your risk tolerance. This is defined as the degree of variability in investment returns that an investor is willing to withstand. It takes into consideration the following elements:

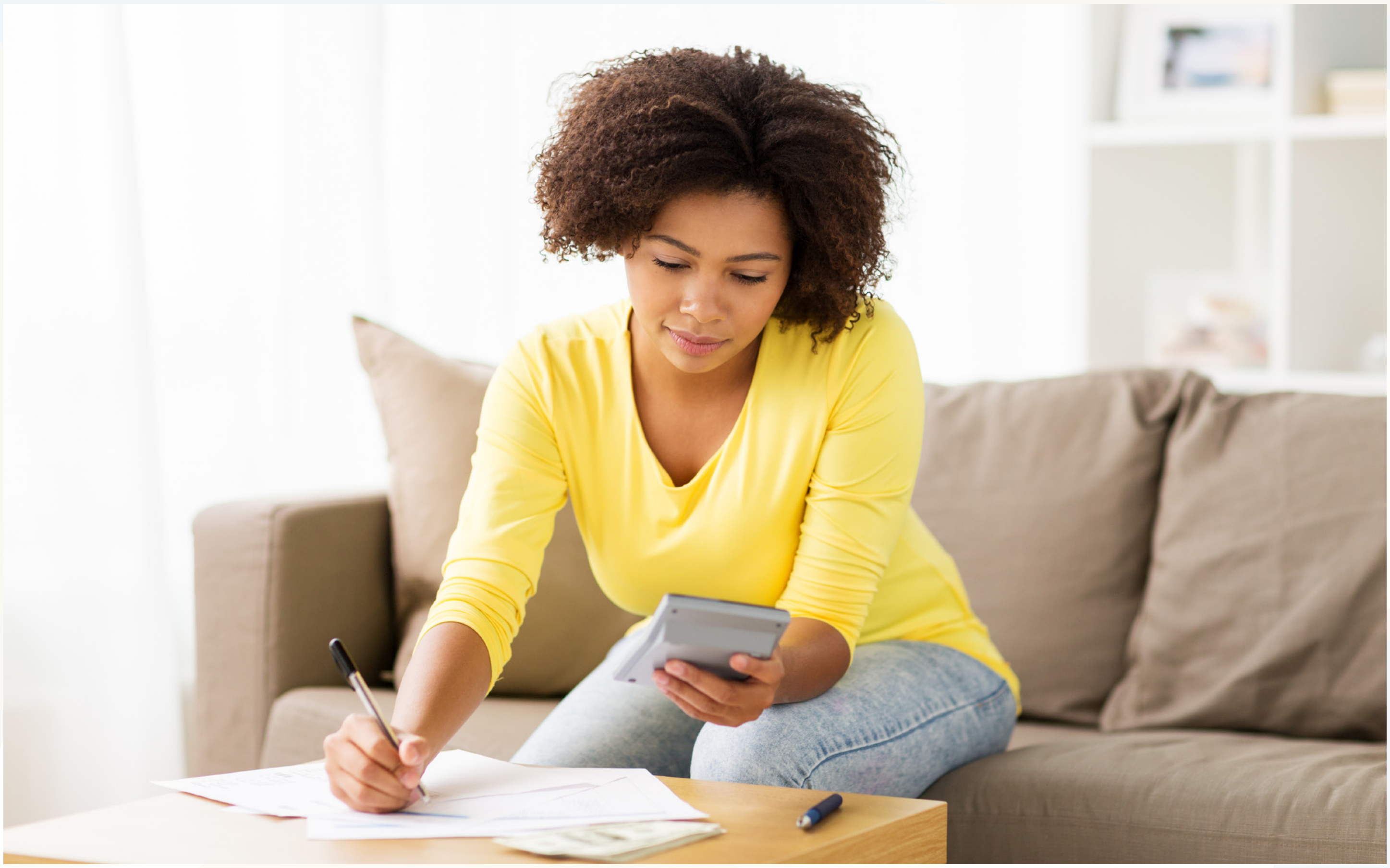
- Age
- Income
- Earning power
- Time horizon
- Any other criteria that's unique to you

Investors with a higher risk tolerance tend to be more likely to invest aggressively rather than paying down debt as they are always seeking the best returns and are willing to accept the risk of bigger losses.

However, the more risk adverse investors would possibly choose to keep greater allocations in cash and fixed-income investments as this greatly reduces the potential of losing money.

No matter where you fall on the spectrum, the longer your time horizon, the greater potential pay-off you could enjoy by investing rather than reducing debt, because of the benefit of compound interest.

It is a tough decision when deciding between paying down debt or investing. It not only depends on your economic environment, but also on your financial situation. You need to determine where the money will be most impactful. There is no universal right answer but if you set reasonable financial goals and evaluate your investment options, risk tolerance and cash flow, you will be well prepared to make the decision that will be most comfortable for your lifestyle. It is important to remember that you can invest in spite of debt.



Key Action Steps

Paying off debt can save you money and reduce your financial obligations and investing takes you one step closer to having the freedom to make decisions without worrying about any monetary implications. They both play an important role in helping you to succeed. The following steps are a good starting point to help guide you to optimally balance your investment with debt:

1. Default to a 50/50 split i.e. apportion 50% of any additional money towards investments and the other 50% can be used to reduce your debt.
2. Once you become more comfortable, the next step is to adjust the percentages based on your personal preference. After some time, if it isn't already clear, you will realise which option stands out. It will be the one that makes you feel more accomplished as well as gives you more piece of mind. It may be daunting but don't be afraid to take the leap and lean in that direction.
3. Even though you may be more drawn to one of the options, it is advisable to make sure that you do not cut out one completely, so you can make progress in both directions, even if one is much smaller than the other.
4. Remember to reassess your preferences and adjust your contributions accordingly. Nothing is cast in stone and you can make amendments to fit your financial situation.

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About the Advisory Services Department

The Advisory Services Department of the Trinidad and Tobago Unit Trust Corporation was established to serve our valued clients seeking financial and investment advice and solutions from a trusted service provider. We will assist you in enhancing your personal wealth and financial well-being by providing you with financial counselling, investment advice and solutions.

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