

Chapter 1

A Better Path

The debt we owe to the play of imagination is incalculable.

—Carl Jung

The path I am going to outline for a better retirement—how you can retire comfortably, minimize taxes, help your family, and buy the things you have always wanted—is centered around the idea of using the strategic benefits of debt. Give me some time and an open mind, and I will show you some tricks that ultra-high-net-worth individuals have been using for years, including how you may be able to increase your rate of return, minimize taxes, and actually reduce risk by using strategic debt.

Can you—and should you—attempt to benefit from what this book will define and describe as “better” debt? Will a debt-inclusive approach to the entirety of your financial life, including the momentous transition known as retirement, make things better for you and those you love? Or will debt—any debt at all—be the heavy lead anchor that sinks your hopes for achieving happiness now and in your golden years?

It depends. It certainly isn't my belief that all debt is good, nor is it my belief that everybody needs debt. The goal of this book is to offer some perspective, a whole different way of thinking about things, a (w)holistic way that includes both sides of the balance sheet—that is, both your assets *and* your debts. I hope to raise questions worth considering and make suggestions potentially worth implementing. Then I will give you my take on what some of your best next steps might be. I hope to present a realistic case of what's possible, and to guide you in the right general direction. I will offer many everyday examples of how you can obviously, immediately, and substantially benefit from my ideas, while also pointing out pitfalls, obstacles, and dangers along the way.

But honestly, it's an uphill battle. Our culture is replete with fearsome admonitions about all debt being inherently evil, how debt will always make you poorer and worse off, and how the *only* way to retire with peace of mind is to get rid of—ideally, get rid of *all*—your debt, before it's too late. Nobody wants to burden their children with debt when they are gone, right?

Consider Shakespeare's *Hamlet*, in which Polonius tells his son Laertes, "Neither a lender nor a borrower be." Or consider financial author and radio host Dave Ramsey's advice: "You can't be in debt and win. It doesn't work."¹

Not so fast!

In the first book in this series, *The Value of Debt* (John Wiley & Sons, 2013),² I describe a variety of ways that debt can make a huge *positive* difference in the lives of those mentally, emotionally, and financially equipped to take advantage of it. In this book, I will reinforce and expand on the key ideas from the first book and illustrate how with a debt strategy it is possible to increase your returns, reduce your taxes, and reduce your risk, which can increase the chances that you will not outlive your money. I'll also show you ways to pay for the lifestyle you have always wanted to have.

A Successful but Controversial Debut

I was humbled when the first book in this series, *The Value of Debt*, made it onto the *New York Times* bestseller list and was named one of the Top 10 business books of 2013 by WealthManagement.Com, one of the wealth-management industry's most prestigious magazines. *The Value of Debt* begins with the five tenets, or action principles, that anchor a debt-inclusive philosophy and practice, and they are worth repeating here.

FIVE TENETS OF A DEBT-INCLUSIVE PHILOSOPHY

1. Adopt a Holistic—Not Atomistic—Approach
2. Explore Thinking and Acting Like a Company
3. Understand Limitations on Commonly Held Views of Personal Debt
4. Set Your Sights on an Optimal Personal Debt Ratio
5. Stay Open-Minded, Ask Questions, and Verify What Works

Now, would you guess that any of these ideas would be controversial? In fact, to a lesser or greater extent, they all are! To begin with, the idea of a comprehensive, inclusive approach that takes debt seriously was, until *The Value of Debt*, virtually missing from personal-finance literature. You might think that the many promoters of a comprehensive and holistic wealth-management approach would naturally want to include *both* sides of the balance sheet—both assets and debts—but literally none have done so. (It's okay to be comprehensive and holistic, they seem to say, but debt is a special case, and there must be a reason why it has been intellectually and emotionally off-limits for so long, right?) Pointing to such an idea as the central premise for a book naturally raised a good deal of suspicion in certain quarters, both professional and academic.

The second idea, another real shocker, is that individuals and families—especially but not only well-off ones—should consider applying the same sort of thinking and acting with respect to debt that companies utilize. Consider this: The total number of sizeable companies in the United States with zero long-term or short-term debt can literally be counted on one hand.³ Why? Is it because they can't afford to pay off their debt? No. It's because the well-educated and well-paid CFOs of these companies—who all realize that correctly structured debt actually makes their companies stronger, longer lasting, and more profitable—don't want to be fired. These CFOs all intuitively understand the Indebted Strengths that arise from strategic debt, which we will briefly review in the next section. They also understand why the use of enriching debt available to their organization is both efficient and rational, as we explore throughout this book.

Rooms full of books and studies—including Nobel Prize-winning studies⁴—show how companies benefit from debt. Given this, you might

have thought that someone, somewhere, would have applied some of the same principles and mechanisms to affluent individuals and families. You would have been dead wrong. As *The Value of Debt* describes, a careful examination of the available literature found just one academic Scandinavian study that suggested individuals *could* benefit from debt the way companies do . . . and that was all.

Naturally, then, this idea raised quite a lot of suspicion and uneasiness in certain circles. “People aren’t companies,” I was told, “and people shouldn’t take the kinds of risks that companies take, like consciously cultivating a strategic debt practice.” It’s true, of course, that people aren’t companies. But like companies, they need money, and like companies, they can benefit from using better debt—what Chapter 3 defines as working debt and, even better, enriching debt—to access and take advantage of their Indebted Strengths. Also, as we consider in Chapter 3, people are living much longer. Like companies that have long-term economic horizons, they need to more effectively plan for increased life spans—including taking advantage of the better debt organically available to them as a result of the success they have already achieved.

Perhaps most important, I wholeheartedly agree that people are not companies. For example, if Walmart goes bankrupt, that impacts about 1 million people. If my wife and I go bankrupt, it impacts five people—the two of us plus our kids. Therefore, one could argue that I could take more risk than Walmart. Perhaps we should have more debt! But that doesn’t seem right to me. Companies are playing a game of probabilities and are in the business of taking risk. People are in the business of surviving first and foremost. For me, nothing is more important than my family. Therefore, in my first book I examine corporate strategies and make them *more conservative* in applying them to the individual household. I believe that if people embraced my ideas, they would be rated close to AAA (the highest rating), something only three companies in America can claim today!⁵ At worst, individuals would be A rated. I don’t want people to have a lot of debt; I want people to consider having the right amount of good debt.

As previously discussed, from Shakespeare to virtually every one of today’s most popular books on personal finance and retirement, debt is culturally, linguistically, emotionally, and even religiously and spiritually held to be bad, evil, repugnant, and something to be avoided at all costs and

gotten rid of as quickly as possible. I wish I were exaggerating, but the idea that debt is evil is so deeply embedded in our language and culture that it is very rarely questioned and almost never seriously challenged.⁶ Similarly, for those who find the idea of personal debt anathema, the idea of having an *optimal personal debt ratio* (debt-to-asset ratio) makes no sense at all.

It's hard to imagine that this would be controversial, as naturally everybody strives to be open-minded, understand things, and find out for themselves whether something works. Well, people will *tell* you that they are willing to examine things in an open-minded way and be open to evidence that contradicts what they already believe and expect, but psychology and simple observation tells us this is often not true.

Consider “confirmation bias”—the tendency to look for and see facts that confirm the outcome one is already expecting or desiring—which is very difficult to overcome. Attempts to describe some of the ways better debt works are often met with counterexamples of a friend or relative who got into an oppressive debt situation that destroyed their financial lives. Well, yes, of course that happens—and better debt concepts are most definitely *not* for people who can't handle having access to any debt. Still, as you will see, many people are already successfully applying a strategic debt philosophy in their lives. Unfortunately, those success stories are filtered out or ignored while debt horror stories are overemphasized.

Bottom line: Nearly everybody will *say* they are open-minded and willing to ask questions to learn what really works, but in reality, few people are actually able to be that way when faced with something new and controversial, especially if it goes against what they've been taught their entire lives. The notion of Indebted Strengths, to which we now turn, is such a concept.

The Fifth Indebted Strength

If you are successful, it is because somewhere, sometime, someone gave you a life or an idea that started you in the right direction. Remember also that you are indebted to life until you help some less fortunate person, just as you were helped.

—Melinda Gates

In *The Value of Debt*, I write a good deal about financial distress—when an individual or family has trouble honoring financial commitments and

paying bills, which can lead to bankruptcy if unrelieved—as well as the direct and indirect costs of that financial distress. I also write about both the *impact* of financial distress (which can increase from negligible to moderate to severe to bankruptcy, and then ultimately can create physical survival issues), as well as the *duration* or length of financial distress (a couple of days, several weeks, a few years, chronically ongoing and debilitating). *I then showed how taking on the right kind of debt—strategic debt, smart debt, better debt—can actually reduce your risk!* Let’s review why and how this can be true.

This brings four key qualities or Indebted Strengths into play:

- 1. Increased Liquidity
- 2. Increased Flexibility
- 3. Increased Leverage
- 4. Increased Survivability

As Figure 1.1 shows, the right kind of debt can bring more liquidity. Generally, the more liquidity you have, the more flexibility you have. As you take on debt you gain access to additional leverage, which can increase your overall rate of return. Taken together, all of this ultimately leads to enhanced survivability—the ability to make it without running

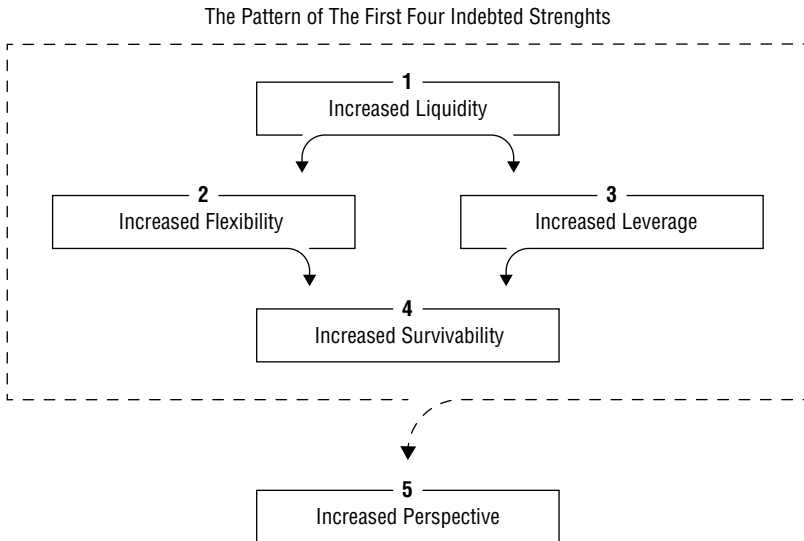


Figure 1.1 The Five Indebted Strengths

out of money! Throughout this book, we will explore these ideas with regard to retirement, showing how the advantages of Increased Liquidity, Increased Leverage, Increased Flexibility, and Increased Survivability can come very directly and personally into play for those planning for, entering, and living in the retirement phase of life.

A *fifth* Indebted Strength that comes into play—especially in retirement—is *Increased Perspective*. This isn't a direct result of debt itself but rather an overall benefit to having a comprehensive philosophy. Those who demonstrate the ability to have an Increased Perspective are able to approach strategic debt with an open-minded attitude and are thus able to implement the strategies.

Increased Perspective is like drawing and painting. People can draw in two dimensions, but the real trick—one that took humanity thousands of years to master—is to use perspective and shading in drawing, so that subjects have depth. Similarly, when you begin to take advantage of strategic debt ideas and consider your situation in terms of both sides of the balance sheet, you are bringing additional depth both to your thinking and potentially to your financial structure. Perspective enables you to see how your whole financial situation fits together and is potentially deeper, more robust, and better able to weather storms than you previously could have imagined.

The final aspect of Increased Perspective is an understanding of our ability to give back to society. No person is an island, and we all have tremendous nonfinancial debts to our parents and those who raised us, our other family members, the organizations and individuals who have made our careers and success possible, and the country we live in. I believe that by embracing these ideas you will not only increase the odds of making it through your retirement, but also will have money left over to leave the legacy you wish!

Who Can Benefit from This Book? Not Only Millionaires! (But They Can, Too)

Debt is part of the human condition. Civilization is based on exchanges—on gifts, trades, loans—and the revenge and insults that come when they are not paid back.

—Margaret Atwood

Are you qualified to adopt—and likely to benefit from—the ideas, strategies, practices, and tools found in this book and on the valueofdebt-irretirement.com website? Ask yourself the following four questions.

Question 1: Do You Have Adequate Resources to Start With?

When I wrote the first book in this series, I was considering promulgating a bright-line rule: For the ideas in the book to be appropriate for you, you need \$1 million or more of net worth (outside of your primary residence). I realized later that *anyone with sufficient assets* might be able to benefit because everyone's circumstances vary so greatly. Since that book's release, I have realized this is a bigger, more important topic that applies to everyone's life.

After *The Value of Debt* debuted and people started understanding and implementing some of its ideas and practices, I started getting requests from individuals of every level of net worth who wanted to learn how to make use of strategic debt. For many people, there may not *be* a way to have a successful retirement without embracing these ideas. While it's true that people with greater resources to begin with are in some ways best positioned to make the widest use of the ideas found in this book, these ideas will also work for people with far fewer assets.

Question 2: Are You Psychologically Disposed to Making Wise Use of Better Debt?

Let's face it, we all know people who buy a bunch of stupid things that they can't afford when given money or access to credit. This book is not for them. It's not about buying things that you cannot afford but about better ways to pay for things that you already can afford. I assume you can handle the responsibility associated with this book. This is critical to understand. *If you can't handle debt, then you should in fact put this book down right now.*

Question 3: Are You Truly Open-Minded and Willing to See What Works?

This is the fifth Tenet of Strategic Debt Philosophy: Are you *open-minded*? Are you really willing to take a beginner's mind stance, ask questions, and figure out if what you're thinking of doing is likely to work well for you? Are you willing to invest substantial time and energy and then, if

you come to the conclusion that you shouldn't go forward with any debt practices, be willing to let it go?

Question 4: Are You Willing to Put in the Effort to Find and Work with Qualified Experts to Make Sure Your Situation and Circumstances Are a Good Fit?

This question concerns *your willingness and ability to be open-minded with regard to finding a reliable, professional, financial services individual or organization to work with* who can help you understand and assess your situation, give you the kind of objective feedback that you can't give yourself, and help with any implementation. More and more financial advisors and wealth managers are becoming aware of the tremendous value of a debt-inclusive philosophy and practice, and you can also find tools and resources at valueofdebtinretirement.com.

The bottom line is that with sufficient resources, a favorable psychological disposition, general open-mindedness, and a willingness to find an assisting individual or organization, you are far more likely to have a successful and even life-changing experience with better debt. If you can't say yes to one or more of these questions, please slow down and think very carefully before reading any further or making any major changes in your financial affairs.

Everyday Example #1: Immediately Better Credit Card Debt

In this chapter and each of the five that follow, *we will provide one of six Everyday Examples of how people are already successfully using debt-inclusive ideas, strategies, practices, and tools.* The easiest to understand involves bringing better debt practices to your existing credit card debt, as follows.

EVERYDAY EXAMPLE #1: IMMEDIATELY BETTER CREDIT CARD DEBT

After his daughter's wedding, Ted has maxed out his credit card at \$25,000 at a 20 percent interest rate. Forgetting for now about

minimum payments, paying down principal, compound interest, and other factors that come into play, this means he will owe \$5,000 a year in interest on that card, or \$416.67 a month ($\$25,000 \times 20\% = \$5,000$, divided by 12 months is \$416.67 a month). That's a lot!

Fortunately, Ted also has a qualifying \$150,000 investment portfolio and is eligible for a line of credit against it. He may be able to borrow money against the \$150,000 at something more like 3 percent interest and pay off his credit card debt. Three percent is better than 20 percent. Let's see how much better:

Instead of owing \$5,000 a year, Ted would owe just \$750 a year in interest ($\$25,000 \times 3\% = \750), which divided by 12 comes out to just \$62.50 a month—a *whole lot less than \$416.67 a month*.

It gets even better: *Many portfolio lines of credit do not have required minimum monthly payments*. If Ted wants, he can allow the interest to “cap and roll” until he is ready to pay off the interest and then the \$25,000 itself.

Of course, Ted has to absolutely keep an eye on how much money he borrows this way, but the reality is that right off the bat he's saving more than \$4,000 a year in interest.

This foundational better debt practice is relatively easy to implement, really works, and already has been taken advantage of by many high-net-worth people. It's time for all Americans to be aware of these strategies!

Getting beyond the ABLF and Focusing on Retirement

Although well received, the first book in this series received some criticism for over focusing on tools and in particular the ABLF—asset-based loan facility—that is, the type of credit we made use of in Everyday Example #1. These are also called securities-based lines of credit, and only a small number of investors who are able to put them into place

have done so. In fact, my experience suggests that 95 percent of people that are eligible for this type of borrowing do not use it, often because they are completely unaware that it is available to them. I believe this is shortsighted.

These lines of credit are set up against your taxable investment accounts (IRAs and 401(k)s are not eligible). Typically borrowers can borrow around 50 percent of their liquid investable assets. For example, if you have a \$300,000 portfolio you can generally borrow up to around \$150,000. Some holdings are eligible for lower and higher loan amounts so you will want to check with your financial institution for your exact eligibility.

The benefits of these facilities are that there generally is no cost to set them up, no ongoing fee to have them, and you are paying only interest expense on the amount you borrow, if you borrow at all. Rates on these facilities are typically a bit above or a bit below Prime. At time of this publication Prime was at 3.25 percent. Pricing typically is based on the size of your relationship with the financial institution with lower priced loans going to larger clients.

Generally you will find that these facilities offer incredible flexibility with respect to the terms. Typically there is no amortization and you can pay down any amount at any time you want. What is pretty amazing is that typically there also is no required monthly payment. You can let the interest “cap and roll” which means that it just adds on to your principal balance. As we will see this may or may not be a good long-term strategy but it offers tremendous flexibility for the borrower—in good times and in bad times. Due to the great rates and flexible terms I will occasionally refer to this type of debt as better debt and/or what I will define as enriching debt.

I use the term *asset-based loan facility* to capture what is called margin and securities-based lending products. One of the greatest risks is that your ability to borrow is based off of the value of your portfolio.⁷ Therefore, if your assets go down in value, you can borrow less money. This means that you have to always pay close attention to your coverage ratio, which is a way of looking at how much you have borrowed versus your ability to borrow. In *The Value of Debt* I recommend that you never borrow more than 50 percent of your available credit. This means that if you have a \$300,000 portfolio I feel that these lines of credit can offer a great liquidity solution for up to \$75,000 of borrowing.

These lines of credit typically offer an excellent rate and not only help you to do things like pay down high-interest-rate credit cards, as in Everyday Example #1, but also can also provide a major liquidity cushion in case of disaster or a sudden substantial opportunity. The line of credit will necessarily continue to play a major role in this book, but *the main focus here will be on debt-inclusive ideas, strategies, practices, and tools that relate to or potentially have a substantial impact on retirement.*⁸

AHAs! ADVISOR HIGHLIGHT ANSWERS

The last section you will find in each chapter of this book will be called “Advisor Highlight Answers,” or AHAs. These are directed toward professional advisors, industry professionals, and sophisticated investors. They will give you an idea about the questions, problems, fears, and considerations that your clients might have as they become exposed to these materials.

Question #1: I don’t think my client has the psychological disposition to handle the ideas in the book. What should I do?

Answer #1: You’re most likely right and need to trust your instincts. I start with the premise that people will be rational, smart, and disciplined with these ideas. But as we all know, many people can’t handle the responsibility associated with debt. If they start down this path, they may abuse the flexibility, spend too much, and buy a bunch of things they don’t need.

The problem on the other side is that many people will not be on track for retirement without these ideas nor will they be able to buy the things they want, minimize taxes, or help their family. In my opinion, balancing these risks is one of the, if not the, most important parts of your job.⁹

Notes

1. Quoted in Chris Carpenter, “The Total Money Makeover: An Interview with Dave Ramsey,” www.cbn.com/family/familyadvice/carpenter-daveramsey/moneymakeover.aspx.
2. Thomas J. Anderson, *The Value of Debt: How to Manage Both Sides of a Balance Sheet to Maximize Wealth* (Hoboken, NJ: John Wiley & Sons, 2013).

3. See, for example, Matt Krantz, “26 U.S. companies with no long-term debt,” <http://americasmarkets.usatoday.com/2014/05/29/debt-free-26-u-s-companies-shun-debt>, which states that as of May 2014, there were 26 nonfinancial companies in the Standard & Poor’s 500 Index that had zero long-term debt. If you count leases for retail space and equipment, and short-term loans to be paid off within a year, that number goes way down.
4. See the concepts of weighted average cost of capital and the Modigliani–Miller Theorem: F. Modigliani and M. Miller, “The Cost of Capital, Corporation Finance, and the Theory of Investment,” *American Economic Review* 48, no. 3 (1958); F. Modigliani and M. Miller, “Corporate Income Taxes and the Cost of Capital: A Correction,” *American Economic Review* 53, no. 3 (1963); and S. A. Ross, R. W. Westerfield, and J. Jaffe, *Corporate Finance*, 10th ed. (New York: McGraw–Hill, 2013).
5. Those three companies are Johnson & Johnson, Exxon–Mobil, and Microsoft. Matt Krantz, “Downgrade! Only 3 U.S. companies now rated AAA,” <http://americasmarkets.usatoday.com/2014/04/11/downgrade-only-3-u-s-companies-now-rated-aaa>.
6. For those interested in a fascinating anthropological study on the roots of debt, and how it relates to both social obligation and money, *Debt: The First 5,000 Years*, by David Graeber (Brooklyn: Melville House, 2011) is well worth the read—not because I necessarily agree with all of the author’s suppositions and conclusions, but because the book opens up the historical landscape and encourages each of us to more broadly think about how we hold and relate to debt.
7. A discussion of risks and nuances of these facilities can be found in Appendix F.
8. Case studies are for educational and illustrative purposes only. They assume eligible assets and that funds are available on the facility. All client situations are unique, and all loans are subject to eligibility and approval by the lender. A lender may deny an advance on an ABLF, preventing the scenarios. Pledging assets reduces and may eliminate liquidity. A market correction could impact market values and/or security eligibility, which could impact the facility size and/or trigger a margin call and/or forced liquidations of assets. See complete disclosures and risks to using an ABLF in Appendix F.
9. Author’s Note: The information in this chapter is to be considered in a holistic way as a part of the book and not to be considered on a stand-alone basis. This includes, but is not limited to, the discussion of risks of each of these ideas as well as all of the disclaimers throughout the book. The material is presented with a goal of encouraging thoughtful conversation and rigorous debate on the risks and potential benefits of the concepts between you and your advisors based on your unique situation, risk tolerance, and goals.

