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Debt is Good, Or Is it?

I have written previously about interest only finance and particularly the pros and cons of such a strategy. Setting aside the current pressure on lenders to restrict interest only funding I think it's worth having a broad look at interest only finance, why borrowers and advisors advocate these strategies and why they may be wrong.

In this article we will talk about interest only finance in the context of money borrowed to acquire an income producing asset such as a business or investment property. The central premise is driven by current taxation rules which essentially allow interest costs associated with a loan to acquire an income producing asset being tax deductible.

The on flow effect of this rule gives rise to the concept of negative gearing, a term which essentially reflects a situation where the income from an investment is less than the interest on the loan used to acquire the asset in the first place. This strategy is most commonly seen in residential and commercial real estate investments. Let's say you lose $10,000 in a financial year and your top marginal tax rate is 30%. You claim the loss against your taxable income (usually a salary or business profit) and the tax man puts in $3,000 while you put in $7,000. As you can see, at this point negative gearing for its own sake is looking like a mugs game. However, all is not lost. Provided your asset value rises by $7,000, you are at break even. Without the capital gain you are spending a dollar to save 30 cents, which doesn't sound too attractive to me. In fact, even with reasonable capital gains to offset your holding costs you may find, after selling the asset and paying capital gains tax, that the whole exercise was a financial waste of time.

What we can see is that the relationship between debt levels and asset values has to adjust over time for borrowing to invest strategies to make sense. Obviously capital growth is one way albeit the investors ability to influence the value of the asset will be determined to a large degree by the market more broadly. The counter position is to pay down debt and thus control the dynamic and the asset value / debt level ratio. I acknowledge that over time the tax benefits will reduce as debt and interest costs fall and hopefully income rises. However, the simply beneficial outcomes of amortising debt can't be overstated.

Obviously as debt is repaid interest costs fall and profit from the investment rises. As we can see from the example above regardless of your tax rate every extra dollar in your pocket will contribute to a better return. That may not equate to improved cash flow because you are using additional funds to reduce debt however, as that loan reduces your capacity to amortise debt improves exponentially. Put simply, more of your repayments go toward paying principal and less to meeting interest.

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An important risk and wealth management benefit then ensues. You start building equity in your asset which not only contributes to your net worth but also hedges against possible unforeseen economic conditions such as asset values falling and rising interest rates. In the long run your low or no debt asset can derive tax effective income or cash into your retirement

In business finance, interest costs are generally tax deductible albeit a negatively geared business won't last long unless you have a stack of cash in the bank , strong external cash flows and a desire to burn the lot. Again, the benefits of future proofing your business by amortising debt cannot be overstated. Building equity buffers and reducing interest costs have long been core investment metrics for some of the most well regarded business people and investors world wide.

Am I saying that interest only finance is bad? Not at all, just as long as the borrower understands why the strategy is being employed. This brings us to the miracle of leverage. Put simply, if you can buy an asset returning 14% using bank debt at 5% then the higher the leverage (debt to asset value) the more money in the investors pocket. We see this dynamic at play in management rights syndicate transactions where 70% bank debt can derive 20% return on equity after interest for investors. Surely there can be no good reason to pay down debt and dilute such a cracking return by diverting cash flows from the investors to the bank loan. I would argue that taking a notional reduction in return to, say 15% and using the excess cash flow to pay down debt, build equity and risk proof the business makes very good sense indeed. Building a buffer for potential changes in bank gearing policies or asset value declines also saves a partnership the worry of needing to contribute lump sum capital at some future time.

Until recently my advice to clients was to take as much interest only variable rate money as the bank would lend and pay it back as fast as you can. The strategy builds a redraw facility war chest, creates notional equity via voluntary debt reduction and reduces interest costs. With banks starting to charge higher rates for interest only money and restrictions on paying extra on fixed rate loans, now might the time to modify your position and formally go to P and I finance. Your bank will love the idea and hopefully reward you with lower interest rates and more satisfactory loan terms, particularly at annual review.

Finally, for all you closet economists, wealth planners, tax agents, investment advisors, property spruikers Et al, I am not a financial planner and this is not advice. I acknowledge that this article oversimplifies a complex issue. It's designed simply to trigger in the mind of a borrower the need to better understand why certain choices are made. And a confession, before Christmas I moved all my interest only property debt to formal P and I. Better rates, forced equity build and less money for cars.....gotta be a good plan !

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