Wealth Reflections

Insights on building, preserving and passing wealth
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Standing in Quicksand – The Dangers of Debt

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In 1991 when we bought our first home, interest rates were climbing. The good news - if you were a saver, a 5-year term deposit gave an 8.25% rate of return. The bad news - the cost to carry a 5 year mortgage rate was 11.25%. As a first time home buyer we sought experienced advice from bankers and economists. Everyone told us that rates were most likely to continue to go up, so it was best to lock in for 5 years.

Taking this advice we then watched rates peak and fall the next year and learnt some valuable lessons:

1. Interest rates cannot be accurately predicted and "experts" won't always be right.
2. While locking in for 5 years "hurt" us psychologically as rates fell, it was strategic decision when rates could have gone either way.
3. In the end we were ahead financially because we reacted to the high rate we paid. We spent carefully, saved diligently and wiped out our entire mortgage within 5 years.

Debt can be a strategic tool. A mortgage helps you buy into a long term home. An investment or business loan may allow you to participate in a lucrative investment or business opportunity. But debt is often non-strategic. Most consumer debt sees the purchaser buying ahead of earning their income and paying handsomely for the use of someone else's money.

The Financial Consumer Agency of Canada website (www.moneytools.ca) has a very useful calculator that allows one to see the true cost of debt over time. For example a $100,000 of mortgage debt amortized over 25 years at a 5% interest rate will see the $100,000 repaid, along with $74,481 of interest. So the cost of that $100,000 was $174,481. If the amortization period is reduced to 15 years (so you pay more each month and get rid of the debt in 15 years instead of 25 years) the total interest reduces to $41,862, so it cost $141,862 to borrow the $100,000. Better yet, if the amortization period is 15 years, but 10% of the mortgage is paid down each year (eg $10k of the principal per year), the mortgage is gone within six years and the total cost of interest is only $14,033. Depending on how one uses debt, the cost to borrow can be drastically different.

Carrying credit card balances or a large variable rate mortgage where little of the principal is paid down, is very much like standing in "quicksand". If you are in for a short while, you don't sink very far and it may be easy to get out. If you have a plan and can pay back steadily without adding more to it, it would be like having a plank below your feet gradually helping you out. But if you continue to add debt, or carry the same debt over long periods, inevitably net worth is critically impacted. No one feels good as they feel the wet sand moving up to their knees, then pressing on their abdomen and their chest. It happens with stealth, simply because it can. We have access to this tool debt providers are not thinking of the consumer's long term financial health.

While most of our clients have a healthy relationship with debt, they do worry about their children and how the easy access to credit will impact them. Sharing the "quicksand" analogy, visiting the website referenced above to review how the math works with mortgages/debt (they have a useful "how to shop for credit cards" section too), and sharing one's own story can help. Learning the difference between strategic and non-strategic debt is key. Strategic debt can be a friend, however non-strategic and mismanaged debt is more likely to pull one down and under.

If you have any questions about this, please give us a call.

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