To Invest or to Reduce Debt – that's the question

By William Artzberger | Updated January 11, 2018

Investors face the dilemma of whether to pay down debt with excess cash or to invest that money in an attempt to turn it into even greater amounts of wealth. If you pay off too much debt and reduce your leverage, you may not garner enough assets to retire. Conversely, if you're too aggressive, you may end up losing everything. In order to decide whether to pay down debt or invest, you must consider your best investment options, risk tolerance and cash flow situation.

Pay Down Debt or Invest?

All debt is not equal. The type of debt you have can play a role in the decision as to whether to pay it off as soon as possible or put your money toward investments.

From a numbers perspective, your decision should be based on your after-tax cost of borrowing versus your after-tax return on investing. Suppose, for instance, that you are a wage earner in the 35% tax bracket and have a conventional 30-year mortgage with a 6% interest rate. Because you can deduct mortgage interest (within limits) from your federal taxes, your true after-tax cost of debt may be closer to 4%.

Student loans are a tax-deductible debt that can actually save you money. The IRS allows you to deduct the lesser of $2,500 or the amount you paid in interest on qualified student loans that were used for higher education expenses, although it phases out at higher income levels.

If you hold a diversified portfolio of investments that includes both equities and fixed income, you may find that your after-tax return on money invested is higher than your after-tax cost of debt. For example, if your mortgage is at a lower interest rate and you are invested in riskier securities, such as small cap value stocks, investing would be the better option. If you're an entrepreneur, you also might invest in your business rather than reduce debt. On the other hand, if you are nearing retirement and your investment profile is more conservative, the reverse may be true.

What Is Your Risk Tolerance?

Risk tolerance is the degree of variability in investment returns that an investor is willing to withstand.

When determining risk, consider the following:

1. Your age
2. Income
3. Earning power
4. Time horizon
5. Tax situation
6. Any other criteria that's unique to you

For example, if you're young and able to make back any money you might lose and have a high disposable income in relation to your lifestyle, you may have a higher risk tolerance and be able to afford to invest more aggressively versus paying down debt. If you have pressing concerns, such as high healthcare costs, you may also opt not to pay down debt.

Rather than investing excess cash in equities or other higher-risk assets, however, you may choose to keep greater allocations in cash and fixed-income investments. The longer the time horizon you have until you stop working, the greater potential payoff you could enjoy by investing rather than reducing debt, because equities historically return 10% or more, pretax, over time.

A second component of risk tolerance is your willingness to assume risk. Where you fall on this spectrum will help determine what you should do. If you are an aggressive investor, you will probably want to invest your excess cash rather than pay down debt. If you are fairly risk-averse in the sense that you cannot stand the thought of potentially losing money through investing and abhor any kind of debt, you may be better off using excess cash flow to pay down your debts.

However, this strategy can backfire. For instance, while most investors think paying down debt is the most conservative option to take, paying down – but not eliminating – debt can actually produce results that are the opposite of what was intended.

For example, an investor who aggressively pays down his mortgage and winds up with meager cash reserves may regret his decision should he lose his job and still need to make regular mortgage payments.

I. Building a Cash Cushion and Managing Debt

Financial advisors suggest that working individuals have at least six months' worth of monthly expenses in cash and a monthly debt-to-income ratio of no more than 25% to 33% of pretax income. Before you begin investing or reducing debt, you may want to build this cash cushion first, so that you can weather any rough events that occur in your life.

Next, pay off any credit card debt you may have accumulated. This debt usually carries an interest rate that is higher than what most investments will earn before taxes. Paying down your debt saves you on the amount that you pay in interest. Therefore, if your debt-to-income ratio is too high, focus on paying down debt before you invest. If you have built a cash cushion and have a reasonable debt-to-income ratio, you can comfortably invest.

Keep in mind that some debt, such as your mortgage, is not bad. If you have a good credit score, your after-tax return on investments will probably be higher than your after-tax cost of debt on your mortgage. Also, because of the tax advantages to retirement investing, and given the fact that many employers partially match employee contributions to qualified retirement plans, it makes sense to invest versus paying down other types of debt, such as car loans.

If you are self-employed, having cash on hand may mean the difference between keeping the doors open and having to go back to work for someone else. For example, suppose that an entrepreneur with a fairly tight cash flow gets an unexpected windfall of $10,000, and he or she has $10,000 in debt.

One obligation carries a balance of $3,000 at a 7% rate, and the other is $7,000 at an 8% rate.

While both debts could be paid off, he or she has decided to pay off only one, in order to conserve cash. The $3,000 note has a $99 monthly payment, while the $7,000 note has a $67 monthly payment. Conventional wisdom would say he or she should pay off the $7,000 note first because of the higher interest rate.

In this case, however, it may make sense to pay off the one that provides the greatest cash flow yield. In other words, paying the $3,000 note off instantly adds nearly $100 a month to his or her cash flow, or almost 40% cash flow yield ($99.00 x 12 / $3,000). The remaining $7,000 can be used to grow the business or as a cushion for business emergencies.

For more on managing debt, read What's Your Debt-To-Income Ratio? and Invest in Spite of Debt.

II. Balanced Budgeting Methods

There are a number of different budgeting methods that account for both debt repayment and investments. For instance, the 50/30/20 budget sets aside 20% of your income for savings and any debt payments above the minimum. This plan also allocates 50% to essential costs (housing, food, utilities), and the other 30% for personal expenses.

Oprah's Debt Diet allots 15% of income to debt repayment and 10% of income to savings.

Financial expert Dave Ramsey offers a back-and-forth approach to tackling debt and investments. He suggests saving $1,000 dollars in an emergency fund before working to get out of debt, excluding your home mortgage, as quickly as possible. Once all debt is eliminated he advises to go back to building an emergency fund that contains enough funds to cover at least three to six months of expenses. Next, his plan calls for investing 15% of all household income into Roth IRAs and pre-tax retirement plans while also saving for your child's college education, if applicable.

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What are 'Current Assets'

Current assets is a balance sheet account that represents the value of all assets that can reasonably expect to be converted into cash within one year. Current assets include cash and cash equivalents, accounts receivable, inventory, marketable securities, prepaid expenses. and other liquid assets that can be readily converted to cash.

In the United Kingdom, current assets are also known as current accounts.

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Quick Ratio

BREAKING DOWN 'Current Assets'

Current assets are important to businesses because they can be used to fund day-to-day operations and pay ongoing expenses. Depending on the nature of the business, current assets can range from barrels of crude oil, to baked goods, to foreign currency. On a balance sheet, current assets will normally be displayed in order of liquidity, that is, the ease with which they can be turned into cash.

Assets that cannot feasibly be turned into cash in the space of a year – or a business' operating cycle, if it is longer – are not included in this category and are instead considered long-term assets. These also depend on the nature of the business, but generally include land, facilities, equipment, copyrights, and other illiquid investments.

I. Key Components of Current Assets

Accounts receivable, bills to customers that have yet to be paid, are considered current assets as long as they can be expected to be paid within a year. If a business has been making sales by offering loose credit terms, a chunk of its accounts receivables might not come due for a longer period of time. It is also possible that some accounts will never be paid in full. This consideration is reflected in an allowance for doubtful accounts, which is subtracted from accounts receivable. If an account is never collected, it is written down as a bad debt expense.

Inventory is included as current assets, but this item should be taken with a grain of salt. Different accounting methods can be used to inflate inventory, and in any case it is not nearly as liquid as other current assets. It may not even be as liquid as accounts receivable, which can be sold to third-party collection agencies, albeit at a steep discount. Inventories tie up capital, and if demand shifts unexpectedly, which is more common in some industries than others, inventory can become backlogged. A seemingly healthy current assets balance can obscure a weak inventory turnover ratio and other problems.

Prepaid expenses are considered current assets not because they can be converted into cash, but because they are already taken care of, which frees up cash for other uses. As the year progresses, the value of prepaid expenses as assets decreases; they are amortized to reflect this fact. Prepaid expenses could include payments to insurance companies or contractors.

II. Ratios with Current Assets

Components of current assets are used to calculate a number of ratios related to a business' liquidity. The cash ratio is the most conservative: it divides cash and cash equivalents by current liabilities, and measures the ability of a company to pay off all of its short-term liabilities immediately.

The quick ratio or acid-test ratio is slightly less stringent: it adds cash and cash equivalents, marketable securities and accounts receivable, and divides the sum by current liabilities. This ratio does not classify inventory as a quick asset, and hence, does not include it in its calculation. This gives a more realistic picture of a company's ability to meet its short-term obligations, but

can be skewed by a backlog of accounts receivable.

The current ratio is the most accommodating, dividing current assets by current liabilities. It should be noted that in addition to accounts receivable, this measure includes inventories, so it probably overstates liquidity in many cases, especially for retailers and other inventory-intensive businesses. In personal finance, current assets include cash on hand and in the bank, as well as marketable securities that are not tied up in long-term investments. In other words, current assets are anything of value that is highly liquid. Current assets can be used to pay outstanding debts and cover liabilities without having to sell fixed assets.

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