The Myth of Constructive Debt

by Mike Restivo, CEO Restivo Wealth Management Co.

"Debt is a tool that can be used to improve a standard of living and to purchase assets over the long-term."

The above paraphrase is held among more than a few investors and non-investors alike. On practical and especially moral grounds, debt is a financial burden and an excessive indulgence respectfully. That observation and opinion applies to individuals, groups and governments as does the paraphrase itself.

Consider the application of debt towards standard of living improvement. Semantics turn on the subjective meaning of "improvement". Focusing on the financial condition, debt is the exchange of promise to repay plus debt charges if any for possession of objects(s) and/or services. Are these objects assets in the generally accepted sense? Possibly … due to their intrinsic monetary value equal to if not greater than the debt assumed for their acquisition. Services as generally understood cannot be resold for equivalent monies paid for them save through the intermediary of a business broker of some type. The typical consumer debt is based upon the purchase of an object or objects to improve personal comfort or business from chairs to personal computers. The resale value of same is much less except in the case of the purchase of anything already possessing a fixed intrinsic value, like a collector's piece. In general then a consumer debt purchase is an expense, not an asset outside of certain business income tax interpretations.

Consequently, a typical consumer purchase through debt is an expense involving the conversion of relatively liquid assets into non-asset expenses, the maintenance of which may in turn cause further expenses and even more debt as a kind of personal holding charge. The maintenance of a vehicle bought by debt is the typical example. Consumer and business debt can beget further debt and no attributable assets, but on the contrary expenses and depreciating possessions.

Consumer and business debt improvements are superficial and/or practical, but of a value that is only subjective. The financial effect of asset conversion to debt is the decrease in wealth of either one's person or a business. Financially considered, this is not an improvement in a standard of living unless net worth is quantitatively increased at least equal to the total cost of debt assumed.

Dealing with the first part of the paraphrase has simultaneously treated the second part: Consumer acquisitions are not assets. In what context can one positively view the advice given? In speculation of any kind, often there exists a relatively short window of opportunity to participate in a potential profit. Notwithstanding risk(s) and time limit(s) involved, the informed view is that a timely profit, so-called special situation, not necessarily large, but relatively unique, makes taking a position through debt worthwhile, especially if the debt service can be carried, amortized or is otherwise short term supportable. This perspective is called speculating, even gambling and is subject to value moral judgment and financial argument pro and con but can be persuasively defended.

Being persuaded is not the same as acknowledging a rigorous arithmetic proof. Speculations are best proven in practice over a long time, not singular indulgences like gambling. Proven strategies over a long time are not speculations. Now what of that class of investment through debt?

For example, consider a loan of $10,000.00 at 5%, say on a home equity line of credit, used to purchase 400 $25.00 each common shares (neglecting commissions). Writing 4, monthly call options on them at a return of 10% simple annualized interest nets 10% – 5% = 5% net profit (excluding option commissions). This is a typical example of constructive debt in a "carry trade": Investment income returns a net profit over the debt assumed to buy the investment. Clearly the financial arithmetic proves this trade has increased the improvement in a standard of living.

What is wrong? There are risks of devaluation of the underlying security (market, microeconomic, macroeconomic, currency, economic, political risks). This inheres from equity possession alone of course, but lowers the value of the respective call options and thusly the gross income on the trade. Writing the options themselves does not expose the writing/selling to option market risk although the underlying equities must be not sold for the option contract duration. The options would have to be re-purchased in the options market at a loss and involving commissions if the stock value decreased to a particular sell point, say 10% decline over any duration of time. In a downturn, the income sold would be reduced by the albeit lower repurchase price les commissions to a degree that can result in a net loss position on the sell and purchase trades especially if the underlying equity is sold at a loss also.

Granted losses can transpire, but financed on debt, one balances known debt against the probability of income exceeding the debt servicing cost. It is best to balance known against known or to a much lesser extent odds against odds. Real losses are best suffered with money that one can afford to lose, that is money that can be replaced through one's labour income. Admittedly no one wants to work to replace losses from a net negative investment practice. There is no free lunch as it were but one employed and capable of the labour can have the capacity of trading losses replacement. Fixed income and/or unemployed investors of wealth do not have the capacity to apply labour toward debt servicing.

A considerable amount of labour and time is required to save $10,000.00 for stock market investment. If lost, then one suffers not more than the loss of the original capital plus a feeling of failure in this trade strategy. The loss of a loan of the same amount involves the obligation to repay that debt and upon total repayment be not any more profitable than prior to seeking the loan. The entire sum may not be exposed to total loss at any one time, but can suffer net losses amid net gains as in three steps forward with two steps back. This is the slow erosion of investment capital under sub optimal trading practice and experience that cannot be known beforehand.

Both the conservative investor and the aggressive speculator must occupy the same investment space affected by the six risks given previously. It is an imprudence, not an improvement financially considered, to willingly undertake known debt against probable if not indeterminate profit especially for those on fixed income and/or unemployed.