STOP BLAMING THE DEBT

How Addicus Defies Conventional Wisdom to Use Debt as a Balance Sheet Weapon

Debt ranks among the most divisive talking points in the world of finance, in part because of multiple decades of rising credit card use and massive abuse in consumer, commercial, and investment spaces. However, while half of the American population is on a mission to scream, "I'm debt free" into their AM radios, some of the world's most successful investors and corporations, like Exxon and Apple, have billions of dollars in cash and other liquid assets at their disposal and opt to carry debt on their balance sheets. This argument is what led average consumers and investors to question Apple in 2015 when the company raised an additional $6.5 billion in debt, despite having hundreds of billions of dollars in cash and assets. The debt is a small part of a strategic global cash flow and investment plan that looks beyond today and tomorrow into the next generation.

01 DEFINING DEBT BY DEFINING ASSETS

Debt can be a very important part of anyone's personal financial enterprise (PFE), but properly structuring that debt begins with defining the types of assets that should be strategically funded by debt.

Houses, cars, boats, and other "toys" commonly enjoyed by the wealthy are lifestyle assets purchased for enjoyment, but these assets are often expensive in upkeep and depreciate. Robert Kiyosaki is right in his book, "Rich Dad, Poor Dad" when he refers to lifestyle assets as "fool's gold" because they don't put money in the investor's pocket. Similarly, assets like primary homes or vacation houses require such investment and maintenance that they shouldn't be considered investments. While a house may accumulate equity over time, the cash tied up in the asset isn't liquid, and the property will likely remain a personal asset that is never monetized at the level of most investments. For this reason, primary residences and second homes are considered a lifestyle asset, not an investment, and shouldn't be part of the debt leverage PFE discussion.

Other assets such as commercial real estate, raw land, business interests, and paper assets similarly have associated costs but are generally created or acquired for the purpose of cash flow and/or appreciation of the underlying asset. Pairing the proper level of debt with these assets can free up resources, and it can greatly increase the rate of return on equity. In these instances, when the borrower's intention is to create additional wealth, the term "leverage" should replace the more negatively associated "debt."

Leverage is the type of borrowing used to amplify returns and should be viewed opportunistically, not negatively. But it should be managed carefully by strategy — like a loaded gun.

02 LEVERAGE: THE ART OF BALANCING FEAR AND RESPONSIBILITY

Much like children are taught zero is the lowest number until their brains can comprehend the more abstract set of negative numbers, people must be taught financial responsibility before they can learn to leverage their wealth. But debt is too often taught as a universally bad thing in consumer finance circles. Teachers, preachers, and call-in show hosts alike say, "Debt is bad," and, "Getting out of debt is good." Consumers are told to avoid any purchase they can't make with cash. To be clear, uncontrolled credit card and high-interest debt is never good, but low-interest, long-term debt can be leveraged for the greater good of a personal financial enterprise (PFE).

The most prevalent reason for society's aversion to debt is fear. Consumers are fearful of their inability to repay a debt if their cash flow becomes impaired. Deep in the belly of every millionaire is a cash-flow concern beginning with the words, "What if?" These fears became a reality for many Americans in 2008 with the financial crisis and market collapse. The "What if?" happened, and debts in the form of mortgages and commercial loans turned into bankruptcies in many cases.

Because of this fear, the average consumer overfunds his or her debts, paying off more than is required or structuring payments in a way that amortizes the debt quickly with the goal of getting rid of the debt as soon as possible to avoid any potential payment speed bumps. The prevailing logic is to get rid of debt as quickly as possible, which sometimes leads to doubling or even quadrupling the normal debt service — creating even more risk and leading to the very cash-flow problem the investor was fearful of in the beginning. When borrowers use their cash assets to overpay their debt, they have diminished access to cash in the event another opportunity, or actual emergency arises.

The second biggest reason for avoiding debt is the financial liability. Obviously, debt has an associated interest cost. When making the decision to purchase an asset using debt, the direct cost of the asset increases, and our cash flow decreases.

When Apple took on $6.5 billion in debt in 2015, the company needed money to complete its stock-repurchasing plan (a paper asset) that would make the company more valuable for investors. Paying cash would have meant bringing its cash assets from overseas hardware sales to the United States, which carried a tax penalty in the neighborhood of 35 percent. Instead, Apple found the asset was more valuable than the debt, and the debt was less expensive than the loss of cash assets. And the company was right. Its debt, which ranged from 1.5 percent to 3.45 percent interest, saw Apple stock increase 30 percent to 40 percent each year. Microsoft made a very similar move in 2016 to avoid paying taxes on repatriated money during its acquisition of LinkedIn.

In 2014, Guardian, an insurance company, issued $450 million in 50-year surplus notes at a 4.875 percent interest rate. In the company's annual report, the issuance was simply described as a low-cost way to fund long-term business objectives, saying the notes are, "... a reflection of how Guardian is determined to find the best opportunities in any economic climate." If the company achieves a return of at least 4.9 percent or more on the $450 million over the next 50 years, it will come out on top.

Debt is not the problem in today's society, and any conversations surrounding it should be recast into conversations about responsibility. There are only two ways to source money for the purchase of an asset: 1) withdraw the money from one of your cash accounts; 2) borrow the money. Purchasing an asset is a conscious declaration that the asset is more than keeping the cash on hand, or that the asset's value outweighs the aversion to debt. Poor decision making is more often the reason debt spirals out of control, not the debt itself. Therefore, it is no longer debt that is stigmatized, but the poor decisions of the chronically uninformed and overextended purchaser.

When paired with strategy and prudent decision making, debt can be leveraged into a cash-flow generator for a person's overall PFE.

03 INVESTMENT STRATEGY SHOULD INFORM LEVERAGE

While leverage is nothing more than access to needed capital for asset acquisition, and debt is nothing to be fearful of, leverage is dangerous when it is not accompanied by and used in accordance with a long-term investment strategy. Using leverage without prudence places the entire personal financial enterprise at risk. Whether using cash or leverage, worthwhile investments should fit the risk parameters of the investment plan. However, the reality is most people don't have a long-term investment strategy associated with their PFE. An Addicus-developed investment strategy leads to a deliberate asset allocation (among private and traded investments), which in turn leads to intentional cash flow and predictable growth for the PFE.

ADDICUS PHILOSOPHY // 1

Debt, used as leverage, should always be accompanied by a well-informed investment strategy.

For the common consumer, what is most often seen is "accumulation allocation" (an allocation developed out of necessity because it was not intentionally planned, but necessitated because single investments were purchased over a period and now, looking at what is owned, needed to be allocated). The sober process of developing an intentional investment strategy (and sticking to it) is key, rather than making large investments from a singular perspective because they "make sense" in the moment. The investment strategy keeps the approach grounded and based on a previously defined set of goals and principles.

ADDICUS PHILOSOPHY // 2

Aggressively paying down debt is the antithesis of protection because available cash is being consumed in the process.

As mentioned, leverage is access to capital. Having access to capital gives the PFE an added level of protection. This is where debt can play a major role in this equation.

Cash is only going to one of a few places. Cash can ultimately be used one of five ways:

1. It can be spent.
2. It can be given away.
3. It can be put in reserves.
4. It can be used for investments.
5. It can be used for debt service.

Other than the cases of consumption or charitable giving, cash used for debt reduction or for investment purposes has the same immediate impact on the balance sheet. The net bottom line is exactly the same. Taking $1 million from a checking account to pay off debt doesn't change the balance sheet at all. Consuming cash to pay off debt puts added risk by removing the ability to use the cash for other opportunities or emergencies as they arise.

3.1 Aggressive Debt Service and Greater Risk

Two men are purchasing a home for the same amount of money at the same 30-year fixed rate. The first gentleman has the goal to pay off the debt as fast as he can, so he continues to pay more than the required payment, while the second gentleman only pays the interest and puts his excess funds in a savings account. Five years down the road, the first man has a significant amount of equity in his home, and the other man has no equity in his house. Both men encounter a financial emergency and find themselves unable to pay their monthly mortgage payment from normal income sources.

Which of the two houses will the bank most likely seek to repossess, the one with the equity built up or the one without? The bank will seek the home with more equity.

Similarly, which of the two men will likely have more financial resources to address the emergency, the man who has spent all his extra money on aggressive debt service or the man who has committed the extra money to savings and now has cash to pay for the mortgage?

Aggressive debt service devoid of strategy puts consumers and investors at more of a risk of the very thing they fear.

04 STRUCTURING DEBT EFFICIENTLY

When structuring debt, Addicus believes it is best to have long-term, fixed-rate debt; non-callable loans; and long maturities.

ADDICUS PHILOSOPHY // 3

Your debt should not mature every year—or two years or five years.

This puts the personal financial enterprise in the passenger seat while allowing the bank to drive. If the investor finds themselves unable to refinance, the bank can then take the asset. In the case where the bank wants to set these terms, paying a little more for the debt may be a worthwhile investment. When we pay a little more interest to get a longer, fixed-term rate, noncallable, or longer maturities, we view it as an insurance premium to guard against unforeseen catastrophes, contingencies, liabilities, etc. Leverage is all about protection and risk management.

For most Addicus clients, all leverage lightning rods back to them, no matter which asset is involved, meaning they are individually responsible as they have provided personal guarantee on debt or leverage instruments. There are no sacred cows — not their house, not their farm, and not their commercial investments. This means Addicus doesn't treat the debt leveraged against one asset greater than another. If a client's home is paid for, but they have a business debt go bad, the lender can then come after any of their assets (even their homestead-exempted home if its value surpasses the exemption). In this instance, debt can protect the home as seen in the previous example.

ADDICUS PHILOSOPHY // 4

Don't over collateralize. Debt is debt is debt. Or, leverage is leverage is leverage.

It doesn't make sense to offer a $2 million piece of property for an $800,000 debt, which would return a 40 percent loan-to-value. Assets must be leveraged to the fullest extent before considering borrowing against other assets. If a lien is required, they will carve out just enough land to give the bank so they don't have a blanket lien on the entire property.

In looking at the total spectrum of a portfolio – the PFE — leverage can be arranged to effectively and efficiently accomplish most goals as long as debt is used strategically. The goal is to minimize the outflow of cash while structuring debt in a way that leaves the PFE in the driver's seat — not force the enterprise to pay debt by any terms other than those that benefit the end goal.

When Addicus organizes leverage, it is done in accordance with a preordained asset priority list. The most attractive asset to leverage is the primary residence, followed by a second residence or vacation home, and then agricultural property or hunting land. These come first because banks and federal land banks will finance these assets on long-term, non-maturing, noncallable loans with attractive fixed interest rates. Following these primary assets, Addicus prioritizes (in this order) owner-occupied commercial real estate, general commercial real estate, and residential investment real estate because it is harder to obtain good financing on these types of assets. Finally, there

AN EYE ON WHAT'S YOURS

are business loans and lines of credit because they typically mature in a very short term and have variable rates.

05 ECONOMICS OF DEBT: IT REALLY DOESN'T COST SO MUCH

Whatever the interest rate, in most cases, other than consumer debt, the government is going to subsidize the interest rate through tax deductions. Today's interest rates are so unbelievably cheap, most borrowing will only have 2 percent net cost or less. If an investment can't make at least 2 percent on a tax-adjusted basis, something is wrong. Unfortunately, most consumers have become disheartened with today's cash earning little or nothing. That may be true today but cash has ancillary earning potential because cash creates confidence and protection. When an investor is sitting on a mound of cash, they are more confident in making decisions in almost every area of their financial life as well as areas of their lives that indirectly affect their financial well-being. They may be more selective in what customers and projects they take on or be willing to take more time off. And they are less likely to pass up good deals while remaining more likely to make aggressive business decisions that will ultimately net higher returns and more wealth. This happens because decisions are being made with a clearer head, confidence, and a sense of peace for a long-term strategy.

5.1 Inflation Goes Up. Debt Stays the Same

IIn 1978, the O'Neal family paid $50,000 for a 1,930 square-foot home on a 3.5-acre lot in the Mountainbrook suburb of Birmingham. The family subdivided two acres from the lot (where they built a much larger home) and sold the original home (minus two acres) for $80,000 eight years later. In 2016, the home was sold again, this time for $685,000. The second home, which was built for $287,000, sold in 2005 for $800,000 and is worth well over $2 million today.

Assuming the O'Neal family financed the original home purchase, these returns far and away outpaced the sub-4% rate paid on the debt used to purchase the assets. Additionally, the O'Neals benefitted from inflation. In 1978, one dollar was worth almost four times its 2016 value. The asset values increased at a greater rate than the inflation (and in part due to the inflation), but the debts couldn't keep up. Holding low-interest debt for long periods of time lets inflation reduce the cost of that debt.

Inflation comes into play with long-term investments. One dollar in 1978 would take four dollars to replace. This means a mortgage of $1,000 in 1978, which was a pretty decent sum of money back then, is the equivalent of $250 today because inflation has wiped out that much purchasing power. Now, that mortgage bill would still be $1,000 if it was somehow financed this far out, but the value of $1,000 today is nothing compared to in 1978.

The house should go up in value, irrespective of whether there is debt on it. If the house is paid for, it won't appreciate any faster than if it is fully leveraged. A mortgage today, in whole dollars, will be the same amount in 2035 as the debt matures, but from a purchasing power perspective, and its emotional and real financial impact, it becomes cheaper and cheaper over time. At Addicus, we believe in taking advantage of inflation to wipe out the cost of interest over time. Considering the house is a good property, it goes up in value over time due to rising property value as well as inflation. Meanwhile, the debt stays the same, the payment stays the same, and it becomes easier and easier to fund because the payment requires less buying power.

There is a lot more opportunity on the upside to do something productive with cash as opposed to using it to overpay debt. Even if the money is put into a low-risk portfolio, access to cash with a net-zero borrowing cost remains.

CONCLUSION

This thinking may go against the grain of everything believed and taught about debt in conventional society, but that is the mission of Addicus: to achieve better results through better informed action. Addicus does not advocate for the masses to run out and borrow money for the sake of accruing debt, but their hope is to cause consumers to reconsider the notion of debt as evil. Debt — or really leverage — can help to achieve financial goals by strategically utilizing it as a tool, and ultimately allowing more control and reducing fear when seeking to acquire valuable assets.

1. Debt, used as leverage, should always be accompanied by a well-informed investment strategy.
   A. Too often a strategy is developed around assets that have been accumulated rather than accumulating investments based on a strategy.
   B. An investment strategy that utilizes leverage leads to intentional cash flow and predictable PFE growth.
2. Aggressively paying down debt is the antithesis of protection because available cash is being consumed in the process.
   A. Debt payments stay the same from year to year, and in fact get cheaper with inflation.
   B. Don't pay down more than you originally agreed to with assets that could be productively used elsewhere.
   C. Good investments and inflation should always outpace debt, investments don't appreciate faster once paid in full.
3. Your debt should not mature every year—or two years or five years.
   A. You should always be in control of your debt, not the lender.
   B. Paying a slightly higher rate for fixed-term debt should be considered an insurance premium against unforeseen contingencies.
4. Don't over collateralize. Debt is debt is debt.
   A. It doesn't make sense to offer a $2 million piece of property for an $800,000 debt.
   B. Assets must be leveraged to the fullest extent before considering borrowing against other assets.