Climbing Mt. Debt: Financial wellness and building wealth with student loans

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Abstract

Student loans do not have to be a barrier to building wealth. All too frequently, recent graduate veterinarians are paying more than their income requires towards their student loans, sacrificing other areas of financial health in order to do so. Financial resources are limited and timing is important when it comes to financial wellness and building wealth. The earlier you can start, the better your long-term self will be. Allocating your income wisely after graduating from veterinary school can help you jump-start your financial plan and build wealth long-term while reducing the stress around student loan repayment.

Key words: student loans, debt, financial wealth

Removing Student Loans as a Barrier to Financial Wellness and Building Wealth

In the first session of *Climbing Mt. Debt: Navigating your student loans and repayment options*, you learn that federal student loans allow you the option to pay no more than 10 to 15% of your discretionary income to manage your monthly obligation. Depending on the income-driven repayment (IDR) plan you choose, you will make payments for a maximum of 20 or 25 years following veterinary school. During that time frame, you will either eliminate your student loan balance, or the remainder will be forgiven when you reach the maximum repayment period. Either way, your student loans are gone. In the meantime, pay what the rules require and look for other more valuable opportunities to grow your wealth and improve your financial wellness.

A Closer Look at Discretionary Income

The IDR plans calculate your monthly payment using a discretionary income formula. Discretionary income for Income-Based Repayment (IBR), Pay As You Earn (PAYE), and Revised PAYE (REPAYE) IDR plans is equal to your taxable income minus 150 percent of the federal poverty guidelines for your family size and state of residence.[1] For example, if your taxable income is $85,000/year with a family size of one, your discretionary income equals $85,000 - 1.5*$12,760 = $65,860. If you use a plan like PAYE or REPAYE where you monthly payment is 10% of your discretionary income, your minimum monthly payment equals 0.10*$65,860 ÷ 12 = $549/month. This is the minimum payment due to keep your loans in good standing whether your student loan balance is $100,000 or more than $300,000. Your first step in working towards financial wellness is to calculate your discretionary income and minimum monthly student loan payment under a plan like PAYE or REPAYE. If you're currently paying more than that towards your student loans, then stop paying more than you have to. There are more financially healthy things you can do with that money that will help you build wealth.

Analyze Your Ins and Outs

Similar to your veterinary patients on fluid therapy, you want to measure your financial ins and outs. Your financial ins are your income. Your financial outs are your expenses. Ideally, your financial ins should exceed your outs. To improve your financial wellness, you have 2 options: increase your ins, or decrease your outs. Both will result in more cash flow that you can use to improve your financial wellness and build your wealth. There are numerous ways to do both. In order to better understand those options, you must first know more about your ins and outs. For a period of at least 3 months, start tracking and categorizing all of your income and expenses. There are dozens if not hundreds of software applications that can help you track income and expenses. Choose one that works for you or you can always use a spreadsheet to start. Included in this manuscript is a link to a Google Sheet[7] that is used as an example of income, expenses, and investment outcomes.

Income

Each time you are paid, examine where the money goes before it even reaches your bank account, i.e. your take-home pay. Categorize your ins:[1] gross income, pre-tax deductions like health insurance premiums, health savings account or flexible spending account contributions fall into the financial wellness category. They help to protect you against known or unknown health expenses. Your retirement contributions contribute to your overall wealth building and preparation for the future. Next up, taxes. At a minimum, you'll have deductions for federal taxes and depending on where you live, state and/or local taxes. If you are an independent contractor, you will need to estimate a specific amount to pay in taxes, usually quarterly. While you may not be able to affect these

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tax deductions too much, it is worth reviewing the deductions to see if they are more or less than is required based on your family circumstances. If you are curious about how these deductions work where you live, try the ADP Salary Paycheck Calculator.

Expenses

Now, list and categorize your major expenses:[1] housing, transportation, insurance, food, student debt, other debt, etc. Expenses are much more personal and vary widely depending on your lifestyle and where you live. You will have to dive in and start working with your own expenses to better understand your outs. The better you can get at tracking and analyzing, the more impact you can make by reducing your expenses.

Build an Emergency Fund

Emergency funds are critical to supporting financial wellness and wealth building. Hope for the best, but plan for the worst. If you have dedicated funds on hand to weather unexpected life changes, then you can avoid credit card debt and relieve the anxiety around feeling trapped by not having funds to make a job change, handle a decrease in income, or whatever curveballs are thrown at you and your family. Most financial experts will recommend having at least 3 to 6 months of expenses[2] on hand in your emergency fund. Knowing your expenses also helps you to start or build your emergency fund. For example, in the Google Sheet expenses example, there are about $3,300 of monthly expenses. That puts your emergency fund target between $9,900 to $19,800. In light of the COVID-19 pandemic, it is probably safer to aim for the 6-month target. To start an emergency fund, look for the highest yielding online savings account you can find using resources like Bankrate.com or Nerdwallet.com and automatically transfer an amount each time you receive income to reach your target. Start with small transfers if you need to, keep adding and increasing when your budget allows, and before you know it, you will reach your emergency fund goal.

Financial Wellness and Wealth Building

Explore opportunities that are before you. Many veterinarians fall into an analysis paralysis around their student debt and budgeting, taking an approach where any extra dollar in their budget goes towards the student loan balance. Using the strategies discussed in the previous *Climbing Mt. Debt* session, most veterinarians can significantly reduce their monthly student loan payment by using the appropriate IDR plan for their circumstances. For example, using the average salary reported for veterinarians in 2019 ($95,460),[5] a minimum monthly payment using a plan like PAYE or REPAYE for a family size of one is $636/month. If you are paying more than your income requires towards your student loans, do your budget a favor and get into an IDR plan. This pegs your monthly student loan payment to no more than 10 to 15% of your taxable income, freeing up cash flow for building emergency funds, paying down other debt, saving for retirement, buying a home, or meeting other financial goals. Next, find a way to maximize your retirement contributions. Whether you are funding an individual retirement arrangements (IRA) or have an employer sponsored retirement plan like a Savings Incentive Match Plans for Employees (SIMPLE), Simplified Employee Pension (SEP), 401(k) or 403(b) plans, understand the short and long-term benefits each provides. Know the annual limits and tax treatments for each and calculate how much it will take to reach the maximum allowable contribution per month or per pay period. Then go back to your budget and work on ways to reach that maximum contribution into that budget. Not only does this benefit your future self when you reach retirement, but it also helps to build an asset that will compound in value over the long-term, building your balance sheet and, ideally, outgrowing your student debt. In many cases, you can reduce your taxes, reduce your monthly student loan payment, and grow that asset balance tax-free over time.

Maximum contribution[6] limits for several types of tax-deferred retirement accounts in 2020:

- Individual Retirement Accounts (IRA, Roth and/or Traditional): $6,000
- SIMPLE IRA or 401(k): $13,500
- SEP IRA: the lesser of 25% of the employee's compensation, or $57,000
- 401(k) plan: limit on employee elective deferrals is $19,500
- 403(b) plan: limit on employee elective deferrals is $19,500

A common trap is comparing student loan interest rates to long-term investing returns. This is a false comparison. Student loans operate on simple interest, meaning your interest is only calculated on the principal and that interest is not capitalized (added) to your principal. Essentially, your student loans do not compound. However, your long-term investments should and do compound in your favor. When you invest, each dollar earns interest and that interest then earns more interest, a phenomenon known as compounding. Investments that compound will always outgrow things like student debt or your mortgage which operate on simple interest.

Another way to compare the interest accrual on something like your student loans against investment returns is by using the VIN Foundation Student Loan Repayment Simulator[8] and reviewing the effective interest rate calculation. Quite often, student loans repaid using an IDR strategy can have effective annualized interest rates that are extremely low, which further supports investing over paying more than your income requires towards your student loans.

Focus on Increasing Income, Long-Term Asset Growth and Appreciation

Personally, I believe home ownership is one of the cornerstones to building wealth. You will find others who

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say that since the great recession of 2007, you may be able to achieve a higher rate of return by renting and investing the difference between your rent and potential mortgage depending on where you live. My experience has shown that I can more easily and quickly outgrow my student loan balance through home ownership than by renting. But I also live in an area (Denver, CO) where the monthly rent and mortgage payment are about the same, with rent sometimes being more than a mortgage payment depending on the specifics for your mortgage.

Even with student loans, you are able to buy a home. Save up enough to put at least 20% of the purchase price down to eliminate any private mortgage insurance (PMI) payment. It is very hard to save up enough for a home purchase if you are paying more than your income requires towards your student loans or you are assuming you have to pay your student loans to zero before you can buy a home. Using an IDR plan frees up cash flow that you can use to save for a down payment and show a bank that you are worthy of a mortgage.

Veterinary practice ownership can be an even more powerful driver of wealth. As an owner, you can draw a salary, dividends, and generate growth and practice appreciation for a successful business. From a recent AVMA report,[4] "...associate veterinarians who graduated in 2010 or later were out-earned by practice owners by almost $70,000, with associates earning roughly $90,000 and owners earning roughly $155,000." A practice purchase, buy-in, or start-up are all attainable, even with student loans. Similar to a home purchase, practice ownership requires cash on hand. Since you never know when an ownership opportunity may present itself, be prepared to take advantage when/if it comes along. That means you need cash reserves, a strong balance sheet, credit history, and business plan to be considered for a practice loan. Just like with a home purchase, your student debt will not prevent you from practice ownership. However, how you manage your student loans can impact your ability to buy a practice if your monthly payment is too high of a percentage of your monthly cash flow before or after the practice purchase.

There are many other investment opportunities that you might consider that can also help to grow your wealth. Nearly all of them will require cash on hand and strong cash flow to pursue. Any of those successful opportunities will also be a better use of your resources than paying more than your income requires towards your student loans. Federal student loans are either eliminated because your income allows you to pay the balance to zero or it is forgiven after 20 or 25 years of repayment. Either way, it is gone. Forfeiting the time of allowing your other investments to build and grow while you work to eliminate your student loans is very difficult to recoup. Allocate resources strategically to maximize your return and growth. A recent short video by CNBC illustrates how time can impact long-term investments.[3] The obvious conclusion is the earlier you start, the more you will grow your investment and the more of the returns result from compound returns rather than cash you contribute. It is a really powerful illustration of the effect of time and consistency on investment returns. The provided Google Sheet is an adaptation from this illustration so you can test various monthly contribution and rates of return for your situation.

Stacking Financial Incentives

IDR plans are based on Adjusted Gross Income (AGI). There are incentives in the tax code that encourages you to save for retirement, save for short and long-term health expenses, have health insurance, buy a home, have children, etc. Some of these incentives have direct impacts to your AGI, thereby reducing the amount you pay in income taxes and the amount you pay towards your student loans using an IDR plan. For example, if you were to contribute $19,500 to your 401(k) retirement plan each year ($1,625/month) from age 30 to age 67 and average a 5% return, you would have a bit more than $2,000,000 as you approach retirement. Of that, you contributed $721,500 and the rest was all compound returns - interest on interest. Try the Google Sheet[7] to adjust inputs for your situation.

In most cases, the $19,500 you contribute to your 401(k) will save the average veterinarian about $5,000 in annual federal income taxes. If you are using an IDR plan like PAYE or REPAYE, you will also reduce your student loan payments by about $2,000 per year by lowering your taxable income by $19,500. This is one example, but the same incentive applies to health insurance and health savings account contributions. The more you stack these incentives, the better your overall financial health and the more wealth you can accumulate over time.

Your Forgiveness Plan is an Asset

If you choose to utilize an IDR plan, there is a chance you will experience student loan forgiveness. If you have a balance remaining after making the maximum payments, the remainder is cancelled but treated as taxable income to you. The tax due on student loan forgiveness should not dissuade anyone from utilizing IDR. Not only is time on your side, but in many cases, forgiveness results in a discount on your total loan repayment costs. Use the VIN Foundation Student Loan Repayment Simulator[8] to project your student loan costs and whether or not you will experience forgiveness. If so, plan for it. Allocate the appropriate amount in some type of investment account(s) that will assure you have your anticipated tax amount on hand when forgiveness occurs. While you are building your forgiveness planning fund, this will also serve as an appreciating asset on your personal balance sheet that will help to offset the student loan liability on your balance sheet. The returns from your forgiveness planning fund, your home, retirement accounts, practice, or any other types of investments can quickly exceed your student loan balance in the near term and help you build wealth and be prepared for the day when your student loans no longer occupy a place on your balance sheet.

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Acknowledgement

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