IFB289: Problems and Pitfalls of Investing with Debt

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Dave

0:00

Alright folks, welcome to Investing for Beginners Podcast. Today we have episode 289. Today, Andrew and I are going to talk about the pitfalls and problems that could come with investing with debt or using other people's money. And Andrew and I were talking about a event that I went to recently, and a lot of people were talking about real estate and some of the ways that they invest. And debt was something that came up a lot. And Andrew and I thought it would be a good idea to talk about debt can be good, but it can also be bad. And maybe we could talk about some of the problems and pitfalls of investing with debt, whether it's real estate or whether it's stocks, there are certainly some advantages, but there's also some risks that need to be considered.

And we thought maybe we could help illuminate some of that for beginners. So maybe let's talk about kind of go back to the beginning, like, where did you kind of learn about this idea of like, you know, I guess not necessarily investing with debt, but just the idea of, you know, financial freedom and kind of becoming your own independent investor, I

Andrew

1:04

guess, I'll shout out to Robert Kiyosaki, he has this great book called Rich Dad, Poor Dad. And it's a super good intro just to the concept of money. Because if you think about money isn't really taught in schools, it's not necessarily something that somebody will speak openly to you with. But money is a tool that you can use to give yourself great freedom later on in your life. If you can grow it responsibly, so rich, Dad, Poor Dad is all about building passive streams of passive income, which is this idea of your money making more money, you build enough of those streams, you're gonna have a pretty nice life, as far as monetary wise. So I remember reading about that concept. Oh, no, I was young, like, maybe teenager or younger. And something about the passive income thing really stuck out to me. And it's a very, very powerful concept, I guess, fast forward, like a decade, and I ran into Dave Ramsey. And he kind of smacked some of those ideas right out of my head. Because Dave also believes in finding financial freedom, but he talks about do not use debt in any circumstance at all, because there are a lot of risks that, that I think, don't make themselves obvious. And then the people like the people at the bank, who are going to give you the money that you can borrow, they're not going to tell you these things. So you know, the people who want you to borrow, they're not going to tell you these things.

And so it is a topic, I think that is worth discussing, even though it can feel like a slap to the face a little bit. Because that and investments is one of those things that you're like Warren Buffett said it best, and I can't think of any other better way to say it, you don't see who's swimming naked until the tide goes out. And investing with debt works until one day, all of a sudden it doesn't. Or until one day you get fed up with all of these hidden problems. That all of a sudden, you know, it's been a huge mistake. So I think thinking those things through before just diving into the hole, using debt as leverage and using that as a tool to grow wealth, it needs to be talked about more, and people need to be very, very careful about it. Especially starting with the stock market. Right? Yeah.

Dave

3:28

So let's I guess let's dive into that. Let's talk a little bit about investing with debt. So we're really talking about personal like retail investors investing with debt, as opposed to whether Microsoft carries too much debt on their balance sheet. So what, what would be some pitfalls? Or what could be some, I guess, problems? Maybe we'll start let's do this. What are the upsides of investing with debt? How can you benefit from it. So mathematically,

Andrew

3:55

you can get this thing called levered return. I think it was a rod who had that video on Instagram talking about this, just trying to show people the basics of so you can invest and you can make money and that can grow and make you more money. But if you use debt, when you invest, now, all of a sudden, you can multiply your returns. And then the compounding happens much, much faster. So I don't have like a great numbers example, like he did to share on the show today, but the way it works is you can grow. You can mushroom the amount that you can borrow, much, much, much, much more much, much faster. Because you can take a little bit of money and expand it to a lot when you borrow.

And then if you do that two or three or four or five times you can have returns that are 234 or five times what you again if you didn't use debt. But the problem comes in, especially in the stock market. When you invest with debt, you're basically have like a ticking time bomb that's working against you. So when we invest in the stock market, we talk about buying in businesses that are going to grow over the long term with the growth of the economy, but in the short term, as you mentioned in a recent episode, in the short term, it's like a wild roller coaster.

And just because you buy today, in six months you sell even if the economy grew in that time, your stock might be down. So when you are buying with debt, you have to be right on your timing. And you got to do it fast enough so that the ticking time bomb doesn't destroy all your capital. So there are two things right there that are working against you. That make it so it's very, very hard to consistently win with debt. How do you see kind of debt and leverage and even options maybe in the stock market? How does that all play in your head?

Dave

5:45

I guess it doesn't. And I think mostly it doesn't, because it's not something that ever really appealed to me. And it didn't make it felt to me, like, it's probably just a bias of mine. So take that for what it's worth. It felt to me like gambling. And I didn't look at the stock market as gambling. And that kind of investing makes it feel to me like gambling, like you're really taking really, really big swings in the hopes that those will come out. Okay. And if I'm not mistaken, I believe some hedge funds or a lot of hedge funds use this kind of investing style as a way to help improve their returns. But they're also playing with a lot more house money than I am.

And so it's probably not maybe as dangerous for them, as it is for a retail investor. And I guess what I disagree, I don't know enough about it to say that with any firm conviction, it's just a speculation on my part, purely. So again, take that for what it's worth, you know, I think it's, it's something I just have never considered doing. It just doesn't really enter my mind as a way to invest in the people that I look up to and admire and have invested for a long period of time. That's just not the way they do it. And so it's just never appealed to me. It's like I never smoked, I know it was never had any friends who smoked. I was never around anybody that smoked.

And so I just never was tempted to do it. And kind of the same thing with debt or working with options or, you know, levered ETFs, or any of that kind of stuff. It's just never entered my vocabulary.

Andrew

7:26

Well, lucky for the audience, I've smoked, I love to gamble, I've traded options, and I am telling you, it is not worth the high. It is investing with that does not work because you have to pay interest on the debt. So when you pay interest, that's an expense that's coming out. And if that's coming out every month, every year, every week, whatever it is, if your margin or if you're playing the options game that's coming out over time, in the way that the option is decaying. But what however much the interest payment that you're paying is coming out, you're not going to get a good game to offset that in any given month, week or year.

Because some years we have the market go down 20%, then could fall another 10%, then they could fall again 2000 2001 2002. Or it could fall and then go back up. But where you sit on that is you don't know where the markets gonna go for the short term. And so at a certain point, you've run out of money, or if the stock goes down, you have to put more money in just to keep your position open.

That's called a margin call. So in the same way that they can mushroom on the way up, and you can expand your returns, it can also mushroom on the way down, and you got to keep throwing money into it in these margin calls, because they need more collateral to cover your you're borrowing. Otherwise, they're gonna close your position out at a loss. So you have very dangerous things, and they're working against you. At any given point in time. If the system becomes unbalanced, you can get really screwed over. And does the system become unbalanced?

Dave

9:12

Yeah.

Andrew

9:14

Yeah, it does. And that's the one thing we see over and over again with the market. So that's kind of hopefully, if it sounded appealing, or it sounded logical, it's something to reconsider. Because when you look over history, and you look at the math of the history of the market, and what you're paying when you borrow, that should be considered more greatly than Ooh, how much can I make tomorrow?

Dave

9:38

So can you think of the interest that you have on the debt as like a hurdle rate? Like if you're paying 5% on a loan, you have to earn at least 5% from your investment, just breakeven, is that would that be a fair assessment?

Andrew

9:53

Yeah, yes, that would be fair problem being again if the investment goes down, because you have to put collateral Okay, so, you know, even if you're able to borrow $100 on the dollar, you still have to put something up to that ratio. So if if it goes down, you have to put more than more than you had put in to make up the extra borrowing. Right. Okay. So that's your boy, to your point to things like kind of to the question you asked. Now, obviously, you have to make that much more than a normal investor who didn't borrow would have to make because like, you're saying you're paying that expense, just to be in the game. Right?

Dave

10:29

So how would this correlate to real estate investing, then?

Andrew

10:33

Well, I, you know, you can say you can argue with real estate that it's a lot more safe. And I'm putting that in quotes, because the income is steady. And it's not like the market where the market goes up and down, and up and down. And up and down. You don't see the price of real estate quoted every day like it is in the stock market. So we don't think of it as going up and down and up and down and up and down. But does it really, I don't know, the problem with the whole real estate thing is feels like stable cash flows when you're renting out your properties. But that really depends. And even you look at the best real estate companies like commercial real estate investment trusts, or residential real estate investment trusts, they don't have 100% occupancy, there's less than 100% occupancy.

And that changes depending on the economic conditions, it changes based on the geographic location. And at least for real estate investment trust the REIT, they might have 100 properties or 500 properties that they can spread that risk over. So their vacancies seems really low. You have one or two properties, and you have a 50% vacancy on two properties. Yeah, now listen, you're underwater on your loan. So, you know, there's so many examples of things that can go wrong, as a small time real estate investor. And that's not even talking about the debt part. But when you add in the debt makes it that much worse, that much more risky. And even though you can do the same math to show look, I'm making higher returns than I would in the stock market. Because I'm using debt, you can really be crippling a lot of different areas of your life, in ways you might not be thinking of now, because you either haven't had the experience to live through different real estate markets, or you haven't studied the history of real estate markets, or you just haven't used your imagination to think of, well, if this happens, what how can that happen.

And that's the problem with debt is when you mix debt with investments, there's a million ways it can go wrong, that you're not thinking of. But no matter what reason it goes wrong, you have to pay that payment, they don't care if you got divorced, they don't care if you lost your job, so many different things can go wrong, you still have to make that payment. And that makes it really, really hard.

Dave

13:05

It does make it really hard. And it's I think sometimes people get drawn into the allure of real estate. It's kind of like all those years I've worked in the restaurant business, I can't tell you how many times people would come up to me and say, it must be so exciting to run a restaurant or to be in the restaurant business. And a lot of times, I would just kind of look at him and give him just kind of glare at him and go, yeah, no. Let me tell you about how sexy it is. You know, last night I was, you know, cleaning lobster guts in a suit. And my tie dipped in the lobster guts.

Later that evening, my Thai caught on fire. And one of the little candles that we had at the end of the table, the sewer backed up in the bathroom and the employees bathroom and I had to clean that out. And our dishwasher or one of our dishwashers sliced his hand really bad. And I had to send another manager to the hospital with them. Which means that I had to wash dishes for about four or five hours. So again, tell me how exciting and sexy it is. It's an industry I loved. And I did it for a reason because I enjoyed it. But I think from the outside, people can look at something and go, Wow, that's super exciting. You know, it must be super fun to like, start your own restaurant and open it and it is until you have to start paying bills.

And then then it becomes a lot less fun when you have to pay your employees and you have to pay the insurance and you have to pay for rent and all those fun things. It becomes very expensive very quickly. I suspect that not owned real estate myself. I suspect that there's a lot of people out there that think this kind of had the same illusion that you know, it would be awesome if I owned five or six properties and I could rent them out. And you know, how easy would it be you just find somebody to manage it for you and then you don't have to worry about it. Well, it doesn't like doesn't always work that way. Like Andrew said there's 1,000,001 different reasons why things can come up that you're gonna have to get involved. Have and get your hands dirty in debt is one part of those the equation that you have to figure because if you start buying real estate and you don't have any collateral or your credit score, isn't that awesome, you're gonna have really high interest rates, you're going to pay on that debt.

And that's gonna eat into your returns that you can generate from the difference between the rent that you charge and the money that you pay the bank for the mortgage. And if you're paying 15 20% for a mortgage payment, good luck trying to mark up a home 15 or 20% or 30%, just so you can make 10%. So those are all things that have to be considered. When you're thinking about investing within the real estate market with debt if you have the means to do so it becomes easier, but if you're trying to do it, you know, bootstrap your way in, it can be a really, really hard struggle. And I'm not saying it's not worth it. But I don't think people should go into it, you know, Misty eyes and think that this is going to be all glamour, and I'm just going to be traveling the world why I make all this passive income from these properties I own it's, it's there's a lot more involved to it, than I think people want to always understand or admit

Andrew

16:13

so did you have to ever evict somebody who didn't pay their bill at your restaurant? Because they went through a job loss and a divorce and had their dog die?

Dave

16:24

I'll never do that. Never ever, ever, ever, ever had to do that. I did have people that would argue with me about the bill for sure. But I never had to evict anybody because they lost their job. For the most part. They weren't coming out to eat looking for a freebie you have an occasional person? You know, I remember a few of them saying to me, what do you mean, I have to pay? Don't you know who I am? I'm super important. I don't know who you are. I'm sorry. My boss expects me to collect payment for everybody that sits down. So yeah, you're gonna have to pay sorry.

Andrew

16:55

What about like the whole HELOC thing? Because you worked in the banking world for a little while. That's one of those that gets talked about a lot as just tap the equity in your house or HELOC, what's a HELOC? And what are your thoughts on that and using it to buy properties as investment? Well,

Dave

17:13

I guess a couple of things. So first of all, a HELOC stands for a home equity line of credit. And basically what that means you can take out a loan revolving or not against the equity in your home. So if you have just use easy numbers, let's say you have $50,000 of equity in your home, you can get a fixed loan for that where you get $50,000 from the bank, and then you pay him back and then you're done. Or you can get what's called a line of credit, which is kind of like a credit card. But it's there's no plastic, and is revolved. So if you pay back some of it, you get some of it available to us again. And I helped people get HELOC when I was in the bank, and the majority of them were for home improvements, there were a couple people that were wanting to do that to get to lower their student loan payments.

And that was highly frowned upon. And I think one of them actually didn't get the loan because the interest for the HELOC was actually higher than their student loan payments. So their debt, the interest that they're paying for the student loan was actually lower. So it wouldn't have made financial sense for the person to do that. So the banks, but there were a few people that wanted to do that to try to buy some properties. And the mortgage banker that I was working with really put the kibosh on that he was very, very, very much against that.

Because the interest rates at the time the bank were charging for the key locks were around eight to 10%. And he said that's too high, if you're going to go out and try to buy a property and rent it out. Good luck getting a mortgage payment that somebody will rent consistently for eight to 10% above the going rate for a home because that's a challenge. And he was very much against it. He did not think that that use of debt for that kind of thing was a real good idea at all. And I would agree with him.

Andrew

19:04

What year was curious,

Dave

19:06

that would have been right around the time of the great financial crisis.

Andrew

19:13

Okay, so people were still shell shocked from Yeah, the aftermath of that? Yes, I asked, because I'm curious if maybe some of the lending standards have changed since and then people are doing those out more.

Dave

19:28

I remember reading a few years ago, during the pandemic, there was a huge increase in heliox being issued by banks because a lot of people were going to the bank to refinance their home or take out equity in their home because interest rates were so low. At that point, the mortgages were 2% Two and a half percent or something crazy like that. So people the HELOC market went nuts for about six months to a year. And then it started to cool off once the interest rates start to rise.

Andrew

19:59

So let's Say the bank does approve somebody for that. And you know, I understand the logic, you're tapping the equity, you're going to use on a renovation. So what you spend on the renovations almost like an investment because it makes your house higher value. What are some of the downsides are the risks that come with doing exactly what we're talking about here.

Dave

20:20

The first well, there's a couple. Number one, the if the values around you fall, there's a real good chance the value of your home is going to fall, as well. And most he locks have a term limit five to 10 years depending on how you work it out. So if you have a five year HELOC, that means you have you borrow 50k, you got to pay that 50k back in five years. And if it doesn't, then it reverts to a fixed term loan. And it can go for a higher rate than what you got the HELOC for. So for example, if you bought a home, let's say you took $100,000 out and you went out and use that to buy some investment properties to rent out. And you don't pay off that $100,000 in in the first five years, and it converts to a fixed term loan, and you borrow that 5%. And that's what you're basing your rentals on your rental rates on.

And then the fixed warrant loan goes into effect that now it's 12%, you just lost 7% of whatever potential you had rent that you're paying, because now you got to pay more higher interest rates, higher payments on that debt. If the if you want to continue to use the equity in your home, because five years have passed, you may have earned more equity in the home, but the value of the home has fallen because the market has fallen for example, then you won't be able to borrow as much. Because you have to once the term ends on the HELOC, you have to go back and reapply for it. And they will base it on the value of the home at the time of the loan, not what it was when you first got the loan. So five or 10 years, the your house could devalue for a myriad reasons, which means that you would have less money to borrow. And which means you would potentially have less money or you'd also pay a higher rate too. So there's all those, I guess considerations to take into account. And then there's just a simple fact of the matter is the bank doesn't care if you got a job or not.

And they don't care if the rentals are rented or not. And let's say the market goes south and the properties that you're renting, their values go down, and people are not dumb. And if they're renting, chances are you just gotta go to Zillow and see how much the house is worth that you're renting. And you can pretty quickly figure out what it would be valued at to buy it. And then you know, if you're, you know, if they think that they discover why am I paying 30% markup on this home, it's not worth that, you know, I'd be better off buying it, they're gonna leave. And you know, they're not going to stay, or they're going to come to you and try to negotiate a lower rent, why they're living there. And all those things can eat into your income. And so those are all things that can and will happen, you know, during the time that you're trying to rent, rent these properties.

So it's not, there's just things you have to account for, you have to consider all those factors, when you're considering buying a home. And the other, I guess the other aspect to buying a property like that. It's not like selling apple in the stock market, you can't just go on your app and sell it in five minutes. If you all of a sudden decide you don't want to be in his business and you want to liquidate your holdings, it can take some time, especially depending on what the what's going on with the market two years ago, you could have sold it for a ton of money. But now, I don't know, you know, it might be a lot harder. And you might get a lot less than you paid for and now you're upside down on that too. So those are all things you have to consider before you go into that you know the whole business and you have to consider before you take out equity in your home to do something like this.

Andrew

23:55

What happens to a HELOC if the interest rate goes up, and I mean like interest rate as in the interest rates that we all are affected by from the Fed to the ones at the bank, but the ones that are all tied the mortgage the treasuries if all the interest rates are moving higher. How does that affect the HELOC?

Dave

24:17

I think it depends on the HELOC and what the contract will stipulate. But in a lot of cases, if it'll be like a credit card, it'll go up it'll rise just like the credit cards do when they raise their bed rates that Capital One raises their rates on their credit cards and a lot of banks will probably do the same thing with a HELOC. I think it depends on what you negotiate with the contract stipulates some are fixed rate and but some will be variable and a lot of it probably depends on your credit score as well and what kind of rate you're gonna get.

Andrew

24:45

Yeah, I guess if it's a revolving, then that's very similar to a credit card and it is those move people like we saw 40 years of falling interest rates for everything for mortgages. The Treasury As the Fed, it's all tied, or maybe two to pretty much two years ago. And now they're climbing back up, and they climb back really fast. So I think a lot of people are maybe betting that interest rates fall back to where they were, over the last 10 years, 15 years. That's not necessarily the case.

So now all of a sudden, you're going into the banking industry, and you're playing with interest rates. And, you know, you're gonna start buying interest rate hedges and all this stuff. Like it's, that's a tough business. And there's a reason why the big banks have all these people work for them to try to figure out how to manage interest rate risk, there's additional risks, even the rest of them everything blowing up, you have lots of ways you could go negative on your, your expected cash flows.

Dave

25:51

Right? Exactly. For me, if I was going to go into if I was going to start doing these types of investments, I would have to create a checklist of all the things that could possibly go wrong, and try to figure out how I could offset those. And kind of like, you're not going to be able to mitigate every risk, just like you can't when you invest in stocks, but trying to figure out a way to have some sort of margin of safety, to anticipate the downsides to help protect you, I think is a great way to go. And it kind of goes back to, you know, investing in margin and being really tight on the money. It's a gamble, it's a risk. And you have to be cognizant of that when you walk into it, that it's not going to be all sunshine and roses that there will be times where it'll go down, and you got to be prepared for that.

Andrew

26:37

Well learn from the whole Circuit City bankruptcy example, which I've used in the past. And it really again reinforces this idea, you only know who's swimming naked when the tide goes out. Because when the tide goes out, that's when a lot of things kind of domino effect on themselves. And in this case of Circuit City, they had all this inventory. And suddenly, when there was a slowdown, and people wanting electronics, they had way too much. And they ended up collapsing, even though they were opening new stores.

They had revenues that were growing their earnings that were growing. But when you don't manage your risks, and you don't think what's the worst case scenario, and am I protected from that, then anything could happen to blow you up a pandemic can happen the boy up a million things can happen the boy up. So in the stock market, we look at like, what's the maximum liability here? Can the company cover it? Or do they have it spread out? You're gonna have it lather, does the debt lather? Well, it's not all a balloon payment. Those are the things you look at with stocks, I would imagine with real estate, there should be similar ways to do it.

But you want to start at the what's the worst case scenario, and just assume it's going to happen, because there could be, you don't know why it's gonna happen. But something will trigger something. And if you know that your worst downside risk is covered, then you should feel much, much better. And that pretty much disqualifies anything that's a floating rate, in my opinion, because rates can go, they can move like crazy. So if you're that's not fixed rate. You really don't know what your potential downside is.

Dave

28:20

Yeah, yeah, exactly. Right. All right. Well, with that, sorry to be Debbie downers, we just want to make sure that everybody's protecting themselves, and is aware of the potential risks. That's our job here, so that

Andrew

28:33

they can not like me, as long as you don't

Dave

28:36

know, I think our job is is to make sure that everybody understands you know, that they need to invest with a margin of safety, whether it's stocks or whether it's real estate. All right, so that's gonna wrap up our show for this week. Don't forget to subscribe to the show on your preferred podcast app. If you enjoyed our little show. If you would kindly consider giving us a review. It greatly helps our show.

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