Tapping into an asset's borrowing capacity can often be more useful than selling the asset itself. In our view, borrowing strategies are best used to achieve four main objectives. (UBS)

Borrowing in retirement

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Many families choose to pay down debt as they enter retirement. Although debt isn't for everyone, borrowing strategies can be an effective tool to unlock the full potential of your wealth and achieve your retirement goals.

How do families borrow?
When we look at how the average family uses borrowing strategies throughout their lifetime, we see a clear trend:

During the **early career** phase, families use debt as a tool to pay for college, buy a home, and to build credit.

In **mid-career**, families continue to tap into borrowing capacity, but their total debt rises more slowly than their net worth. During this phase, families tend to prioritize paying down student loans, car loans, and credit card debt at this stage, while continuing to accrue real estate debt.

When **transitioning to retirement**, families tend to pay down their debt balance in absolute terms. During this stage of life, it's more common to tap into securities-backed lines of credit (SBLs) and home equity lines of credit (HELOCs). We also see a rise in the “Other debt” category, which includes medical debt as well as loans from retirement plans, life insurance policies, and other non-residential assets.

During retirement, family debt continues to fall as a share of net worth, even as many retired families spend down their savings. During this phase, we see many families choosing to fully pay off their debt balances.

In our view, this pattern of deleveraging isn't entirely rational. While many families view “debt” as offensive as other four-letter words, we believe that borrowing strategies are an important tool for achieving your goals.

Why borrow in retirement?

Most assets on your balance sheet can be used to support a loan. Tapping into an asset's borrowing capacity can often be more useful than selling the asset itself. In our view, borrowing strategies are best used to achieve four main objectives:

1. As a temporary "bridge loan": To provide cash flow while you wait for income from a real estate sale or other liquidity event, and you do not want to sell your other investments because of tax consequences or opportunity cost (the earnings that you will miss while you're out of the market).

2. To manage taxes: Borrowing can help you to defer realizing capital gains taxes from liquidating investments. If you are able to defer capital gains taxes until you pass away, you may be able to avoid capital gains taxes entirely because your estate may receive a step-up in cost basis. For some types of loans (like mortgages or credit lines), some interest may be tax-deductible. See, "Advanced Planning: Tax-aware borrowing," for details.

3. Boost return potential: Borrowing to invest can often enhance your return potential. A 60% stock, 40% bond portfolio would have outperformed its borrowing cost in about 73% of all 2-year periods since 1988, adding around 3.3% to annualized returns.

4. To enhance diversification: If you are harvesting capital losses and deferring capital gains for many years, this will naturally leave your taxable accounts with an increasingly concentrated portfolio, often with the bulk of their value held in a handful of stocks and sectors. This "structurally illiquid" result is common for retirees—especially those who are aiming to defer capital gains in order to get the stepup in cost basis at death. If this is your situation, you may want to consider borrowing against your concentrated assets to enhance your portfolio's diversification. By adding investments that are less correlated to the bulk of your net worth, the careful use of leverage can help you to improve he risk-adjusted return on your net worth, and provide you with assets that can succeed even if your concentrated investments struggle.

Conclusion

When managed prudently, borrowing can lead to favorable outcomes. Borrowing strategies incur explicit interest costs, but help to reduce the opportunity cost that is incurred when assets on your balance sheet aren't fully invested to help you to grow wealth and generate income to support your retirement spending (as well as your inheritance and philanthropic goals).

Maintaining some strategic leverage in retirement is likely to result in more growth and income potential to support retirement spending as well as inheritance and philanthropy goals. Borrowing capacity can also be a valuable tactical tool, providing an alternative to locking in otherwise temporary market losses and/or realizing taxable capital gains.

Ask your financial advisor about how you should think about debt as a tool in your financial plan and your investment strategy. Your financial advisor may also be able to help you find ways to utilize borrowing capacity to enhance your estate planning and philanthropic strategies.

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Read the full report **Modern Retirement Monthly: Borrowing in retirement** 28 February 2024.

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