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ENRICHING INVESTORS

Understanding The Difference Between Good Debt & Bad Debt

By Robert E. Caplan, MBA, CFA

Before the advent of easily accessible consumer credit, cash was king. Most, if not all, purchases were made with cash, and Americans embraced the concept of saving up for big-ticket items. Today, only about 40 percent of transactions in the U.S. are paid for with cash. Credit cards and on-the-spot financing are increasing the payment of choice. So how can a savvy consumer figure out when they should go into debt for something?

Good vs. Bad Debt

Is all debt bad? The fact is that understanding debt is similar to tracking your cholesterol. There is both good debt and bad debt, and to remain financially healthy, you need to understand and manage the two. It's virtually impossible in today's economy to not have debt. Having well-managed debt helps to establish a better credit rating.

To make the distinction between good debt and bad debt, you have to know the difference between a "want" and a "need." Money borrowed to pay for something that you "need" and that will appreciate in value is good debt. Borrowing for things you "want" and that usually depreciate in value is bad debt.

Taking out a home mortgage is probably the best example of good debt. Mortgages are good debt for a number of reasons. First, they allow you to purchase an asset that will probably appreciate over the course of the loan. Secondly, the interest is income tax deductible. Finally, the interest rate on mortgages (currently around 3%) is much lower than what you pay on other forms of debt; for example, credit cards average 17.55% annually.

Student loans utilized to obtain a degree that will expand your employment and lifetime earning prospects are also good debt. Commercial loans for real estate or business expansion fall in the good debt category, provided you have a well-thought-out plan to generate cash flow to service the loan costs.

Basically, bad debt provides no positive return on your investment. Credit card debt — in the form of unpaid balances — is bad debt in most cases. The double whammy with credit card debt is that you pay not only interest, but penalties as well. Borrowing money from your 401(k) plan is rarely a good idea. If you don't pay it within five years, you could get hit with heavy early withdrawal penalties. So, don't do it unless it is absolutely necessary.

The Gray Area

Not all debt falls neatly into the good or bad category. As in life, there is always a gray area. Taking a loan out to purchase a car is a good example. On one hand, it could be considered good debt because a having a car will allow you to go to work to earn money. But, if you buy a very expensive car and stretch the financing over five years, your transportation choice may have turned into a bad choice.

Debt, both good and bad, can also help you establish a better credit rating. Credit agencies don't differentiate between the two when determining your credit score. Just be careful to not let your debts total more than 36% of your total gross income, or your credit score will get dinged.

The best litmus test for determining good or bad debt is whether the money will be used for something that will have a positive or negative effect on your financial situation.