Good and Bad Debt

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You've probably read articles that talk about 'good' and 'bad' debt, but what, exactly, is the difference?

The simple answer is that good debt is borrowing in order to enhance your future net worth or personal prospects. You might put a home mortgage in this category, since over time homes tend to appreciate, and in the meantime, you have the roof over your head to keep off the rain.

Borrowing to pay for higher education might also be considered good debt, but there's a fine line there. If the degree you're financing doesn't lead to a job that will generate enough income to pay the interest on the student loan, then the debt moves into the 'bad' range.

Small business loans, if the money is used wisely, can be considered good debt; they firm will add staff, or a marketing budget, or otherwise use the loan proceeds to raise the value of the company. Of course, is the money is not deployed wisely, or if the projects invested in don't bear fruit, then we can retroactively say it was bad debt. Almost a third of small businesses fail to survive their first two years, so startup money is more likely than not to eventually fall into the bad debt category.

There are numerous examples of bad debt, but they tend to fall into a few categories. Buying luxury items that you don't need (think: an 80-inch TV, or a very expensive automobile that also happens to be a gas guzzler) immediately fall into the bad debt category; if you really want or need those things, it's better to save for them, pay cash, and avoid the interest rate charges. Especially problematic are those second homes on the waterfront that not only put you in debt, but also incur annual maintenance costs.

How do you know when you have too much debt? The Debt.org website suggests that if your monthly debt payments come to more than 43% of your monthly income, then it becomes a red flag to potential lenders. For instance, you probably won't be able to get a mortgage if your ratio exceeds that amount.

There are a variety of debt consolidation options that can help people who fall into this 'deeply in bad debt' category, but they only work if the would-be consolidator is disciplined about paying off the consolidated debt on time each month, and is able to control spending (i.e., not racking up more credit card interest) going forward. It always helps to have a plan, even when the financial plan is focused on the debt side of the balance sheet.

Sources:

https://www.debt.org/advice/good-vs-bad/

If you have any questions about this article or want to discuss your family finances, investment portfolio, or financial planning advice, please call on me anytime at my number (215) 325-1595 or you can click here to schedule a meeting.

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