When Debt is Good

As strange as it sounds, debt isn’t always a bad thing.

Debt can help you acquire new assets, earn more money and survive lean times. The trick is knowing the difference between good debt and bad debt – and being discriminating about when you go into the red.

"There’s a myth that debt is dangerous," said Adriane Berg, a financial expert and publisher of a newsletter, Wealthbuilder.

The best type of debt is when you are buying something that will increase in value, such as a home or an investment property, said Elissa Buie, owner of Financial Planning Group. Loans for school tuition and new businesses are also good debt.

"When you take on debt you increase your risk, but you also increase your return," Buie said. If you buy a property valued at $100,000 with a $20,000 down payment, you’d make a 50 percent return if you sold it for $110,000, Buie said.

Some people might think it’s better to put a bigger down payment on their home and pay off the mortgage faster. But Buie said "it could be smarter to have a smaller down payment and invest the rest, as long as the mortgage interest rate is less than the expected rate of return on your investments."

"It’s unrealistic for people to think they can live their lives without debt," Buie said. In fact, without ‘well-placed borrowing,’ the average person isn’t likely to increase his wealth, Berg said.

"It also makes sense to borrow when your money is put to better use somewhere else", said Susan Bradley, first vice president for financial planning at Raymond James and Associates.

"You can take out a bank loan to buy a car at 8 percent interest instead of dipping into your 401(k) where it’s earning 10 percent", Bradley said.

"Replacement debt is another positive way to owe money", said Robert Garner, National Director Of Personal Financial Counseling at Ernst & Young.

For instance, a person might take out a home equity loan at a rate of about 7 or 8 percent – and pay off credit card debts that charge 19 percent interest. Interest

on a home equity loan is also tax-deductible.

"Your ability to borrow will also be a safety net to carry you through lean times if you lose your job or suffer another life crisis", Garner said. "Many people find it hard to keep three to six months' living expenses on hand for emergencies", he said.

What about the other extreme?

The granddaddy of bad debt is credit-card debt. The universal advice is to pay off the cards immediately and cut up all but one for emergencies. "I see very little other sources of financial catastrophe than credit-card debt", Buie said.

"That doesn't mean you should postpone saving money", Bradley said. She advises paying off credit cards and saving money at the same time so you can build a small emergency fund. A couple could pay $300 to the credit card companies and put $100 into a savings account.

Other bad debts are consumable items, such as boats, clothes, travel, and expensive meals. That includes credit for Christmas presents. Some people probably didn't pay off 1996 presents until late summer, said Buie.

Lastly, there's another type of debt risk-adverse investors should probably avoid: so called "margin investing", where you borrow to invest in the stock market.

"Under such as system, an investor seeking to buy $10,000 of stock might put up $5,000 and borrower the other half. It's a strategy that magnifies your earnings – or your losses – so it's not for everyone", Bradley said. "It should only be done by people who know what they're' doing."