

"Good Debt vs. Bad Debt"

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Do you know the difference?

True or False?

- You should always pay off your house as fast as possible to save interest expense.
- The most important thing when financing a car is to make sure you can make the payments.
- Smart people never borrow money for college expenses.
- It's OK to pay for a vacation with a credit card as long as you pay it off in a year.
- People who are financially savvy have no debt and never lend money.
- If you have to borrow money for a car, an 8% car loan is better than using an 8% home equity loan so you don't have a lien on your house.

If you thought the answer to any of these questions is "True," this article may be helpful to you in sorting out the difference between "good" debt and "bad" debt.

Some of us got the message as children that any debt at all was basically evil, maybe a necessary evil for a short time, but not something that nice people did. Other families were always in debt, and children expected that calls from bill collectors were a normal part of life. Seldom are we taught the difference between "good" debt and "bad" debt.

To be "good" debt, two elements need to be satisfied:

1. Whatever is being financed should last longer than the loan; and
2. Financing should provide positive leverage.

Let's discuss these two criteria. For example, since a house last longer than the mortgage, paying off your house as quickly as possible may not be the best use of your money. If you are in a 28% tax bracket, a 7.5% mortgage actually costs you less than 5.5% after taxes. So, over a 15 year period, instead of paying an extra \$100/month on your mortgage, you are probably better off investing it in an index fund.

Over the past 70 years, the stock market has increased an average of 11% per year. Investing the \$100/month at that historical rate would net you almost \$40,000 after capital gain taxes in 15 years. Since making extra payments would reduce your 30 year 7.5% mortgage by about \$33,000, by investing the \$100/month you could pay down your mortgage to where it would have been and still have \$7,000 left over! Plus, you would have saved over \$4,200 in taxes on the additional interest you were able to deduct over the 15 years.

Borrowing money at a certain rate (e.g. 5.5% after tax) and investing it at a higher rate (e.g. 11% less capital gain tax is an after tax rate of about 8.8%) is an example of "positive financial leverage."

Whenever you can invest money at a higher rate than it costs to borrow it, it is to your advantage. Plus, with a fixed-rate mortgage you are protected against future inflation. If inflation increases, your rate remains fixed; if interest rates drop, you can refinance. And of course you can pay off your mortgage anytime your want to.

Let's apply these criteria to car loans. If you finance your car for two or three years, that meets one test for a "good" loan since your car will probably last longer. But if you finance your car for 10 years, or put your vacation on a credit card, that is "bad" debt since the debt outlives the purchase.

If you are buying a car so you can get to work, or borrowing money for college, you are getting positive leverage from your financing since you will be able to more than cover the additional costs from your higher earnings. Unless, of course, you want to finance a Porsche instead of a Taurus; since you don't get any additional leverage from a Porsche, that would be "bad" debt even if you can make the payments.

The old saying, "Neither a borrower or a lender be" may be good advice when dealing with friends and family, but whenever you invest money, even in government bonds, you are being a lender. And buying a home is so advantageous financially, having a mortgage is almost always preferable to paying rent.

Finally, the tax consequences of borrowing money can make a substantial difference in deciding the best way to borrow money. A home equity loan is better than a car loan at the same rate because the interest is deductible. So government is subsidizing 28% of your interest costs (if you are in that bracket) in most instances.

Should you borrow against your house, or use a margin loan? Is it better to borrow against your 401-K, or against an insurance policy? Is leasing better than financing a car, or better to pay cash? Should you cash in your U.S. Savings bonds for college, take out an education loan, or gift appreciated stock to your children?

The answers to these questions can be complicated and depend on your individual situation. Your Cambridge Advisor is the best source for this kind of personalized, impartial advice, since he or she will take into consideration your total financial and tax situation.

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