The Malay Mail - Profit: Good debt vs bad debt

Written by Administrator
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<p>The Malay Mail - 18 September 2006</p><table border="0" cellspacing="0" cellpadding="0" class="abstract"><tr><td id="abs" class="para">When borrowing is a smart move... </td></tr></table><p>Debt has a negative connatation attached � but if you insist on paying cash for everything you buy, the system might work against you. You might think all debt is bad, but some form of debt can work out to be in your best interests.</p><p align="justify">According to Webster�s dictionary, debt is �something that is owed or that one is bound to pay to or perform for another or a liability or obligation to pay or render something�. </p><p align="justify">Bad debt is when you borrow money for something that will go down in value, such as buying a pair of designer jeans, a car or even a fancy dinner. Good debt, by contrast, is when you borrow money for something that will generate future cash flow, such as a loan to get a new business off of the ground. </p><p align="justify">Good debt is anything that you can�t afford to pay for up front, but have the money to pay for on a schedule, such as a mortgage or home equity loan. It is best to accumulate financial assets � such as stocks, bond and real estate � before spending a lot on non-financial assets like cars, clothes and furniture. Good assets are ones that can be converted to cash quickly. Assets also include your income and equity. If your assets are growing faster than your debts, then you are OK. </p><p align="justify">Bad debt is anything that you can�t afford to pay for up front, that is usually something you want instead of something you need � or you can�t or didn�t save up the money to pay for, so you apply for a loan or charge it. </p><p align="justify">The most common form of bad debt is a credit card. </p><p align="justify">Credit cards should be used with discipline. The best way to establish and maintain good credit is to purchase something with a credit card and then pay off the balance when the bill arrives. This shows the credit card company that you pay your debts on time and are a responsible shopper. </p><p align="justify">Other examples of bad debt are cars and personal loans. You might argue that you need a car, but then look for a second-hand one: you don�t have to buy a new car. The value of a car starts to depreciate as soon as you sign the paperwork. It is better to buy a used car, and finance it for one or two years or save money to buy the used car with a higher amount of cash in hand. </p><p align="justify">Examples of good debt are a mortgage and business loans. Some other financial experts may disagree and include car loans with this � but anything that you can borrow against and that has a monetary value is a good debt. </p><p align="justify">The value of a car only decreases so although the car has a monetary value, that value is less than the original price paid for the car. </p><p align="justify">An exception to the above statements is student loans. </p><p align="justify">Student loans are a good debt, because the end result is furthering your education, which results in a higher paying job (monetary value). The money from that job can be used to pay off your student loans. Some of you may say �I can borrow against my credit card to get a cash advance�; but it is still a bad debt, because you didn�t have the cash up front and you will be charged a higher interest rate and fee to get the cash advance. </p><p align="justify">Also, the value of cash does not increase unless it is in a mutual fund or investment. </p><p align="justify">The best way to determine if you have good debt or bad debt is to prepare a liability statement. This statement will identify your income and all of your debts and the difference between the two equals your total liabilities (your total debt). </p><p align="justify">Bad debt has no value or the value decreases over time. </p><p align="justify">Good debt has value and has the ability to increase in value over time. </p><p align="justify">Keep in mind at any time a good debt can turn into bad debt if you miss a payment or if you are living above your means. Your debt-to-income ratio should be between 28 per cent and 36 per cent. If you debtto- income ratio is above 36 per cent

then you need to do a financial health check and see how to cut expenses, reduce interest rates, and increase the amount sent to pay for your monthly debt payments. </p><p align="justify">When going in debt is good: buying property (by Sujartha K) With spiraling property prices, it�s highly unlikely you�ll pay for a new home in cash. When you�re about to buy a home, see how much down-payment is required (usually, this means 10 per cent of the price of the property). The more you put in as down payment, the less you�ll owe and the less you�ll pay in interest over time. </p><p align="justify">Right � you might think now�s the time to clean out the sofa and plunk down every spare ringgit in your down payment. That�s not the best move. You still need funds to act as an emergency stash, just in case a crisis happens. </p><p align="justify">You might find you�re your spare cash does well in other investments. For instance, the home loan might charge a 6 per cent interest rate, but if your money could earn higher in the e-stock market or parked in a money market fund. </p><p align="justify">It�s also unwise to place all your moolah into a property if you have other debt. Mortgages tend to have lower interest rates than other debt, you see. If you have, for example, credit card debt, concentrate on paying that off first, since that charges a whopping 18 per cent per annum, compared to a housing loan which can be had for 6 per cent plus the base lending rate. </p><p align="justify">A 10 per cent down-payment is the norm. If you cannot afford the down-payment, and have no savings, it�s a worrying sign; perhaps you�re not really ready to commit to a mortgage until you�ve practiced saving regularly. </p><p align="justify">Many home buyers do put down less amounts for the down-payment � even nothing at all. Some property developers have waived down-payments, and require no payment whatsoever until after completion. Do beware � they might have built in the cost of the initial down payment into the purchase price of the home. </p><p align="justify">A mortgage also acts as enforced savings. If you have legally committed to RM500 every month, you�re more likely to comply, as opposed to telling yourself that you�ll save the same amount very month. The latter, you see, evaporates right about the time your favourite brand goes on sale, or your friends decide an overseas holiday would be necessary. </p><p align="justify">You�re not likely to fritter your money away if you realise that you�re legally bound to pay off your monthly debt. </p><p align="justify">Getting red notices from lawyers is a surprisingly good motivation into reining in your spending and instead, deciding to pay off your debt.</p><p> </p>