



Is debt a dirty word?

Not necessarily. If used well, debt can help you achieve your goals. But make sure you understand debt and manage it well.

Here are some tips on taking back control of debt...

The “good, the bad and the ugly”:

Do you have different types of debt and don’t know how to manage it all? Well let’s go through the “good, the bad and the ugly” of debt.

“Good” debt enables you:

- offset the cost of debt against your income in your tax return (for example this could include debt against an income producing investment property (it is “deductible” debt) and/or
- it helps you invest in an asset that will grow and hopefully make you money.

Any debt that does not achieve either of these things is generally considered to be “bad” or “ugly” debt.

The ugly sister of debt

So let’s start with the ugly sister of debt – nasty credit card debt. If you have a credit card, you should be paying off the balance every month. If you pay the minimum payment every month, you will pay more in interest and it will take you longer to pay off your balance. From 1 July 2012, your monthly statement must give you information about how long it will take to pay off the entire balance by making minimum repayments. As an example, my latest credit card statement tells me that if I only pay off the minimum amount on my credit card then it will take me 84 years and 6 months to pay off and I will have to pay \$58,865 in interest! If I pay off 2.5x the minimum amount I will pay it off in 2 years so you can see the benefit if you pay out the debt quickly.

You should focus on paying down any outstanding credit card debt as an absolute priority. It can be a useful tool to help pay bills and expenses in a month (and you can rack up points that can be redeemed for vouchers or products) but you need to use it just for that – a temporary account that gets paid down every month before the due date.

So what’s the “bad” debt?

Well this could be a personal loan for a car. It is a loan for an asset that goes down in value or is spent quickly (like a holiday) and does not earn any income. This type of debt can help you achieve a personal goal (to balance life and take a break), it can improve your credit rating and the interest rates you pay aren’t as nasty as credit card debt but the debt isn’t tax deductible nor is it improving your financial wealth, so try and get rid of this sort of debt after paying off credit cards. Start with the loan with the highest interest rate. And if you need a holiday, then it’s better to draw down on your mortgage (if available) than take out a personal loan.

What about “good” debt?

Warning! There is no such thing as “good” debt if you can’t afford to manage the debt within your budget. Let’s assume you can.

A mortgage could be considered to be “good debt” because your home is a capital gains tax free investment (you pay no tax when you sell). So if you’re paying down a loan on a home that will appreciate in value over time then this makes investment sense. Similarly a loan on an investment property could be considered “good” debt where you are negative gearing (income from rent is less than loan repayments) and the property appreciates in value (this is the big test and not guaranteed). But make sure you completely understand what negative gearing is before you consider taking it on. Many don’t. And if the value of the investment goes down you will be burnt badly.

If you have a redraw facility on your mortgage and you have paid more than your required repayments, then it would make sense to redraw the money and pay down any “bad” or “ugly” debt. That way you will consolidate your debt (put it all together in one spot) and pay lower interest rates. And of course, make sure your mortgage is competitive. Shop around if you need to.

Once you have paid off the ugly and the bad debt, try and pay off your mortgage as quickly as you can.

So make a simple list of your different types of debt and list them under the headings “good, bad and ugly” debt and get to work!

Cheers,

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