

Good versus bad debt

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Special to Londoner

It seems that not a day goes by without another media report on the amount of personal debt carried by Canadians: the amount of debt we carry per household compared to other nations, our attitudes towards debt, or whether we have too much debt compared to the national average. Is all this conversation much ado about nothing?

All you need to understand to be financially responsible is to recognize the difference between good debt and bad debt. Is there such a thing as good debt?

Let's first discuss bad debt. We would classify bad debt as consumer debt, or essentially purchasing goods and services, beyond your financial capabilities. This is typically referred to as "living beyond your means." Your income is simply not sufficient to match expenditures, which results in more bills than pay at the end of the week. A glaring indicator of consumer debt is unpaid credit card balances carried over month to month or taking on excessive debt to purchase a depreciating asset such as a vehicle.

It is interesting how vehicles are sold in this country. Often the sticker price of a vehicle is not even posted in the advertising, instead replaced with an "affordable" payment option. Why not purchase that brand new car with 0% financing and a weekly payment of less than \$100? That seems affordable? Unfortunately the vehicle is worth less than the amount owed on it, the minute you drive it off the lot.

Debt can be your friend if used prudently to acquire assets that appreciate in value, such as real estate, or

to leverage investments that pay a higher return than the cost of the borrowed money. We refer to this as good debt. Let's review two simple examples:

In the first example, let's assume you have purchased a home for \$200,000 with a bank debt (mortgage) of \$190,000 and a \$10,000 investment on your part. Not factoring in any lender/closing fees or any repayment of the mortgage and assuming the home is worth \$205,000 in one year, you have taken your initial investment of \$10,000 and parlayed that into \$15,000 or a return of 50 per cent in one year. Sweet! That is why real estate is so effective for wealth creation - the ability to leverage bank financing to generate wealth.

In this second example, let's assume you borrow \$50,000 from the bank at three per cent as part of an investment loan. Your monthly payment with simple interest would be \$125 per month. Now take that money and reinvest it at 9% and your monthly income stream would be \$375, a monthly profit of \$250. Your return on the investment is infinite, as you are using only the banks money to earn that \$250 in income. The trick of course is first, your ability to borrow funds and second, your ability to find a suitable safe investment with a greater return than the rate at which you borrowed. Is this possible? Of course.

Don't be afraid of debt, but understand the difference between good debt and bad debt. Make debt work for you, and use it effectively to create personal wealth.

Bruce Smith is a mortgage broker with Cash Management Group

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