FROM YOUR ADVISOR

GOOD DEBT VERSUS BAD DEBT

Managing your debt properly can result in lower overall interest payments and help you to become debt-free sooner

Debt could be called a "necessary evil." Just try booking a vacation without a credit card or buying a house without a mortgage.

Too much debt, however, can prevent you from reaching your financial goals. One way to keep debt under control is to determine which debts are worth taking on and which debts should be avoided, reduced or eliminated as soon as possible.

Knowing the difference between "good" debt and "bad" debt can help you to lower the amount of interest you pay and help you to become debt-free sooner, says Laurie Campbell, CEO of Credit Canada Debt Solutions Inc. in Toronto.

In general, Campbell says, good debt is a loan incurred to acquire an asset that will appreciate in value over time. Bad debt is a loan for an asset that depreciates.

Some examples of good debt:

Mortgages

A mortgage is a loan used to purchase a home — real estate that is very likely to increase in value over time. If that is the case, you will realize a return on investment when you sell your home.

Taking out a mortgage on a house you plan on renting to others also is good debt. That loan would be used to generate both rental income and equity in the home.

Beware of home equity lines of credit (HELOC), Campbell warns. These are loans secured by the equity you hold in your home. Making withdrawals from a HELOC before your mortgage is paid off can be tempting, but doing so can reduce the equity you have in your house or condo.

Student loans

A loan used to pay for a post-secondary education is a form of good debt — assuming the degree or diploma you earn helps you get a well-paying job afterward.

RRSP loans

Taking out a loan to make an RRSP contribution can improve your RRSP portfolio's investment returns in a rising market. And those returns can offset the cost of the debt. Just keep in mind that investing involves risk, and earnings are not guaranteed.

For an RRSP loan to be effective, you must pay it off within a year. You can use the tax refund generated by your RRSP contribution to help repay the loan.

Some examples of not so good debt:

Car loans

The vast majority of cars depreciate in value from the time of purchase; so, from a debt perspective, borrowing for a car purchase is not a great idea. In reality, for many people, financing a car purchase is the only way get the mobility they need. But before you decide to buy, the Ontario Securities Commission's investor education website (*www.getsmarteraboutmoney.ca*) advises that you take a close look at the cost of borrowing vs using a portion of your savings. And if you do take out a car loan, pay it off as quickly as possible.

Credit card debt

If credit cards are managed properly, they are a great financial tool. However, credit card balances usually carry high interest rates and should be eliminated as soon as possible. Make paying off your credit card balance every month one of your monthly goals.

Payday loans

Short-term loans offered by payday loan companies come with high fees and lofty interest rates. They are, Campbell says, "Bad, bad debt."

A good debt is a loan incurred to acquire an asset that will appreciate in value

By Fiona Collie

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