Managing Debt: The Good, The Bad, & The Ugly

Debt has such a negative connotation associated with it. I think most of the negativity stems from the irresponsible issuance and management of debt. The Great Financial Crisis of 2008 came with a massive unwind of debt that had been building up over several decades prior to this defining moment in history.

Is debt bad? Is it evil? Should it be avoided like the plague?

My gut answer would be, “it depends.” I will get to that in a minute in more detail. But as a rule I would say that **my philosophy is to earn interest rather than pay interest**. At least that is my goal.

At the end of the day I think there can be an argument made for “Good Debt.”

The Ugly (Credit Card Debt)

Let’s start with the toxic debt that you should most definitely avoid like the plague. The debt that I am talking about is what I am going to refer to as ***consumer debt***. In my opinion, unless it is absolutely necessary (due to an emergency or unforeseen event) you should **NEVER** be carrying a balance on your credit cards.

First, the interest rates on credit cards are insane, ranging from 12-36%. Try finding an investment that pays that kind of return on a consistent basis. The credit card companies love people with balances.

Now I am not saying that credit cards are evil. I use a credit card to pay for almost anything and everything that accepts the little plastic thing as payment. But the rule is I can’t charge anything I can’t payoff that same month when the statement comes. You get all kinds of free protection when paying with a credit card and the convenience of not needing to balance a check book is nice. I have one payment I make once a month. Plus as a bonus if you pick the right card there are some really awesome rewards programs.

My wife and I get about $1,200/year back from a cash back card that we use. Then I have an Amazon card that gives me 3% back in the form of credit to spend at Amazon, which I tend to buy everything from.

This makes sense if you think about the types of charges that end up on your credit card: gas, groceries, dinners out, entertainment, clothes, etc. If you don't have the cash in the bank, don't charge it because you can't afford it. And if you don't have the discipline to refrain from charging things you can't afford, it's better you leave the credit card at home.

The Bad (Financing Toys & Cars)

Another form of consumer debt is when you have to finance your toys and cars. Don't get me wrong here, I am just as guilty when it comes to the "bad" debt. I currently have 1 of our cars financed and we still owe $7,500 on it. It bothers me, which is why we will get that paid off by the end of this year. I won't go into it now, but we have very strategic reasons for the financing of the car and actually have 6X the amount in our savings account to pay it off. I only bring it up to show you that I am not perfect, and that sometimes there are exceptions to the rule.

With that said, it is best practice not to finance your car or toys (i.e. boats, motor cycles, etc.). These are all depreciating items, meaning that they start losing value the day you purchase them. However you end up paying the sticker price plus all the accumulated interest. For example, you may end up paying $40,000 for a car that initially only cost $32,000, and will only be worth $16,000 or less when you finish paying it off.

More often than not, the option of financing these types of expenditures not only makes you a slave to them, but typically allows you to spend more than you can really afford. There is no reason to make your life harder than it has to be.

All I am saying is that you should try your best to avoid consumer debt, because that is the epitome of the rat race. Consumer debt will keep you on the hamster wheel for years to come. If you want to move further away from financial freedom then by all means load up to your eyeballs in debt.

Good Debt

Is there really such a thing as good debt?

Some may disagree, but I will make the argument that there is such a thing as good debt, especially when you are just starting out in life. To me good debt is any debt that puts or eventually will put more money in your pocket over time. Here are some of the things that I consider to be good debt:

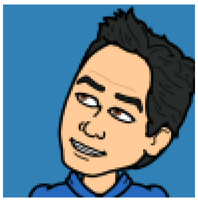
1. **Education**: The best investment that you can make is one in yourself. Now I am not saying that you need to go off and pay $40,000/year for a college degree. But I am saying that if you have to its okay to take on some student loan debt. Try to get all the grants and scholarships you can and even work a bit to pay for school. Only finance what you absolutely have to. While I was in school I accumulated about $12,000 in student loans by the time I graduated. Coming out of college I was earning $58,500/year, that's almost a 5X right out of school. The lifetime return on that debt I took out (and have since paid back) is enormous. Even if you argue that I could have made $40,000/year without my degree, that is still a $18,500 annual premium or $740,000 over a 40 year career. You do the math. And for those of you that are not college inclined, it can be any form of education that gets you more money than you could make without acquiring new skills.
2. **Mortgage:** When I was in college, one of my business professors advised us to do anything and everything we could in order to buy our first house. The problem is, I don't think he meant it that literally, because you do need to be smart about buying a house to make sure you don't over leverage yourself. My rule of thumb is that the cost of your home should not exceed 3X your annual income. Now you're probably wondering how a mortgage puts more money back in your pocket. Well there are a few ways:
    - <u>Tax Advantages</u>: You get to write off the interest and property taxes that you pay every year. So let's say that you pay $20,000 in interest and property taxes and that you are in the 25% tax bracket. Now the calculation is not quite this simple, but you would save almost $5,000/year in taxes.
    - <u>Fixed Cost of Living</u>: When you buy a house you get to lock in the cost of living over a very long period of time. Unlike when you are renting a place the prices can potentially go up every year. Even if you can buy a house with a mortgage payment (including taxes, HOA, etc) that is the same as the rent you are paying, it's a better deal. Because you have to remember that you get the tax benefit, so your effective payment ends up being far less than renting for the same cost.
    - <u>Appreciation</u>: Real Estate is a fixed asset and appreciates over time.

When you rent, all your money is basically thrown away. However when you own, you build equity into a property that goes up in value over time. You have to have a roof over your head, so you might as well have one that is going to be worth more than what you bought it for.
    - Rental Income: You can turn your house into a source of rental income by renting out a room. Or if you eventually out grow your house you can rent the entire house out and let someone else amortize your loan and thus build equity for you.
3. **Business:** My first recommendation would be to try to bootstrap the business and not go into debt. But there are times where you may have an opportunity to buy or start a business that may require more capital than you have. In these cases it could make good sense to use debt, but very strategically.

Now don't take this the wrong way, if you don't need the debt to pay for these things then by all means avoid it. Unless you come from money, it is likely that you will benefit by strategically using debt at one time or another in your life. Especially when it comes to a purchase of a home.

What are your thoughts on debt? Can you think of other "Good" uses for debt?

– Gen Y Finance Guy



Gen Y Finance Guy

Hey, I'm Dom - the man behind the cartoon. You'll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I'm a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own financial stats. I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! Read More