Credit/Debt

Return to article

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Keeping Good Debt Can Net You More Money

By Ellen Chang

NEW YORK (MainStreet) — Paying off your mortgage quickly means you could lose money for your nest egg in the future.

Since inflation erodes the value of your existing finances, working to pay off only the entire mortgage may wind up costing consumers in the end. If a consumer has a $1,600 a month mortgage, the money will have about a third of its purchasing power in 30 years.

"You may be losing money in the long run," he said.

Instead, consumers should determine what types of debt is considered to be "good debt," which is debt that is at a low, fixed rate and preferably tax deductible, Chadwick said.

"If you can make monthly payments and still have enough money left over to save for retirement needs, it may not be in your best interest to pay that debt off too quickly," he said. "It does not need to be tax deductible to be good debt, but we consider that the icing on the cake."

Determining which debt needs to be paid down first can be determined by whether or not a consumer is "earning more on his or her money than he or she is paying on the debt," Chadwick said.

The underlying asset should be taken into account since the debt accrued for some cars and homes winds up being a loss if the asset is a "money pit," he said.

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Deciding when to pay off a mortgage can be tricky, but Chadwick advises consumers to avoid paying off a mortgage if the rate is low.

"People are safer having a mortgage and an equal or larger amount of money accessible to them," he said. "This is a psychological exercise, not an economic one."

Contrary to popular belief, homeowners need to recognize that "the bank controls the equity in a home, not the owner," Chadwick said.

Mortgage debt is misunderstood by most people who often try to pay their house off as soon as they can be making extra payments or by obtaining 15-year mortgages, said David Shucavage, president of Carolina Estate Planners in Wilmington, N.C.

The issue that commonly arises is whether the money invested in your home is safe since value of the house can decrease and the equity is not liquid, he said.

"The houses they foreclose on first are the ones with the most equity because they can sell them at a lower price and still get their money out, so money in a house is not really safe" said Shucavage.

The rate of return on a house can be zero even if the value of the house is increasing since the money itself does not earn any interest, he said.

"If you lock in one of today's low interest rates, it's likely that in the not too distance future you could earn more money in a CD than you are paying on your mortgage," Shucavage said. "Mortgage debt can be to your advantage, just don't use it to buy a house that is bigger and has bigger payments than you can afford."

Some consumers choose the avalanche method when paying off debts by starting with the one with the highest interest rate, said Kevin Gallegos, vice president of the Phoenix operations for Freedom Financial Network. This method calls for making minimum payments on each debt except the one with the highest interest rate. Pay the minimum, plus any extra you can afford and repeat this process every month until that debt has been paid off.

"Keep paying the same monthly total, but take every dollar you were using to pay off the highest interest debt and put that towards paying off the debt with the second highest interest rate," Gallegos said. "Keep following this strategy until you've cleared away all your debts."

Keith Fenstad, a partner at Tanglewood Wealth Management in Houston, believes that consumers should instead follow the debt snowball approach.

"I'm a believer of the psychological momentum that comes from paying down the smallest balance, moving on the next smallest and so on," he said.

Contributions to a 401(k) should stop when a consumer is paying down debt, Fenstad said.

"It depends on how lucrative the plan's matching formula is, but often the answer is 'yes,'" he said. "Getting the crushing consumer debt paid off will add more to your long-term financial security than missing a few years' worth of 401(k) deferrals."

Student loans are generally considered healthy debts, because they typically carry reasonable interest rates, said Gallegos. Making the required monthly payments while putting extra money toward paying down high interest credit card debt is a good strategy since student loan debt never goes away.

"Even in a bankruptcy, it cannot be discharged," he said. "The hope is that people can do some or all of these – even in minimal amounts – simultaneously."

Credit card companies are normally willing to negotiate with consumers since recovering debt can be enormously expensive for finance companies, said Tim Kim, an analyst at Francis Financial in New York City.

"Call to see if you can reduce your interest rate or rollover the balance to a 0% APR credit card," he said. "Most companies are sympathetic to people who cannot afford repayments."

Choosing to become entirely debt free can mean you are not leveraging your money. The gratification of paying off a mortgage by using an inheritance or a settlement to eradicate all of your debt is not always a good idea. A combination of paying ahead on the debt and also investing money along the way is a better option, said Courtnie Nein, co-founder of Good Life Advisor Systems in Wyomissing, Penn.

"The one thing that we can't get back is time, which is a major part of the equation that comes into the growth of an investment," she said.

Taking on debt to buy high return stocks, bonds and other investments can also be good in the long run, said Howard Dvorkin, a Fort Lauderdale-based CPA. If interest rates are low and the return will be higher from investing, then it will make more sense to invest than to pay off your mortgage or student loans, but consumers need to be aware that timing the market is tricky.

Bad debt is any debt that you cannot responsibly manage, said Gail Cunningham, spokesperson for the National Foundation for Credit Counseling.

"A person is living on a slippery financial slope without an adequate rainy day account," she said. "It is smart to keep all debts current while putting any extra money toward the emergency fund until it is built up to equal one month's salary, which should be enough to sustain you through most short-term emergencies."

--Written by Ellen Chang for MainStreet