ALEXANDERFORBES
Securing your financial well-being

GOOD DEBT | BAD DEBT

Not all debt is the same. Knowing the difference between good and bad debt is an important part of being able to make good decisions.

Good debt has the potential to grow your financial well-being. To check if a debt is good or bad there's a handy rule of thumb: **If it won't go up in value or generate income, you should carefully consider if it's a good idea to buy it.**

We're often tempted to borrow money when the unexpected happens. There are two important questions to ask before buying on credit or taking out a loan:

Will the debt incurred **be good debt or bad debt?**

What will it really cost, taking interest into account, **to borrow it?**

TIP Sometimes things can't be classified neatly as "good debt" or "bad debt". if you want to buy a car, for example, consider the total cost of ownership including repayments, insurance and maintenance. Compare this to your other options. If you decide to buy a car using debt, get one you can afford do that the costs don't stop you from reaching your other goals.

Find out more **on the next page.**

‘Good debt’ versus ‘bad debt’

Living completely debt-free, isn’t always possible. Very few people earn enough money to pay cash for life’s most important purchases like a home, car or university education. The most important considerations when buying on credit or taking out a loan are whether the debt incurred is **good debt** or **bad debt** and if you can afford the repayments. If your total debt repayments per month are above 40% of your income after tax, you may be getting into a situation that could lead to financial stress, depending on what other expenses you have. Always do a budget to check if you can afford your debt repayments before taking out a new loan. Let’s look at two examples of **good debt** and **bad debt**.

GOOD DEBT = an investment that will grow in value or generate long-term income.

Example 1: Taking out student loans to pay for tertiary education.

- Student loans usually have a very low interest rate compared to other types of debt.
- Tertiary education increases your value as an employee and raises your potential future income.

Example 2: Taking out a bond to buy a home.

- Home mortgages generally have lower interest rates than other debt
- Although mortgages are long-term loans (20 years in many cases), those relatively low monthly payments allow you to keep the rest of your money free for investments and emergencies.
- The ideal situation would be that your home increases in market value over time, enough to cancel out the interest you’ve paid over that same period.

BAD DEBT = debt incurred to purchase things that quickly lose their value and don’t generate long-term income.

Example 1: Buying a luxury car

- Although a car loan may be necessary if the vehicle is essential to doing business, many people buy expensive vehicles and then struggle to keep up with the monthly repayments and insurance premiums on those vehicles.
- Unlike homes, most vehicles lose value over time.

Example 2: Maxing out your credit card

- Credit cards usually carry a high interest rate. If you buy a fancy R2 000 pair of shoes on your credit card, but can’t pay the balance on your card for years, those shoes will eventually cost you thousands more.

The general rule to avoid bad debt is: if you can’t afford it and you don’t need it, don’t buy it. Always speak to your financial adviser before making any financial decisions that could leave you with bad debt.

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