



DEBT MANAGEMENT

use debt to your advantage

Not all debt is created equal.

There is 'good' and 'bad' debt. A sensible approach to debt can be a powerful tool in helping you get the things you want out of life.

There's no instant miracle when it comes to reducing your debt. You need to go back to basics: increase your income or reduce your outgoings. But if you use debt effectively, it can be a powerful tool for creating wealth.

While most of us want to be debt free, the fact is, in some cases it makes good sense to have some debt – and can actually help to grow your wealth. It comes down to categorising your debt as 'good' or 'bad'.

Bad debt is...

The main differences between good and bad debt are tax-effectiveness and return on investment. The vast majority of credit such as a personal loan or credit card isn't tax deductible, so is 'bad' as you must pay tax on your income before you make the repayments.

If you use debt to buy items that don't appreciate or at least hold their value, this is also 'bad' debt. For example, credit card debt is likely to be made up of consumer items that depreciate in value, and unless you're paying the balance off each month, you're paying additional interest on the purchase.

Good debt is...

Any debt that works to make you more money than it costs you is classed as 'good' debt.

Borrowing money to purchase growth assets – those that will continue to produce an income – is widely known as 'gearing'. It has the potential to increase your net wealth over time, so is considered 'good' debt. However, your higher potential return comes with a higher risk. Should the investment fail or fall in value you'll not only lose your cash, you'll also have to pay back what you borrowed, so it's not a strategy for the faint-hearted or those less disciplined with their cash.

Home loans bridge the gap between good and bad debt – although you're getting a return on your investment in the form of the property as an asset, as mortgages aren't tax deductible they are generally classed as bad debt.

Turning bad into good

If you have a loan linked to an investment property, or if you moved to a larger property and kept your current home as an investment property, this can make your loan very tax effective.

Making additional mortgage repayments is a safe and sensible strategy because it represents a tax-free, risk-free return. You could also use the equity you have created in your home as security for tax-effective borrowing for investment to grow your wealth – so turning your 'bad' personal loan debt into 'good' wealth-generating debt.

A disciplined approach of releasing cash flow to gradually transform bad debt into good can help create lasting wealth. By investing some of your funds in assets such as shares, property, or assets which are likely to appreciate in value, you can grow your surplus income to optimise your wealth.

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What's stopping us?

Many of us have been brought up to think instinctively that debt is bad and must be paid off as soon as possible, so using debt to create wealth goes against the grain. But if you're managing your cash flow and have a clear plan, borrowing to invest can be financially rewarding as well as providing useful tax benefits.

Gearing

Borrowing to invest is essentially a wealth creation strategy, which can have the benefit of generating tax deductions.

As long as you manage it well, you could increase your wealth a lot faster by borrowing to invest than by simply saving up, but be warned, losses can also be higher if your investments fall in value. You should consider this option carefully and consult with your financial adviser before making a decision.

If you're not a risk-taker or you know you're not as disciplined with debt as you should be, then your adviser may not recommend using debt to create wealth. You may benefit from a more conservative debt management strategy which retains the norm of savings=good, debt=bad.

Thinking of taking on more debt?

Bear in mind that no amount of deductions will make up for a poor investment return, so gearing shouldn't be used as a tax reduction strategy.

Before taking the plunge:

- ✔ Is this the most cost-effective way to borrow what you need?
- ✔ How long will it take you to save the money?
- ✔ Calculate how much interest you'll end up paying – is it really worth it?
- ✔ Be honest with yourself about how disciplined a borrower you are.
- ✔ Speak to an expert. A financial adviser will be able to suggest alternative ways of raising the cash you need, whether it's for a new car or investment capital.

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