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Debt management basics

When used properly, debt can be a very effective tool that may help you to achieve your financial goals. Debt can be used to purchase a range of items that, otherwise, you would not be able to afford. It is also important to understand the important difference between 'good' debt and 'bad' debt.

Debt can assist you to buy the family home, purchase a car or consumer goods and also enable you to purchase investment assets such as shares, managed funds or a rental property. By using debt smartly, you may be able to reach your financial goals sooner.

'Good' debt and 'bad' debt

Where debt is used to acquire investments such as shares or property, this is known as gearing and this is often referred to as 'good' debt - due to the potential to claim a tax deduction in respect of the borrowing as well as the fact that you have borrowed against an asset that can appreciate in value.

'Bad' debt is non-deductible debt like borrowings for consumer goods such as cars and holidays. Even though a loan for the family home is non-deductible, it should not necessarily be viewed as 'bad' debt - the value of the home has the ability to grow over time.

In any case, paying off non-deductible debt before deductible debt will usually be the most appropriate course of action for many people.

Borrow to invest

Borrowing to invest simply allows you to access a greater asset amount than would otherwise have been possible. Gearing is, however, not without its risks - while it may allow you to multiply your gains, similarly, it may also magnify any losses.

There are different ways that you can gear into investments including margin lending, with a home equity loan or even via a geared managed fund that borrows internally.

It is possible to be positively geared or negatively geared. Positive gearing occurs when the income generated by the asset exceeds the cost of the borrowing.

Negative gearing is quite often associated with gearing into property. This occurs when the interest on the borrowing and other costs of maintaining the property exceed the return income generated.

You financial planner can help you to determine if your investment profile might allow you to consider gearing as an option.

Techniques to manage debt

- Make loan repayments more often

Many home loans have the default repayment frequency as monthly. However, by making fortnightly instead of monthly repayments you can cut the term of your loan and save a substantial amount of interest in the process.

The saving arises because some of the loan is being repaid two weeks earlier than if the repayments were made monthly, on a continuing basis, and the total annual repayment is higher.

- Debt consolidation

It is possible that people may build up a variety of different types of borrowings including a home loan, car or boat loan, credit cards, investment loan etc.

Often, by consolidating several loans it will enable you to have a lower overall borrowing cost, allow you to service your debt sooner, direct repayments to 'bad' debt first and in the process save you interest - not to mention that fact that you may also be able to simplify your finances significantly.

Remember that the smart use of debt strategies can assist you to reach your financial goals. Your financial planner can offer further advice that will best suit your own circumstances.

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