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Author: Lawrence Carrel

Good Debt, Bad Debt: It's Mostly Bad For You

After six years, the era of deleveraging household debt is over, according to the Federal Reserve Bank.

Since the fiscal crisis, Americans have reduced their household debt by $1 trillion, from $12.7 trillion in the third quarter of 2008 to $11.7 trillion in the third quarter of 2014.

But in November, the Fed reported that the trend reversed during the third quarter of 2014, when Americans increased their debt by $78 billion, or 0.7%.

While many signs show the economy to be growing, there is enough conflicting evidence to leave Americans uncertain about what 2015 will bring for their financial plans. Given the state of the economy, it's prudent to reduce borrowing to as close to zero as possible.

When taking on debt, it's important to remember the basic concept of what it is. It's borrowing money that you have not yet earned, with the promise to pay it back with interest. The big risk is whether you will be able to pay it back. Should you suffer some kind of financial hardship, such as a layoff or reduction in income, will you still be able to make the debt payments?

"Even if they have a good job, most people have budgets that rely on everything going well," said Kathryn Moore, certified consumer credit counselor at GreenPath Debt Solutions, a non-profit consumer credit counseling service based in Farmington Hills, Mich. "But what if something happens that the budget can't handle? For that reason, pay down the debt to leave yourself flexibility."

Moore says that even if people don't lose their jobs or suffer a salary cut, sudden price hikes in necessities such as food, energy, health care or rent may cause them to have trouble paying their bills.

Having too many liabilities, especially credit card debt, can be a symptom of having lost control of the management of one's household finances.

"When we don't have control over our money, it causes a lot of stress and anxiety," said Donna Skeels Cygan, author of "The Joy of Financial Security" and owner of Sage Future Financial, an Albuquerque, N.M., advisory firm. "People need to make a commitment to eliminate credit card debt as quickly as possible."

Cygan says that people don't know where to start, so they put their heads in the sand and hope their situation will get better, but it won't. She recommends that people start by creating a networth statement, listing all their assets and liabilities. "Many people have no idea what they have. Looking at the bottom line gets your head out of the sand," she said.

"There are only two ways to cut the debt," said Moore. "Either bring in more money with another job, or cut expenses."

In addition to cutting back on entertainment spending, getting rid of premium cable channels, eating out and going to bars, Moore says that other ways to find money are to stop smoking, refinance a mortgage, lower insurance premiums and cut back on saving for retirement until the debt is eliminated. Cygan suggests not buying any new clothing for the next three months, not replacing technology gadgets for a whole year, keeping a car for 12 years and taking inexpensive vacations within your state.

And, of course, stop using your credit cards.

"The best way to pay off debt is to roll it into cheaper debt, like home equity," said Adam Thurgood, a managing director at HighTower, a Chicago wealth management firm with $25 billion in assets under management. "But you need the discipline to pay it off. Still, it's risky, because it allows you the opportunity to rack up more high-interest credit card debt."

But he opposes using home equity loans to purchase items with short useful lives.

Not all debt is bad. The experts say debt that helps acquire an asset — especially one with a long life or benefit, such as a mortgage, car loan or student loan for college — is good debt. Still, bad choices can be made with these loans.

Thurgood says that mortgages with variable rates around 1.5% have been perfect for the past five years. But, he adds, this "Goldilocks" period is coming to an end, and it now makes sense to transition to a fixed-rate, 30-year loan, even at a higher rate. That's because interest on adjustable-rate loans could shoot above current fixed-rate mortgages.

Car loans with low rates can be a good move, but if these loans start charging 6%, Thurgood says, it's better to borrow the money from your portfolio, pay the car loan off and pay yourself back with interest in monthly installments over a four-year period.

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