REAL ESTATE/ASSET MANAGEMENT

How To Manage Personal Debt

Look at your debt levels to help mitigate risks and maximize opportunities.

by Matt Alderton | Posted: January 07, 2011

Left unchecked, a personal balance sheet can start to look a lot like an untended garden. If you ignore it, it will grow out of control and accumulate unwanted vegetation.

In a garden like that, it's often hard to tell the flowers from the weeds.

And just as you would tend a garden regularly, you also should review and clean up your balance sheet on a routine basis, says Paul C. Hornung, Senior Credit Officer of Wells Fargo Private Bank.

A critical wealth-planning tool, your personal balance sheet tells you what you have and what you owe so that you can accurately assess whether your future assets will be enough to satisfy your financial goals. To get a clear picture, you need to know what you're spending your money on and whether you're spending it wisely.

Hornung suggests that your liabilities are a good place to start building and assessing that personal balance sheet. "The goal is to grow your net worth over time. If your debt keeps getting bigger over time, your net worth is going to get smaller," he explains.

Calculate your debt

1. Debt payments. Assess whether you can afford your payments and whether you are comfortable with the amount you're paying, based on your income.
2. Debt-to-asset ratio. Consider the amount of debt on your balance sheet compared to the amount of assets. To calculate your debt-to-income ratio, divide your monthly debt payments by your monthly income.
3. Type of debt. Understand the type of debt on your balance sheet.

Types of debt

1. Mortgage debt. This is the first and most obvious category of debt and consists of the loan you used to buy your house.
2. Investment debt. This kind of debt is used to pay for assets, such as rental properties. Your investment should generate a sufficient rate of return to carry the debt.
3. Credit card debt. This first kind of "lifestyle debt" typically is used for convenience to buy groceries, gas, entertainment and other everyday purchases.
4. Other debt. Other debts, such as a home equity loan, are a second category of "lifestyle debt." It is used to finance major purchases, such as college tuition or a home remodel, to close cash flow timing gaps.

Assess your risk exposure

No matter the type or amount of debt, the best way to mitigate its risks is to assess it in relation to your income, Hornung says. "There is no magic number for the right amount of leverage," he says. "The most important thing is to make sure that the debt you're taking on is at a relatively tolerable level in relation to your overall financial picture."

Instead, ask these questions about your debts:

1. Is there any expected return on leveraged investments? Debt that leads to income or capital appreciation typically is more welcome on a balance sheet.
2. Is your lifestyle debt growing over time? You may be living beyond your means.
3. How much is your disposable income being reduced by loan payments? Even if you can afford to make all your monthly loan payments, you're not investing in assets that are growing.
4. Will a new debt become a problem? Would an interruption to cash flow — you get sick and can't work, you get laid off from your job, there's a divorce and the family income declines by half — make meeting those debt payments difficult?

Protect your financial future

"Debt isn't intrinsically bad," Hornung concludes. "But if the asset against which you took out the loan is not earning a rate of return that matches or exceeds the interest that you're paying on your loan, it's probably not a very good investment. In that case, I would say it probably makes more sense to sell the asset, pay off the loan and stop earning a negative return on that investment."

Matt Alderton is a Chicago-based editor and writer. This article was originally written for and published in Your Legacy magazine, spring 2009.

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