Don't Be Fooled: Here's How Sign-Up Bonuses on Credit Cards Can Come Back to Haunt You

Description

Getting a welcome bonus on a rewards card or cash-back credit card is, hands-down, one of the easiest ways to collect a massive amount of rewards in a short period of time.

Just spend a certain amount of money within a specific time frame, and you'll have cash or rewards deposited into your account. How could you resist that?

Well, for as lucrative as these bonuses sound, sometimes they don't live up to their reputation. What makes a sign-up bonus on a credit card go wrong? Let's look at three common ways they can come back to haunt you.

1. You overspend to get the bonus

Welcome bonuses are truly bonuses when you earn them without changing your spending habits. They become a liability when they encourage you to spend more money than you normally would.

The truth is: that's *why* credit card companies offer welcome bonuses. They want you to "come out of your shell," to let your guard down, to spend a little more here, a little more there, to "feel good: about blowing your budget, because, well, you're getting a bonus right?

Don't fall for it. As long as the spending requirements fit your budget, the bonus remains a bonus. Otherwise, don't waste your time.

2. The card has an annual fee

Annual fees aren't terrible. But they can turn a hefty welcome bonus into pocket change if you're not careful.

The trick to profiting off a card with an annual fee is to do some math. You want to answer two questions before you take out a card with an annual fee:

- Will you earn more cash back or rewards than the card's annual fee costs you?
- Would you have earned more cash back or rewards on a card with no annual fee?

For instance, imagine you're considering a cash back card with a $120 annual fee and a 3% earn rate on groceries and gas. In order to cover that fee, you need to spend at least $4,000 on groceries and gas per year.

But that's not the end of it. You also have to consider what your opportunity cost is, that is, what you're missing on a card with *no* annual fee. To figure that out, write down this nifty formula:

Annual Fee / (Difference in Rewards) = Breakeven Point

Imagine we have another cash back card. This one has a 1% earn rate on groceries and gas with no annual fee. If we plug in our numbers, we get:

$120 / (3% – 1%) = $6,000

The moment you earn more than $6,000, you know the card with an annual fee is worth it. If the earnings are worth the cost, the welcome bonus is icing on the cake.

3. You get a card *just* for the bonus.

A welcome bonus is *not* a good reason to apply for a rewards or cash-back credit card. A welcome bonus is a great supplement to a card that will earn you the most cash back and rewards. But if you're applying for a credit card solely to cash in on a great offer, you have the wrong idea of credit cards.

To be honest, I'm not against "churning" — that is, opening multiple credit card accounts to score sign-up bonuses, only to close the account after you used the bonus. In fact, for Canadians with high credit scores, churning might be a minor source of passive income. But if you're looking for your primary rewards or cash-back card — the card you plan to use for your everyday expenses — then you want to look beyond welcome bonuses.

Bottom line

Many of Canada's best rewards and cash-back credit cards offer massive bonuses that can help you accumulate a mound of rewards in a short period of time. As long as you mind these three pitfalls, you can turn that bonus into a source of passive income.

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