

# August 2005 Newsletter

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## Fixed Rates... Who wins???

Many people, at one time or another, consider fixing their mortgages interest rate. There are many reasons for fixing your rate, but probably one of the most common is that people think they might be financially better off. Is this fact or fiction?

### Hindsight – a wonderful thing

It's easier to make a fixed versus variable decision if we know where variable interest rates are heading in the future. Therefore, maybe we can learn from the past. I obtained some interest rate data from the Reserve Bank of Australia and compared the average standard variable rate to the average 3 year fixed rate (average of the large lenders on the last working day of each month). To make this assessment more meaningful, I discounted the average variable rate by half a percent on the basis that all borrowers shouldn't be paying more than that (through the use of professional packages or basic variable loans). My calculations end on June 2002 because any 3 year fixed loan that was established after this date would still be running so it's impossible to calculate the profit or loss.

The results are clear. Over the past 15 years, you would

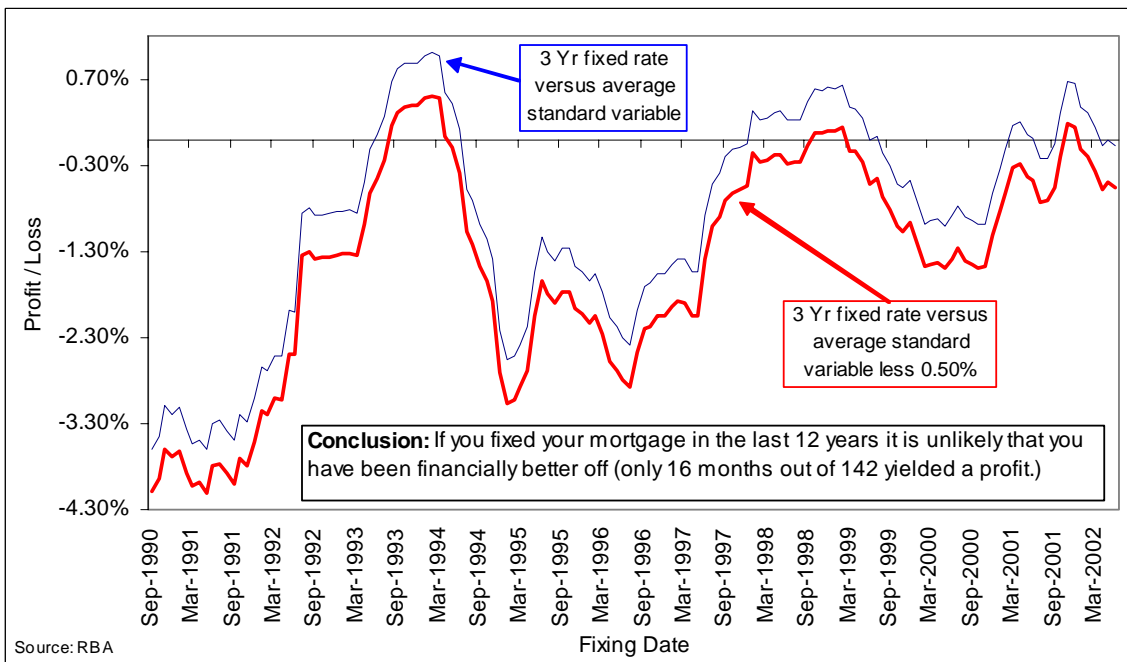
have only been better off if you entered into a fixed rate loan in only 16 of the past 144 months (i.e. only 11% of the time). Therefore, based on historical results, there is a 89% chance that you will not be better off. On average (over the period), fixed rate borrowers paid 1.43% more per annum than a variable rate borrower.

The profit/loss line is trending upwards in that the likely loss resulting from entering into a fixed rate loan has reduced in recent years. The average loss over the past 10 years is just over 1.00% and the average loss over the past 5 years is just under 0.60% (since January 2000 its 0.80%). There may be many reasons for this including a more competitive and knowledgeable wholesale money market, a different interest rate management (government) regime and a significant reduction in fixed rate profit margins (for the banks).

My conclusion is that you are more likely to be worse off financially by fixing your interest rate. It's not a good gamble in my opinion. At the moment the 3 year fixed rate is around 6.80%. The average standard variable rate less half a percent is 6.82%. Therefore, the market is suggesting that variable rates will not materially change in the medium term. Based on the information we have today, I think this seems about right.

### The Theory

The problem with fixed rates is that they are dictated by the wholesale money and bond markets. The major players in these markets are governments, large companies and banks. The market, through demand and supply, arrive at a wholesale interest rate for a particular term, let's say 3 years. When participating in this market (i.e. buying/selling fixed interest securities) all parties consider the likelihood of future interest rate changes. Therefore, future interest rate changes are already factored into the fixed rates. This creates a timing issue for borrowers because if variable rates are expected to rise in the next three years then it's likely that the banks (via the wholesale money markets) have already factored in these changes. If fixed rates are relatively low, then that probably means the market thinks variable rates will decline – so why fix your rate. If this line of thinking is true, then the only people that would see some financial



benefit in fixing their rate are the people that think the opposite to the market. Therefore, in a market where fixed rates are relatively low (compared to variable rate – today’s market), the only people that would see value in these fixed rates are the people that think variable rates will increase. Since fixed rates are low, the market thinks variable rates will decrease over time – that’s the general market sentiment. Therefore my question is; what makes you better at forecasting the interest rate market? The market is a collective representation of a lot of informed people’s views – is it sensible, as a non-expert, to take the opposite view?

**Fixed rates protect you from future rate increases... NOT**

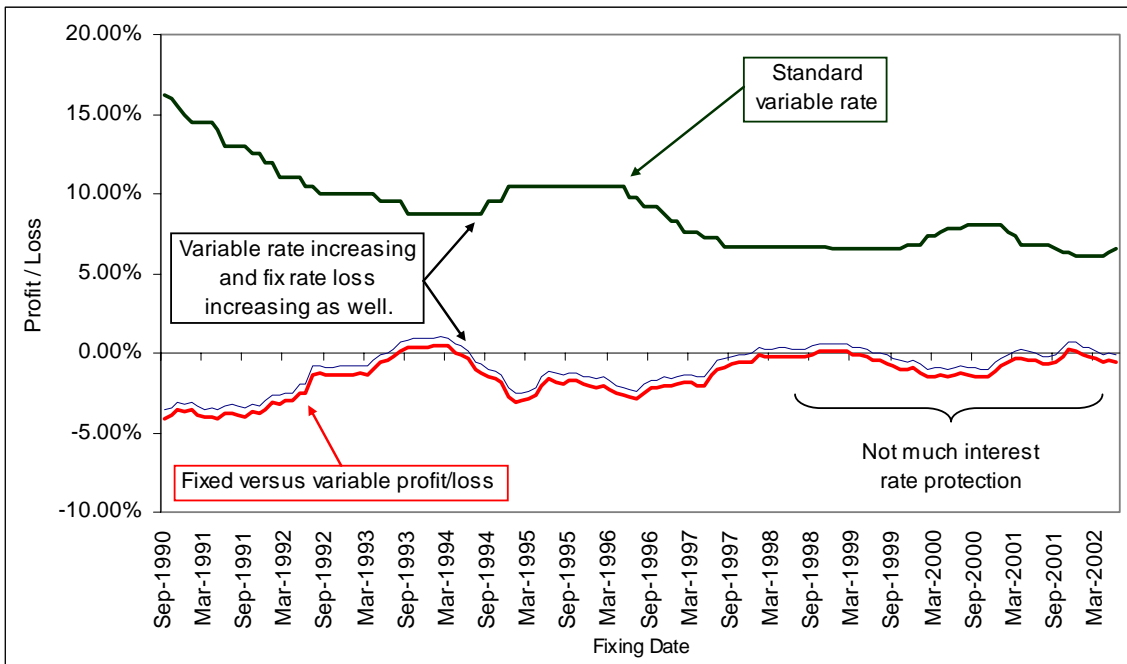
One of the commonly cited benefits of fixing your interest rate is that it will protect you from future interest rate increases. It is true to some extent. Your interest rate won’t change during the fixed term. However, consider the graph below which compares the standard variable rate to the fixed rate profit/loss position. This graph shows that you are more likely to be financially better off with a fixed rate when the variable rate is decreasing or at the bottom of the cycle. However, in these situations there is not much motivation to fix because people don’t feel threatened to fix. However, more people consider

fixing their rate when the variable rate is increasing or about to increase. This is the worse time to fix because, as the graph shows, you are more likely to make a loss.

**But there are other things**

I have only discussed about the financial pros and cons of fixed versus variable. However, I haven’t considered the non-financial issues. Sometimes these can be more important than the financial benefits. Some issues to consider include:

- If you fix your interest rate then you will have peace of mind that your rate won’t increase for the term of the fixed rate. This suits people that are very concerned about interest rate increases. It’s a bit like insurance. It might cost you more but it may make you feel more secure.
- Fixed rate products are not very flexible. They often limit the amount of extra repayments you can make and there can be some very high costs involved if you break the fixed rate term. This “lack of flexibility” needs to be considered.
- Fixed rates are probably useful if your cash flow is tight. That is, if interest rates increase you may struggle to comfortably meet loan repayments.



**Your call**

The fixed versus variable decision is a very personal one. I guess there is no right or wrong decision – it just depends on your personal situation. The only thing I would caution you on is fixing for the sole reason of thinking you will be financially better off – you might be, but it’s unlikely.

**Mortgage Insurance Changes**

At last the mortgage insurers in Australia have finally adjusted their policy to compensate for the changes in property prices and purchasing power. As standard policy they have increased the maximum loan to \$650,000 where the loan to value ratio up to 95%. In fact, the mortgage insurers now have the ability to approve loans up to a maximum loan to value ratio of 95% and a maximum loan of \$1,000,000. This means that property purchasers don’t need as much deposit as they used to.

**ProSolution’s List of Trusted Professionals**

We understand that people want to find professionals that they can trust, will provides good 'old fashioned' customer service and will always act in their best interest. Therefore, we maintain a list of professionals that we have found provide good consistent levels of service. Professionals that you can trust!

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