

December 2006 Newsletter

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Invest or repay extra into your home loan?

Many people are very focused on repaying their home loan. In fact, some people will put off borrowing any other funds (to invest) until their home loan balance is zero. Is that the best thing to do? Or is there some middle ground that may allow you to borrow to invest and repay your home loan?

Naturally, you may think that I have a vested interest in promoting borrowing more to invest. This may be true. However, as many regular newsletter readers will know, I always back up my analysis with numbers. In addition, it is important to recognise that my "analysis" will not be applicable to everyone. People have different debt tolerances. You should only ever borrow within your own comfort zone.

In this article, I will assume that the investor will purchase a residential investment property. This is only used as an example. Of course, an investor could invest in any asset class. However, should the income yield and capital growth vary from my assumptions, then the outcome and findings could also vary.

How much does it save?

I have assumed that a home owner has a home worth \$800,000 with a mortgage for \$400,000 at 7.5%. The normal principal and interest repayments would be just under \$2,800 per month. The borrower will pay over \$600,000 in interest costs if they make the minimum repayments. However, if the borrower repays \$1,000 extra per month (say \$3,800 in total), they will save \$350,000 in interest and repay their mortgage in less than 15 years.

The investor also has more equity in their property, because they have reduced their loan amount (increasing the difference between the outstanding loan and the property's value). They repaid an extra \$1,000 for 14 years and 5 months. That amounts to \$173,000.

Therefore, this person is better off by a total of

\$523,000 (\$350k + \$173k).

Investing in property

Assume that the investor purchases a \$400,000 investment property. This investment property may end up costing approximately \$1,000 per month (i.e. total costs such as interest less rental income = \$1,000 per month). Generally, the negative cash flow that an investment property produces reduces every year. Many investment properties produce a negative cash flow for the first 6 to 10 years. After this time, the rental income will generally be sufficient to pay for all of the properties expenses. I will assume that this investment property will produce a negative cash flow for 10 years. After this time, the investor can then divert the extra cash (i.e. the \$1,000 per month) to repaying their home loan.



Using a spreadsheet model which accounts for capital growth and property expenses, I have calculated that the investment property will increase a person's net wealth by just under \$840,000 (the major assumption is the property's capital growth rate of 8% p.a.). This increase in wealth takes into account the negative cash flow that the investor has had to contribute, as well as the increase in the property's value.

In addition, the investor will save interest, as they redirect the \$1,000 per month back into their home loan after 10 years (once the property starts paying for itself). This will save them a little over \$150,000 in interest costs over the term of the loan (21.5 years). It would be unfair to include all this interest saving as we need to compare apples with apples. That is, in the first scenario (i.e. repaying the home loan), the term was 15 years. Extra principal repayments of \$1,000 per month over 5 years equals \$60,000 plus the interest saving of say \$75,000 results in an estimated saving of \$135,000.

Therefore, the overall increase in wealth is \$975,000 (\$840k + \$135k). This is almost double the 'repay your home loan scenario'.

The winner is...

A person is better off buying an investment property

instead of making extra repayments on their home loan by over \$450,000 after 15 years.

Not without risk

The 'invest in property' scenario is not without risk. The key assumption is the property's capital growth rate. I have assumed that the property will increase in value by 8% per year on average (over a 15 year period). This is a reasonable assumption, as many properties located in 'blue chip' suburbs have performed better than this over the long term. Therefore, in my opinion, it is very reasonable that you can achieve this level of capital growth. The key risk is correct asset selection. That is, you need to make absolutely certain that you chose the best possible property for your money. Purchasing an asset that does not provide strong capital growth from the start will do more harm than good. For example, based on the scenario above, if the property's capital growth is less than 5.4 % per year, then you will be better off repaying your home loan. Conversely, if the property's capital growth rate is greater than 8%, say 10%, then the investor is better off by just under \$900,000 after 15 years.

I don't know how many times I have to make this point, but buying a good quality property from the start is absolutely critical. In this regard, I would strongly advise people to seek professional assistance and advice from a professional Investment Property Advisor. As demonstrated above, the difference between 8% capital growth and 10% capital growth amounts to \$450,000 after 15 years. I have used the services of an Investment Property Advisory when purchasing my investment properties. Capital growth is not absolutely guaranteed. However, due to their experience and skill, the risk of buying an under performing asset is greatly reduced. I am very confident that they are going to do a much better job at selecting a strong asset than I could.

In my next newsletter, I will discuss how important it is to constantly review your investment performance and dispose of underperforming assets as soon as possible. People rarely like to dispose of property if it's not performing well. Instead, they will hang onto it just in case it "turns around", but often, it doesn't!

What is the point of equity?

After 15 years, the investor will have a lot of equity in their investment property. However, they will still

have a larger home loan and therefore a larger expense compared to the person who repaid their home loan. Therefore, to some extent, the investor will be asset rich and income poor. The "home loan repayer" will be the reverse.

Most people's aim is to retire. To do that, they need to be generating an income stream. That is hard to do if you are still repaying a home loan. Therefore, the decision to repay a home loan or invest greatly depends on your stage of life. If you are still 10 to 20 year away from retirement then investing in a property will pay dividends in the future. If you are planning on retiring in a few years, then you may be better served by reducing your home loan.

In regards to the benefit of equity, it creates opportunities. It will generate an increasing income stream in the future. It will allow you to invest in other assets or more property. If you sell some or all your property, you will be left with a large sum of cash (although you must consider capital gains tax). Equity can also help your family (children, grandchildren) purchase a home. There are many benefits of having equity in property.

Do your sums

Investing in property or any other asset for that matter does not suit everyone. You need to prepare a budget and be absolutely comfortable with taking on the additional debt. You also need to understand the risks associated with each option. Hopefully, I have demonstrated that repaying your home loan may not necessarily always be your best option (in terms of increasing your wealth).

Christmas Office Closure

Our office will be closed from 12pm on Friday 22 December 2006 and will re-open on Wednesday 3 January 2007. We wish you a safe and enjoyable holiday season and a prosperous 2007!

Our Best Interest Rates

Basic variable	7.24%
Offset	7.30% (0.77% ongoing disc.)
Offset (> \$1 million)	7.19% (0.88% ongoing disc.)
1 year fixed	6.69%
2 years fixed	7.09%
3 years fixed	7.09%
4 years fixed	7.14%
5 years fixed	6.99%

Above rates are current as at 14/12/06 and are subject to change without notice. Standard lenders terms and conditions apply.