HOLM TRUTHS

Down to earth advice for savers and investors from independent investment commentator Mary Holm

SPRING 2006

Mortgage moves

You've probably got the message by now, from Holm Truths and the like: It's a great idea to pay off your mortgage as fast as possible.

Paying off an 8% mortgage, for example, is equivalent to making an investment that pays you a guaranteed return of 8% after fees and taxes. And it's risk-free.

But not everyone is in a position to pay extra off their mortgage. There are other ways you can make the big loans work better for you. Here are some FAQs:

Should I add high-interest debt to my mortgage?

In most cases, yes.

For a start, it makes life easier to put all your debts together, so you have just one payment to deal with.

And adding credit card and hire purchase debts to your mortgage is certainly better than taking up other debt consolidation offers that sometimes charge interest as high as – if not higher than – credit cards and so on.

The big advantage of adding your debts to your mortgage is, of course, that you pay lower interest. **But there are two disadvantages:**

1. You may have to pay early-repayment charges on the other debts. Make sure your interest savings will more than make up for that.

2. Unless you take steps to avoid it, you turn short-term debt into long-term debt. By repaying the money over a longer period, you can end up paying more total interest despite the lower rate.

The trick is to continue to pay off the same amount as you would have paid on the high-interest debt, in addition to your regular mortgage payments.

That way, you will get rid of the debt faster and end up with a genuine interest saving.

While we're at it, try not to take on any more high-interest debt. If you save for items before buying them you will end up much better off. *(CONTINUED PAGE 2)*

TOO INTERESTING?

Some lenders offer interest-only mortgages. Keep in mind, though, that you will never pay off the principal (the amount borrowed).

And you might be surprised at how little extra you would have to pay each month to make inroads into the loan.

On a $200,000 interest-only mortgage at 8%, you would pay $1,333 a month.

But if you were instead repaying principal and interest over 30 years, you would pay $1,468 a month – just 10% more. And after 30 years you would own the house mortgage-free.

THE PRICE OF LENGTHENING YOUR MORTGAGE

$100,000 mortgage with monthly payments of $775

You start with a 20-year mortgage at 7%. When interest rates rise, you extend the term to keep your monthly payments constant at about $775.

Term of mortgage	Interest rate	Total interest paid over life of loan	Principal repaid after 5 years
20 years	7%	$86,000	$13,700
25 years	8%	$132,500	$8,000
30 years	8.5%	$179,000	$5,000
40 years	9%	$272,000	$1,900
50 years	9.2%	$365,000	$600

For a $200,000 mortgage, double the numbers in columns 3 and 4.
For a $300,000 mortgage, treble the numbers, and so on.

IT'S NOT A RIPOFF

Let's say you can't afford your mortgage payments so you extend the term of your loan. You end up paying more total interest. But you are not necessarily being ripped off. Interest is the price you pay for using someone else's money. If you use it for longer, it's fair enough that you pay more for it.

However, it pays to be aware of the interest cost of these moves. The more years you spend paying interest to others, the fewer years you have to accumulate savings for yourself – at which point you will be the one earning interest or other returns.

Is it better to make mortgage payments fortnightly or monthly?

Lenders sometimes claim that you save lots by paying half the monthly amount each fortnight.

But that's mainly because you will make 26 half payments a year, which totals 13 full payments. In other words, you are simply paying off the loan faster, so of course you will pay less interest.

You could achieve the same result by boosting your monthly payments by one-twelfth.

This, however, ignores the real issue. It's best to match the frequency of your mortgage payments to the frequency of your salary or wage payments. Have the money transferred to your mortgage the day after you receive it.

There are two advantages to this: You're not tempted to spend the money on something else. And the money doesn't sit around in a bank account earning no or low interest, which is taxable. Once the money is in the mortgage account, that's the equivalent of earning you the mortgage interest rate, free of tax!

Footnote: If you are paid weekly, the mortgage lender might not accept weekly mortgage payments. You should opt for the closest to weekly, which will probably be fortnightly payments.

Is a no-deposit mortgage a good idea?

Most people probably shouldn't take on a mortgage if they can't save at least a few thousand dollars for a deposit on a home.

Don't rely on a keen mortgage lender to assess your ability to service a loan. Make sure that you won't find yourself unable to meet mortgage payments and having to sell your house at a time that doesn't suit you.

If you do face a forced sale, you are not in a strong position to bargain. If it happens to be when house prices have fallen, in particular, you may well end up owing the bank more than you get for your house – possibly leading to bankruptcy. It's happened before and it will happen again.

Another negative is that 100% mortgages usually include lender's mortgage insurance, which can raise the fees considerably and protects the lender, not you.

A safer way is to find out roughly how much mortgage payments would be on the sort of house you might buy. Save that amount, after allowing for your rent, for a year or two, and use that money as your deposit. Then you will know you can probably cope with the mortgage.

What should I do if I just can't meet new higher payments when interest rates rise?

An obvious answer is to reduce your other expenses. If you keep track of all your spending for a month or two you may find areas in which you can cut back.

In some households, though, that's easier said than done. Another solution is to negotiate with the lender to keep your payments at the old lower level and extend the term of the mortgage.

For example, on a $100,000 20-year loan at 7%, monthly payments are $775. If mortgage rates rise to 8%, you can keep your payments constant by extending the loan to 25 years.

And if rates rise to 9%, you can still keep paying $775 a month if you extend the loan to 40 years.

The downside: At 8%, over the life of the loan you will pay more than 50% extra in interest and at 9%, you will pay more than three times as much interest. (See table).

Of course, most people won't own the same home for 20 years, let alone 40 years. But you'll still be paying much higher interest for the period in which you do own the home.

There's another point too, which is particularly relevant if you own your home for a relatively short period.

The longer the term of the loan, the smaller the proportion of your early mortgage payments that will go towards reducing the principal.

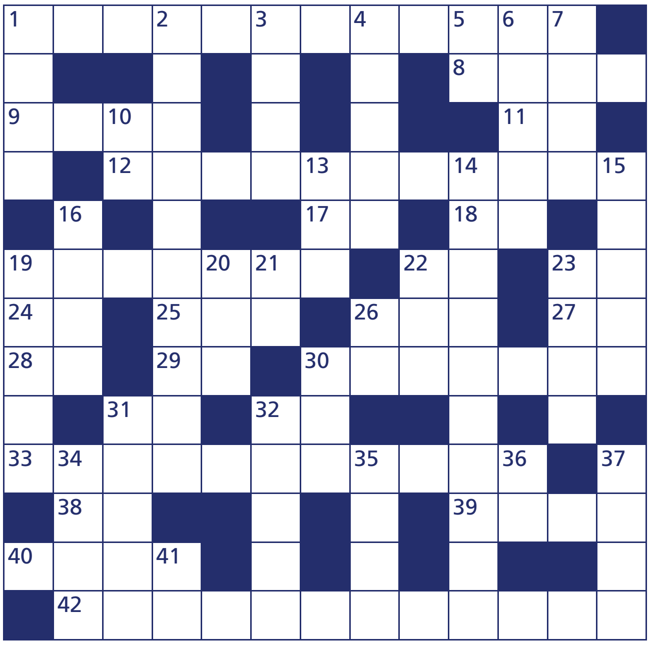
In our example, after five years you will have paid $13,700 off a 20-year loan. But with a 40-year loan, you will have paid off a mere $1,900. And with a 50-year loan, you will have made only a $600 dent.

If you do extend the term of your loan, it's a great idea to reduce the term again later, whenever your income rises of mortgage interest rates fall.

> ***"Before borrowing money from a friend, decide which you need most."*** Proverb

HOLM TRUTHS CROSSWORD

SPRING 2006



Solution: Back page

ACROSS

1. Price of a loan (8, 4)
8. Tunnelling animal (4)
9. In _ _ _ _ of (4)
11. "_ _ You Like It" (2)
12. 24 hours (5, 3, 3)
17. Wizard's country (2)
18. Exists (2)
19. What landlords don't want (7)
22. Written afterwards (initials) (2)
23. About (2)
24. Same as 11 across (2)
25. Boy (3)
26. Extinct bird (3)
27. Boy's name (abbreviation) (2)
28. California city (initials) (2)
29. For instance (initials) (2)
30. Dangerous part of pool (4, 3)
31. Indefinite article (2)
32. Same as 31 across (2)
33. A tendonitis (anagram) (11)
38. A record (initials) (2)
39. US state (4)
40. Skid (4)
42. Gathering, stockpile (12)

DOWN

1. Island (4)
2. Of the same value (10)
3. Every (4)
4. Yellow gem (5)
5. Morning (initials) (2)
6. Amphibians (5)
7. Girl's name (4)
10. Printer's measure (2)
13. Plaything (3)
14. No tips paid (anagram) (10)
15. Return (5)
16. Space programme (initials) (4)
19. Legitimate (5)
20. Pester (3)
21. Modern 38 across (initials) (2)
22. Edgar Allan _ _ _ (3)
23. Grade, position (4)
26. Myself (2)
30. Found in cells of organisms (initials) (3)
31. Savoury jelly (5)
32. Year (5)
34. Girl's name (4)
35. Charge to cross bridge (4)
36. Not yes (2)
37. Profit (4)
41. Computer or policeman (initials) (2)

From the Mailbox

Dear Mary:

My wife and I just bought a house not long ago. We have only a small mortgage, so we think we want to re-invest some of the equity of the house in either shares or other properties.

I personally prefer shares. It seems less hassle. Could you recommend some investment options for our situation please?

Dear Reader:

Your reaction is a common one: "I have equity in my house, and I want to make use of it." But be cautious!

While the lender will probably let you increase your mortgage and invest that money elsewhere, that's a relatively risky thing to do.

To come out ahead, you must earn a greater return on your investment – after brokerage, fees and so on – than the interest you are paying on your mortgage.

> **Borrowing to invest works only if you make riskier investments.**
>
> **Make sure you have reliable alternative income.**
>
> **Be aware of the tax risks.**

Even then you benefit only by the difference between the two numbers. Money (including dividends, rent and capital gains) comes in; interest goes out; and you keep what's left.

The only way you can earn a high enough return is through riskier investments like shares, a share fund or property.

This is not easy. In almost all cases of current property investment, the rent after expenses won't cover your mortgage interest. It's only the capital gain when you sell – an unknown number – that gives you your profit.

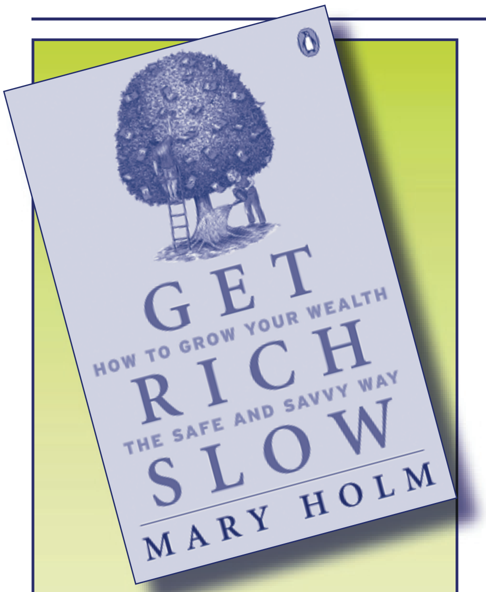
With shares or a share fund, it's possible but unlikely that your dividend income will cover the mortgage interest. You certainly can't count on it. Again, it's usually the unknown capital gain that makes it all work well.

In the meantime, you must be sure you have a reliable source of other income to cover the shortfall. Could you cope if you lost your job? If you both work, that reduces the likelihood you will be caught short.

Consider, too, what would happen if your dividend income plunged, or you had a long period without tenants or faced a major maintenance expense on a rental property.

You should be confident that, whatever happens, you won't find yourself forced to sell your investment when you didn't plan to – possibly at

(CONTINUED PAGE 4)



WINNERS

The winners of the give-away of my new book, ***"Get Rich Slow: How to grow your wealth the safe and savvy way",*** *are:*

Dianne Green, *Wellington*

Joy Jordan, *Upper Hutt*

Keith Murray, *Christchurch*

Jonathon Pearce, *New Plymouth*

Jo-Ann Pearson, *Titahi Bay*

By the way, ***"Get Rich Slow"*** *went straight onto the New Zealand non-fiction bestseller list as the top finance book. Thanks to all of you who have bought it!*

WRITER AND PUBLISHER

Award-winning journalist Mary Holm writes the *Money* column for the NZ Herald and *The Investor* column in the Waikato Times, Dominion Post, Christchurch Press and other major newspapers. She runs seminars, and is the author of *Get Rich Slow* (Penguin, $29.95, at good bookstores); *Snakes & Ladders – A guide to risk for savers and investors* and *The REAL Story – Saving and investing now that inflation is under control* (both published by the Reserve Bank). Mary holds a BA in economic history, MA in journalism and MBA in finance. Her website is www.maryholm.com

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(FROM THE MAILBOX, CONTINUED)

a loss. As I said in the previous article, forced sales are a no-no.

You also need to be confident you wouldn't bail out in a panic if the share or property market falls for a while.

If you feel you are in a position to go ahead, you face the diversified shares v property question.

You're quite right that shares or a share fund are less hassle. And you may be better diversified, given that you already own your home.

Also, if you unexpectedly find yourself in a tight spot for a short period you can quickly and easily sell a small portion of your shares or share fund units. Not so with a property.

However, many people say they prefer rental property. They like to be able to look at their investment and to boost its value with do-it-yourself projects.

And the property market is generally not as volatile as the share market.

Either way, be aware that it's always possible Inland Revenue will take a close look at your capital gain. Assuming you don't trade frequently, generally speaking whether your gain is taxable depends on your purpose when you purchased.

If the income from your investment doesn't cover the mortgage interest and other expenses for years – particularly likely with a rental – it would be hard to convince Inland Revenue that you invested for the income rather than the capital gain. And if you can't convince them, you're likely to be taxed on the gain.

There's one way around this. Assuming proposed legislation is passed, from next year you will be able to invest in a PIE (portfolio investment entity) that invests in New Zealand and Australian shares. Such funds will be exempt from capital gains tax.

Given your tendency towards shares, that might turn out to be a good choice for you. Just remember, though, that borrowing to invest in anything ups the ante. If the investment goes well, you do very well. If it doesn't, you can end up worse off than when you started.

If you're not that keen on risk, don't feel obliged to "use" the equity in your house. You're already using it. It gives you rent-free shelter.

> ***"Sometimes your best investments are the ones you don't make"*** Donald Trump

You're welcome to send questions to From the Mailbox. Email them to mary@maryholm.com, or mail them to P.O. Box 8520, Symonds Street, Auckland 1150. Please include your phone number. Unfortunately, Mary can't answer all questions in Holm Truths, and cannot correspond directly with readers.

Holm Truths Crossword Solution

I	N	T	E	R	E	S	T	R	A	T	E	
S			Q		A		O		M	O	L	E
L	I	E	U		C		P			A	S	
E		N	I	G	H	T	A	N	D	D	A	Y
	N		V			O	Z		I	S		I
V	A	C	A	N	C	Y		P	S		R	E
A	S		L	A	D		M	O	A		A	L
L	A		E	G		D	E	E	P	E	N	D
I		A	N		A	N			P		K	
D	E	S	T	I	N	A	T	I	O	N		G
	L	P			N		O		I	O	W	A
S	L	I	P		U		L		N			I
	A	C	C	U	M	U	L	A	T	I	O	N

HELPFUL WEBSITE

I've recently launched a website, www.maryholm.com, which has all sorts of information that I hope you will find useful. You can:

- *Read my latest NZ Herald column and latest syndicated column (which runs in the Waikato Times, Dominion Post, Christchurch Press and other major newspapers).*
- *Read the first and last chapters of my book "Get Rich Slow", and click through to an online book-shop to buy it.*
- *Subscribe to the website for just $20 a year in an introductory offer and you can search through previous columns and Holm Truths for information on any financial topic.*
- *Learn about hiring me to run a seminar!*