

Volume 9, Issue 2

Summer debt, 2005

WWW.JOHNQREGG.COM

Planner

Debt Strategies

FLOATING TO FREEDOM FASTER?

To lock it up? Or to float away? The Asia triplets ponder the nearly inscrutable: new mortgages.

Each has located the perfect home, saved the down payment, arranged parental assistance, and now negotiates a \$100,000 mortgage to be amortized over fifteen years.

1. LOCKED INTO SAFETY

Phant, the more squeamish sister, locks into a five year rate at 6%. She appreciates knowing that precisely \$840 will be required monthly for the next 60 months. Youthin, a flexible type, opts for a variable rate mortgage (VRM) at 4.25%. His first payments will be \$750 monthly. He enjoys the freedom of being able to dump any windfall profits on the principal. He needles Phant, pointing out that while he can lock into a guaranteed rate at any time, she can't go the other way without a severe penalty.

But Phant notes how heavily the VRM is flogged to young borrowers. (Along with high-ratio or no-down-payment mortgages, a scary story for another day.) They may start out as two-wage earning

families, but soon become reliant on one, simultaneously beset with the high cost of disposable diapers. If they struggle to meet \$750 at 4.25%, how will they possibly afford \$840 when prime hits 6%? Or \$921 if it reaches 7.5%?

2. FLOATING ON HISTORY

Youthin, though, is not speculating on the direction of interest rates; in fact, he fully expects short term rates to trend upward. But upward, downward, or sideways, since 1950, 88% of Canadian mortgage history** clearly favours the VRM. And the remaining 12% Youthin regards as historic anomaly not likely to be repeated: the early 80's when mortgage rates hit 25%; banks brutalized borrowers, especially those with the temerity to request short term pain.

\$22,100 is the average historical difference in interest costs between the two strategies. This can be considered the premium Phant pays for security on \$100,000 borrowed, or the savings Youthin earns for guts.

1.75% is Phant's premium in interest. Not only would the VRM have to catch up to this premium, but, for each month it

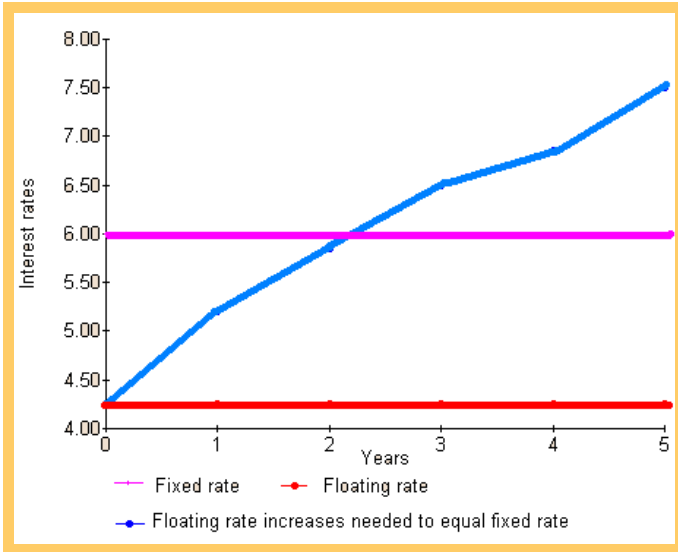
(Continued on page 2)

*A plethora of VRM flavours are currently offered. For this paper consider it generic: at bank prime, fully floating, fully open. "Prime" is the bank's key lending rate, and tends to move in step with the overnight lending rate charged banks by the Bank of Canada. "Fully floating" indicates the VRM rate will automatically adjust along with prime. "Fully open" indicates that any additional payments may be made at any time, without penalty.

**This paper is built from various research reports and articles of Moise A. Milevsky, Professor of Finance, York University. For detail, see www.milevsky.com.

(Continued from page 1)

doesn't increase, it would need to increase even more significantly for Youthin's interest costs to catch Phant's. See the chart. If Youthin's floating rate were jacked along the blue line, he and his sister would break even over her five year term. Such dramatic spikes are not in Youthin's forecast.



3. COMBO: A FASTER FREEDOM

Sister Melon has a further take on the issue. She borrows at the VRM rate (\$750 monthly) but pays at the five year rate (\$840). This benefits her two ways. First, it knocks down the principal owing by an additional \$90 monthly. Second, it builds in forward protection against future "rate shock." Her budget is set for the next five years.

Melon, history suggests, may save as much as her brother. But she does it in a different way. By knocking down the principal faster, she shortens her amortization period. She'll be mortgage free three years before either sibling. Her disposable income will then improve by \$10,000 annually, enough to play RRSP catch-up. Which, as they say, is another story.

To subscribe, unsubscribe, or to receive this letter electronically, go to

WWW.JOHNQGREGG.COM

MATURITY VALUE OF SAVINGS DISTRIBUTION

1950 – 2000

How much would have been saved on a \$100,000 mortgage at floating prime versus five year fixed rates over a total 15 year amortization? Professor Milevsky plotted rolling time periods (January 1950 to January 1955, then February 1950 to February 1955, and so on), such that 420 historical observations were tracked. The results below suggest how much of the time one saved more than a specific amount. For example, for 80% of the time, one would have saved over \$13,690. This could, then, be considered "probability". There's the very slim 5% chance of saving over \$59,000, equivalent to the chance of spending \$18,000 more.

Probability Percentage?	MVS
5	59,380
10	50,894
15	42,220
20	36,669
25	29,865
30	26,839
35	25,012
40	23,598
45	21,404
50	19,916
55	18,993
60	17,758
65	16,694
70	15,932
75	15,107
80	13,690
85	11,351
90	-8,393
95	-17,974

Source: Moshe A Milevsky, *Mortgage Financing: Floating your Way to Prosperity*, IFID Centre Research Report #01-01, March 25, 2001.

#2 – 654 Harper Road, PO Box 679, Quathiaski Cove, British Columbia, V0P 1N0

[250] 285-3169 — johnq@johnqgregg.com