PAY OFF YOUR MORTGAGE OR INVEST?

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Ahh, "Should I pay off my mortgage or invest?"

If I had to declare my favourite money management question, this would be it. Why? Because it has the potential to be financially life changing.

Life changing? Well, how does over $2.4million over 30 years sound?

A figure like that should rightly raise your curiosity levels. Now I'm not automatically suggesting that what you're about to see illustrated is going to be the same for everyone, because it won't be. I always recommend you should seek professional advice to get your own numbers crunched before doing any investing because it's a big financial decision and one that you need to fully plan for and understand in order to ensure it's the right thing for you.

Before I share with you exactly how this is possible, let's first recognise the two most common household beliefs:

1. **You should pay down your mortgage debt as quickly as possible**

2. **You can't afford to invest in property AND also pay off your own mortgage**

From the outset, these assumptions seem valid, don't they?

For one, a large chunk of our hard-earned money is already feeding the monthly repayments on our own mortgage — surely there's no room to take on another one? Plus, you don't really want debt "hanging over your head" forever, am I right?

I get it — holding debt is actually the major reason why the majority of us don't take this path. Paying off the mortgage makes us feel like we're making progress — you're seeing your debt going down — whereas buying an investment property means more debt. Debt that, without first crunching the numbers, might feel like you'll never pay it off and, in the process, you'll end up paying a huge amount of mortgage interest.

The potential problem with this line of thinking is that households wait too long before they start investing. They don't give themselves enough time to build an investment nest egg big enough to sustain the quality of life they might be enjoying now. My advice here is: be careful of making financial decisions based on feelings rather than the numbers.

With that in mind, let's get back to the $2.4 million dollar question...

"Why should you prioritise investing in property rather than pumping all of your cash into your mortgage?"

So, let's meet Alan and Julie.

Here's what their **current financial picture** looks like:

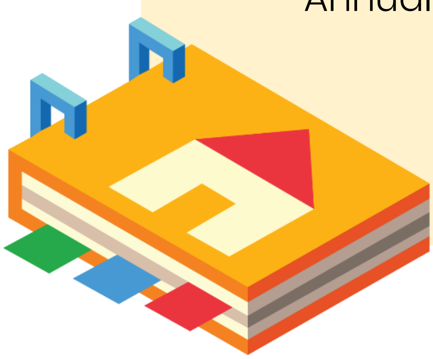
They're a mid-30s couple, each earning $60,000 p.a.

Total Income: $120,000 gross = net income of $96,766

Their home is worth $665,000
Current Mortgage is $400,000
Annual mortgage repayments of $35,505 (4% interest, Principal &Interest repayments with 15 years remaining on the original 30 year term loan).

Annual household expenditure is $47,400 (Bills/Spending)

Total Annual outgoings: $82,905
Annual Household Surplus (cashflow) is 13,861 ($1,155.08 per month).



Option 1 – Pay Off Mortgage Only Option:

PAY OFF MORTGAGE ONLY				
Year	**Family Home**	**Debt**	**Cash/Savings**	**Net Position**
0	$ 665,000	$ 400,000	$ -	$ 265,000
1	$ 711,550	$ 367,751	$ -	$ 343,799
5	$ 932,697	$ 210,007	$ -	$ 722,690
10	$ 1,308,156	$ -	$ 52,991	$ 1,361,146
15	$ 1,834,756	$ -	$ 399,221	$ 2,233,977
20	$ 2,573,340	$ -	$ 835,439	$ 3,408,779
30	$ 5,062,150	$ -	$ 2,052,774	$ 7,114,924

As demonstrated in Table 1 – if Alan and Julie commit to trapping their surplus cashflow of $13,861 to make extra repayments on their mortgage, and then continue to trap this surplus over the 30-year modelled term, their future value position will be $7,114,924. In today's dollar terms (allowing for 3% inflation) this will be $ 2,931,254.

On the mortgage front, by focusing on paying it off sooner, Alan and Julie would pay off the entire loan early in an impressive 9 years and 1 month, instead of the 15 years remaining.

This will save them $51,796 in mortgage interest. Nice job, right?

Option 2 – Buy a $500,000 Investment Property (and Take a Little Longer to Pay off Mortgage)

Well, let's take a look at what might be possible if they chose to invest in a property instead. Spoiler Alert! – I'm going to show you the result first and *then* unpack how they did it.

BUY ONE INVESTMENT PROPERTY WITH THEIR MONEY								
Year	**Family Home**	**Investment Property**	**Total Value**	**O/O Debt**	**INV Debt**	**Total Debt**	**Cash**	**Net Position**
0	$665,000	$500,000	$1,165,000	$400,000	$530,000	$930,000	$ -	$765,000
1	$711,550	$530,000	$1,241,550	$385,197	$524,049	$909,246	$ -	$856,353
5	$932,697	$631,238	$1,563,935	$306,843	$493,896	$800,739	$ -	$1,257,093
10	$1,308,156	$844,739	$2,152,895	$148,745	$444,490	$593,235	$ -	$2,004,150
15	$1,834,756	$1,130,452	$2,965,208	$ -	$263,341	$263,341	$ -	$2,965,208
20	$2,573,340	$1,512,800	$4,086,140	$ -	$ -	$ -	$229,377	$4,315,517
30	$5,062,150	$2,709,194	$7,771,344	$ -	$ -	$ -	$1,769,448	$9,540,792

In this scenario we see Alan and Julie buy a $500,000 investment property. When you compare the two results, we see and learn a lot.

Firstly, let's look at the difference in cash positions: they have $283,326 in additional cash if they paid off their home and saved the cash.

What about the additional interest they paid overall in buying the investment property? They paid $47,921 in additional mortgage interest on their home loan.

But here's the kicker – this additional interest allowed them to control one investment, which in turn made them $2,425,868 in net worth over the 30 year period. Given them a total net worth of $9,540,792. (In today's dollar terms this amounts to $3,930,680.)

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None of these scenarios assume that they have an offset account.

100% transactional offset accounts are an Australian invention. They operate like a standard bank account, yet importantly they help offset the interest cost that is paid on your mortgage on a nightly basis.
Let's look at another example.

You have an outstanding balance of $100,000 on your mortgage on the first day of the month. Your mortgage interest rate is 4%. In your 100% transactional offset account, you have $25,000. Tonight, when the bank rolls over in to the next day, it will calculate how much interest to charge you for this day. **How will your interest be calculated?**

It'll be based on $75,000 because the $25,000 reduces the loan balance for that day to $75,000! It'll save you $83.33 that month *(without you doing anything!)*

For more in-depth analysis on how much you can save and be smarter around your mortgage, check out our best-seller book!

So How Did They Do It?

Firstly, you need to understand what it costs to acquire and maintain an investment property. At this point, it's important to note that there are a lot of variables to this question, as some properties are going to cost more than others; just as some are going to perform differently, in terms of investment returns. Again, speak to a qualified property investment advisor to learn more about the types of properties and investment returns.

In the example I use, we're focused on a growth property, meaning we want its value to grow over time.

UPFRONT COSTS AND LENDING	
Investment Property Purchase Price	$500,000
One off Acquisition Costs - Stamp Duty, Legal etc. (allow 6%)	$30,000
Loan Amount	$530,000

We learn a bit more information about Alan and Julie's intensions from Tables 3. They're going to borrow the full amount to purchase the property and cover the upfront costs. They're able to do this based on the **equity** they have in their existing property, as no lender is going to lend more than the investment property is actually worth, without additional security to support the borrowings.

So they're using their home as security to borrow the full amount.

This is a very common approach for most property investors starting out, as it means they don't need to use any of their own cash savings.

What is the ideal equity 'sweet spot' and how do I work it out?

In my view, the equity 'sweet spot' is when you do not need to use any of your own cash or savings. Instead, you can cover the upfront costs by using borrowings.

Let's use Alan and Julie's example to show how to work this out:

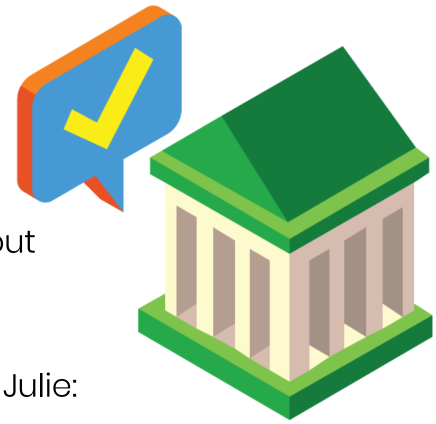
They own a $665,000 property with an existing $400,000 debt. This represents a Loan to Value Ratio (LVR) of 60.15% (400,000/665,000 x 100/1). Banks are comfortable in lending up to 80% without asking the borrower to insure the risk of going higher by paying Lenders Mortgage Insurance (LMI).

So I recommend for most people to stay under 80%. This means we have $132,000 in available funds using the family home as equity (665,000 x 80% = 532,000 less $400,000 already borrowed = $132,000).

The same rule applies for the investment purchase to keep this under 80% LVR. If we want to buy a $500,000 property, then an 80% LVR is $400,000 against this property. For clarity this loan will be also be a principal and interest loan over 30 years.

Assuming our upfront costs are 6% for stamp duty, legal fees etc, ($30,000) then to complete the purchase we need to find $130,000, which we worked out we have. So, for me, the equity 'sweet spot' when you are in the accumulation phase of buying an investment property, or adding one to your portfolio, is to keep you global LVR below 80%.

Can You Afford it?



Calculating the equity 'sweet spot' is one of the two critical components needed to work out what you can afford to buy. The other very critical component is: cashflow - can you afford to borrow all this money without affecting the household budget?

Let's now look at the ongoing holding costs for Alan and Julie:

In my view, the equity 'sweet spot' is when you do not need to use any of your own cash or savings. Instead, you can just cover the upfront cost by using borrowings.

ONGOING HOLDING COSTS*	Money IN	Money OUT
Rental Income (Occ. Rate 95% p.a)	$ 19,000	
Annual Expense		
- Property Management (@ 7.7% rent)		$ 1,463
- Maintenance (1% of initial value index 3% p.a)		$ 5,000
TOTAL ANNUAL EXPENSES		**$ 6,463**
Interest Expense (@ 6% P&I 30 yrs)		$31,623
Principal Repayment		$ 6,508
TOTAL COSTS		$44,594
Gross Cash Flow		-$25,594
Tax Addback Benefit (@32.5%)	$ 6,203	
Total Net Cash Flows		-$19,391
Equals Monthly Cost of (after tax)		-$1,615.96

*Year 1 example shown, as income and costs vary each year

If they want to buy this investment property, the numbers show us that they will need to cover the monthly cost of $1,616. If we look back at their current monthly surplus, it was only $1,155 each month. So, currently they are $461 shy each month of being able to cover holding this property.

What are their options?

The logical first option is to look at their current bills and spending to see if there is any discretionary spending they would be willing to sacrifice to find this money, remembering there is potentially a life changing financial story here. Are they willing to forget some short term spending for long term financial gratification? Hopefully some will, but the statistics tell us they won't. However, what if it were possible to find this $461 a month without impact the family budget?

Here is a way to do it.

You refinance the existing 15-year home loan term on the family home, whereby the current monthly repayments are $2,958.75 loan, back to 30-year home loan term, whereby the new monthly repayments will only be $1,909.67, which results in an additional $1,049 cashflow surplus. This clearly covers our $461 shortfall and leaves $588 to go back into Alan and Julie's mortgage offset account or available redraw if they need any short term funds for an emergency. And we learnt earlier what this move costs in terms of additional interest charges on the home— only $47,921.

This household budget restructuring strategy can be a game changer for most people who don't realise, up until now, that it's possible to realise the dream of owning an investment property, and in doing so, potentially building greater wealth.

The conclusion

Deploying one's money in different ways, such as buying an investment property instead of just paying off your home loan sooner, can yield significant transformation in terms of one's financial wellbeing.

It does, however, require a sound understanding of the numbers and potential risks involved, combined with a focus and desire to take a well-planned path less travelled.

Assumptions used in this report:

No Offset on either scenario
Growth Assumption on Family Home 7%
Growth Assumption on IP- 6%
Yield Assumption on IP - 4%
Investment Loan Interest Rate - 6% P&I - 30 Years
Home Loan Interest Rate - 4% P&I - 30 Years
Provision for Holding/Maintenance Cost pa. - 1%
Occupancy Rate - 95%
Property Management Fees - 7.70%
Initial Acquisition costs - 6% (Borrowed)
Indexation / Inflation - 3%
Household Living Expenses p/m - $3,950
Global LVR - <80% (Peaking Gearing)
No allowance made for depreciation
PAYG Withhold Variation used

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> Mid 40s couple with 2 kids. Watch here.

> Professional couple in their Late 50s. Watch here.

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- Trap your cash flow surplus each month

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- Make every dollar work harder for you
- Pay for holidays, kids' education, property and other big-ticket items
- Achieve total control of your money in this new age and invest for your financial future
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