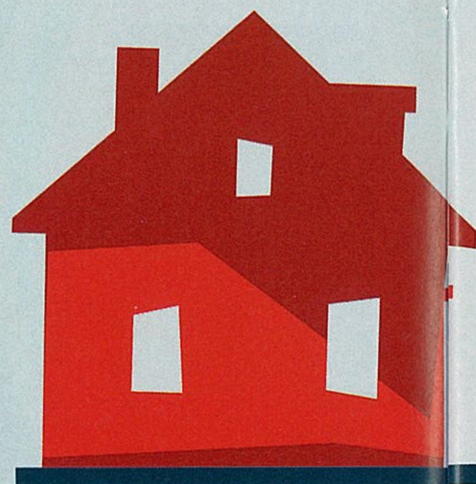
Pay off the mortgage or invest

HOW TO DO BOTH



OUR EXPERT PANEL

BRYCE HOLDAWAY

SAM HENDERSON

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Should I pay off my mortgage or invest? It's a question *Money* is commonly asked and right now, with rates at rock bottom and rental and dividend yields on the slide, you may think it's a no-brainer – put everything in the mortgage to have a guaranteed rate of return of around 4% versus an unknown rate for shares, property or super. But as our three experts show, that's not entirely correct. In fact, you could be as much as $2.5 million better off over 30 years with another strategy.

Each expert focuses on a different approach – Bryce Holdaway, from Empower Wealth, looks at buying an investment property; Sam Henderson, from Henderson Maxwell, explores putting it in super; while Ben Graham, from Graham Financial, tackles investing in the sharemarket.

Whether focusing on your mortgage or investing is the better option depends on several factors, including your age, cash flow and appetite for risk, plus interest rates and investment returns. If you're willing to take on more risk and have decent cash flow there are benefits to diversifying and investing wisely in other assets. "Essentially, you have multiple assets growing together creating wealth faster – but not without greater risk. And in times of low interest rates, growth assets tend to perform strongly, as we've seen with property in recent years," says Henderson.

Paying off your mortgage gives you a return equal to the rate on your loan – and it is tax free. For example, if you are paying 4.5%pa interest on your home loan then 4.5%pa is your guaranteed rate of return. Chances are you can you do better than that – even if you take tax into consideration – but you must be prepared to take on risk. "Managing risk is an essential to the success of the investor," says Henderson. "Time and patience are also important. You need to be able to ride out inevitable cycles in all asset classes and time is your friend."

There are times when it might make more sense to focus on reducing your mortgage rather than diverting extra cash towards investments. "People who have modest income and who are averse to risk should focus on paying off their mortgages," says Henderson. So if finances are tight and you're anxious about taking on extra debt, then this might not be an option for you. It also pays to think about how much equity you have. A rule of thumb is that you should have 50% equity in the family home before you invest extra money in other assets.

At the end of the day, by concentrating just on your home loan you may sacrifice after-tax returns that are better than your mortgage interest rate. Get the strategy right and it could be very worthwhile. Get it wrong, though, and you might wish you had kept things simple.

Give your wealth a $2.5m boost

STORY BRYCE HOLDAWAY

Overcome the fear of debt and leverage off the equity in your home to buy an investment property

Ever wondered what runs through a would-be investor's mind as they wrestle with the idea of adding a layer of financial complexity to their lives by investing in property? From my experience in talking to hundreds of people in this very situation over 18 years of advising property investors, it's this: "Should I wait to pay off my mortgage first before I start investing?"

After all, didn't previous generations tell them to stay out of debt and pay cash for everything, and here they are contemplating whether or not they should do the exact opposite? Surely they'd be better served by just chipping away at their mortgage so they can be free of debt as soon as possible. Therefore contemplating the idea of getting into more debt is just silly, isn't it?

Maybe! We now have a generation of people who are quickly approaching retirement age and realising that owning their own home without any other assets to provide an income in their twilight years is leaving them vulnerable to merely an "existence" rather than the "life" they'd once dreamed about. Now they are wondering if the once noble goal of simply paying off their home as their sole strategy was a wise one.

So this raises a question: if they are to go against generations of conditioning to embrace the idea of investing sooner, is the added risk of taking on more debt while they pay off their mortgage worth it?

I would argue that it is. By the clever use of leverage we can control a much larger asset base and, in return, get the associated compounding benefits that will ultimately provide us with more money in retirement.

For those people who have been diligently paying off their mortgage and accumulating sufficient equity in their home, they can access this store of wealth to use as security to buy an investment property. In fact, you can not only borrow the entire amount

you need to purchase an investment property but you can also cover the stamp duty and costs, which means typically borrowing 106% of the purchase price and thereby eliminating the need to save for a deposit. I'm sure this is welcome relief to most mortgage holders as we're already committing most of our monthly surplus towards paying off the mortgage.

The sweet spot for the minimum amount of equity you need is best explained by using a rule of thumb. Assuming you borrow using an 80% loan-to-valuation ratio (LVR) for the investment property, you will need to have access to $26,000 for every $100,000 of purchase price. That is $20,000 for the deposit and $6000 for the stamp duty and costs, as the bank will comfortably lend you the remaining 80% against the security of the investment property. So, for example, if you were to purchase a $600,000 investment property, you would need $156,000 ($26,000 x 6) of releasable equity available to you. Importantly, there is no one-size-fits-all sweet spot as it will need to take into account your surplus cash flow each month and your individual risk tolerance. But this guide allows you to maximise your leverage while ensuring that you avoid expensive lenders mortgage insurance (LMI).

To illustrate the point further, here's an example of a couple who are not in the sweet spot in terms of equity but are still able to afford to invest in a $600,000 property. Michael and Sophie are in their mid-30s with no children and both earn $60,000 a year. Their own home is worth $600,000 and their mortgage is $400,000. They have no credit card or personal loan debt. They are putting all their spare money into their mortgage and therefore they don't have any material savings. They are committed to paying their mortgage so they have kept their living costs to a modest $30,000pa.

> **The strategy doesn't work if the asset doesn't grow in value over the longer term**

This is what their loan structure would look like to buy the $600,000 investment property:

Loan $1,036,000

Lenders mortgage insurance $18,000

Total lending $1,054,000 ($400,000 plus $654,000 for the investment property).

Importantly, in the restructure of the lending we would change the principal-and-interest (P&I) loan on the principal place of residence (PPR) to interest only. While at face value this may seem counter-intuitive, this strategy would link a 100% offset account to the PPR loan as Michael and Sophie will park all the spare funds in there to effectively reduce the amount of interest they pay, as you would be if you were chipping away at the loan via P&I payments. However, the benefit of this approach is that they remain in control of their cash, gain greater flexibility and free up additional surplus cash flow to give them the confidence to invest without placing an additional drain on the family budget.

So what difference would investing in a property make to Michael and Sophie's overall financial picture? From the table we can see that after 30 years the difference is significant. They would be in control of property assets worth close to $6.7 million as opposed to $3.45m had they not invested in property. The net result is they would be more than $2.5m better off by investing in property rather than simply paying down the mortgage. This result illustrates my point that leveraging into investment property while you're paying off the mortgage is a superior financial strategy to simply waiting until the mortgage is paid off before starting or, worse still, not investing at all!

So with the benefit of investing so clearly evident, it's important to be balanced about the potential pitfalls that could derail this positive outcome:

COMPARE OUTCOMES: SAVE & PAY DOWN MORTGAGE OR BORROW TO INVEST AND PAY DOWN TOTAL DEBT

YEAR	PPR[1] VALUE (APPLIES TO BOTH OPTIONS)	PAY DOWN			BORROW TO INVEST							DIFFERENCE IN NET POSITIONS[2]
		OFFSET OR SAVINGS BALANCE	PPR[1] DEBT	NET POSITION	INV'T PROPERTY VALUE	TOTAL PROPERTY VALUE	OFFSET OR SAVINGS BALANCE	PPR[1] DEBT	INV'T DEBT	TOTAL DEBT	NET POSITION	
0	$600,000	$0	$400,000	$200,000	$0	$600,000	$0	$400,000	$0	$400,000	$200,000	$0
1	$636,000	$34,149	$360,667	$309,481	$600,000	$1,236,000	$19,554	$380,446	$654,000	$1,034,446	$221,109	-$88,373
5	$802,935	$191,170	$150,118	$843,988	$757,486	$1,560,422	$124,330	$275,670	$654,000	$929,670	$755,081	-$88,907
10	$1,074,509	$251,602	none	$1,326,111	$1,013,687	$2,088,196	$384,903	$15,097	$654,000	$669,097	$1,804,002	$477,891
15	$1,437,935	$770,980	none	$2,208,915	$1,356,542	$2,794,477	$438,478	none	$215,522	$215,522	$3,017,433	$808,518
20	$1,924,281	$1,422,052	none	$3,346,334	$1,815,360	$3,739,641	$462,874	none	none	none	$4,202,515	$856,181
25	$2,575,122	$2,228,667	none	$4,803,790	$2,429,361	$5,004,483	$1,360,229	none	none	none	$6,364,713	$1,560,923
30	$3,446,095	$3,219,292	none	$6,665,387	$3,251,033	$6,697,127	$2,522,337	none	none	none	$9,219,465	$2,554,078

[1]PPR = principal place of residence (owner-occupied property. [2]Borrow, invest and pay down minus save and pay down.

- **Poor asset selection.** I would avoid medium- and high-density property, such as off-the-plan high-rise apartments and house-and-land packages, as I prefer to buy established properties with a proven track record of performance that are more likely to have owner-occupier appeal and scarcity, which will help the asset perform better over the longer term. The strategy doesn't work if the asset doesn't grow in value.
- **Poor financial management.** If you're a poor financial manager of household finances, then investing in property will only amplify that shortcoming. Leverage can be a terrific friend but an awful enemy.
- **Poor advice.** Well-meaning friends and family might have your best interests at heart but may not be qualified to offer you the best advice. Engage a professional adviser who will take into account your personal circumstances as well as your risk profile.
- **No buffer.** It's important to prepare for unforeseen circumstances, so borrowing an additional amount to act as buffer is smart even if it means paying lenders mortgage insurance to obtain this facility. Generally, the LMI would be tax deductible on the investment lending over five years.

Robert Kiyosaki, who wrote *Rich Dad, Poor Dad*, says it best: "Leverage is the reason some people become rich and others do not become rich." With good money management skills, optimal loan structure and investment-grade assets, the answer to the original question of "Should I wait to pay off my mortgage first before I start investing?" is quite simple:

"No", if you want to be wealthier.

Bryce Holdaway is a partner at property investment adviser Empower Wealth, co-host of The Property Couch *podcast, co-author of* The Armchair Guide to Property Investing *and co-host of* Location Location Location Australia, *on Foxtel's The Lifestyle Channel.*