Should You Leverage Your Home or Pay It Down Rapidly?

There is a great debate within the inner-mortgage circles these days. Should we, as loan professionals, encourage clients to borrow as much money as possible? Or would consumers benefit more if we helped them to understand the advantages of 15-year amortization schedules and pre-paying principal? Let's examine the pros and cons of both strategies.

Leveraging Your Property.

In order to understand why you'd want to borrow as much as possible for your home purchase, you must first grasp the concept that equity has a zero rate of return. Here's an example:

If Consumer "A" buys a home for $300,000, and puts 20% down, then they have $60,000 in equity. Over the next 5 years, the property appreciates $100,000 in value. Consumer "A" now has $160,000 in equity.

Consumer "B" buys a home for $300,000, and puts no money down. At the end of 5 years, that same home is now worth $400,000. Consumer "B" has $100,000 in equity, which is the same appreciation as Consumer "A", a net $100,000.

As you can see, your down payment has nothing to do with your rate of return. What becomes important is how you choose to manage the $60,000 you didn't use as a down payment. If you use it for frivolous activities, such as buying toys or going to Las Vegas, it would be more prudent for you to use that money as a down payment. Especially since this will enable you to obtain a lower interest rate.

However, if you were to invest the $60,000 in a vehicle that can out-earn the cost of that debt, then this could be a formula for success. This is why some lending professionals suggest putting as little down as you possibly can, maximizing your tax write-off, and investing the rest. This principle has been applied for many years in the life insurance game. The old saying goes, "Buy term and invest the rest." The key component is taking the money you would have used as a down payment and creating an asset accumulation account. This account should earn a significant enough rate of return to enable you to pay your mortgage off entirely and achieve the ultimate goal of being debt-free.

Paying Your Home Down Rapidly.

There are very few that we have seen a client with zero debt and no financial difficulties. Choosing to pay off all of your debt can reduce stress and help you to gain freedom of cash flow for investment opportunities. A 15-year mortgage or a bi-weekly payment strategy provides structure. It can also put you on track to have your mortgage paid off within a set timeframe. Simply put, it contains built-in discipline.

It's important, however, to understand that regardless of how rapidly you pay your home off, you're not getting any greater rate of return on your investment than if you paid it off slowly.

Conclusion.

So how does one determine which scenario is best? The choice depends entirely upon the individual. Savvy consumers who are disciplined, and are comfortable taking chances from an investment perspective, would do well with the first scenario. Over the course of time, it's been proven that your rate of return over the long-haul will be far greater than the rate you'd pay for a mortgage in today's rate environment. It's important to seek the advice of a skilled investment advisor to ensure success with this strategy.

The second scenario is best for those who have a difficult time managing their money or who'll sleep easier at night knowing they have a plan in place to pay their loan off more rapidly. Be sure that your budget can handle accelerated payments. When consumers "bite off more than they can chew" with a 15-year mortgage, they frequently end up having to refinance back into a 30-year schedule.