mortgage guide

How to slash years and dollars off your mortgage

By David Sandbrand

Most people know that the usual way to finance a property – as a home or an investment – is with a mortgage, but what many don't realise is the variety of options available. Working as I do with people involved in investing in real estate, I have the chance to talk to them about different investment strategies and the relative returns, and these can include using cash, or money locked into underperforming RRSPs, or leveraging against the family home with a Home Equity Line Of Credit (HELOC).

One strategy I want to mention, if used correctly, can be very effective in paying off the mortgage on your own home in a fraction of the time it might take otherwise. This is clearly incredibly powerful and it's one I'm happy to assist some of our investment partners to use.

In simple terms, if you have equity in your current home, you can borrow against it (with a HELOC) and invest those funds in strong real estate. Then in several years, you sell that investment asset and use the profits to pay off the mortgage on your own home.

It's safe to say that most Canadians want to pay off their mortgage as soon as possible. The interest portion of a mortgage payment is a non-deductable expense – and nobody wants to retire and still have to pay that amount every month.

Because of this, many Canadians place a high priority on paying down their mortgage. In fact, many not only keep their loan term (the amortization period) as short as possible, but often make accelerated payments – or even prepayments – every month in an effort to pay down the principal amount faster.

On a typical 25-year mortgage, accelerated payments can easily chop three years off the loan, and a simple prepayment of $400 per month turns one over 25 years into slightly more than 15.

Many of these same people have lived in their home for a few years and, because of the extra payments and market appreciation over that time, they now have a significant amount of equity in it.

If this average buyer makes $400 prepayments each month, after five years the balance of the mortgage would be down to $147,956. Even given the slightly lower resale values right now, the same average home would be worth $290,347 – namely, $142,391 of equity in the place, according to the Canadian Real Estate Association's data from August 2008.

Good as this sounds, let's look at it another way. Let's say you stop making extra payments and instead, use that $400 per month for an investment.

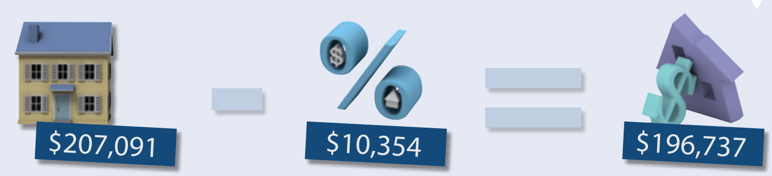
In this situation, you borrow against the equity in your home, and the $400 per month pays the carrying costs on that loan. With today's interest rate, you could

Average year-over-year appreciation (1990–2007)

Halifax	4.87%
Toronto	2.92%
Regina	5.26%
Calgary	7.48%
Edmonton	7.77%
Vancouver	5.85%

Source: CMHC

Typical mortgage



Home purchased in 2003 for $207,091
(Canadian average for 2003)

5% down payment

Mortgage of $196,737

Strategy 1

5.5% fixed interest rate mortgage, 25-year amortization

Monthly payment: $1,200.87
Total out-of-pocket payments: $360,261.00

Strategy 2

5.5% fixed interest rate mortgage, 15 years, 1 month to pay off

Monthly payment: $1,200.87 with $400 prepayment = $1,600.87
Total out-of-pocket payments: $289,757.47

Savings between strategies 1 and 2: $70,503.53

Strategy 3 – accelerated strategy

5.5% fixed interest rate mortgage, 11 years to pay off

Total out-of-pocket payments: $182,514.84

Savings between strategies 2 and 3: $107,242.63

Equity-building tenants

In the game of real estate investing, the property isn't the asset – it's the tenant. If you think it's the property, just skip a few mortgage payments and you'll soon find out whose asset the property really is. If you consider that each month the property takes money out of your pocket (as a mortgage payment) and the tenants put money into it (as a rent payment), you'll quickly see that the tenant is the key to long-term success.

As the tenant is such an important piece in the real estate game, it's critical that you choose only people who take care of your property as if it were their own. These are respectful of others and of the property itself, they pay their rent on time without you chasing them, and stay for more than three months before giving notice. It's these tenants who take care of the property while its value goes up – they're 'equity-building' tenants.

easily borrow $100,000 with less than $400 per month cost, but let's be cautious and say you borrow $75,000 as a nice round sum. Then, even if interest rates rise, your monthly interest costs on the $75,000 don't exceed $400.

You then use the $75,000 borrowed on the HELOC to buy a piece of investment real estate. Again using the current average property price of $290,347, if you put a 20% down payment on the property, and got a mortgage for the remaining 80%, it would be $232,278 (80% of $290,347) with a down payment of $58,069 (20% of $290,347).

The down payment comes out of the $75,000 loan, leaving $16,931 still available – from which you then pay the legal fees involved in buying it (about $2,000), do some maintenance and repairs to your new investment property (about $8,000) to attract high quality tenants, leaving a reserve fund of $6,931.

Put the reserve in a bank account dedicated to this property, to sit there until it's needed. This 'sleep-at-night fund' is designed to ensure you don't worry about a water heater blowing up, or a couple of months' vacancy that might come up. But… do not spend this money.

Because real estate is a long-term investment, you want to be sure you're not tempted to sell when the market hits a plateau or downturn. This is why it's critical that you buy only investment properties that provide a monthly surplus of income after all expenses are paid – this is called 'positive cash flow'.

Fast-forward six years. Your own home has appreciated and your regular non-accelerated payments have paid down the mortgage. In that time, you paid $29,052 towards the principal, reducing your mortgage balance to $118,920.

The investment property also went up in value and using a conservative percentage (for Calgary) of 6% appreciation per year, what you bought for $290,347 is now worth $411,863. Because you put equity-building tenants (see box on the left) into this property, your mortgage on it went down by $21,833 – leaving your investment mortgage balance at just $210,365.

If you sell it at this point for $411,863 and pay the mortgage balance, you made $201,498 in profit. So, you pay back your original investment of $75,000 out of this, leaving you with $126,498 in profit.

Now you can pay off your personal mortgage of $118,907 out of this profit and still have a balance of $7,591 with which to celebrate your new mortgage-free status – in the Bahamas perhaps!

So, with the $400 per month as leverage against your existing equity, you paid your personal mortgage down to zero in 12 years – four years faster than if you'd kept paying it as prepayments.

As for other aspects of this strategy, first, we budgeted $400 per month to cover the interest costs on the HELOC, but only borrowed $75,000. As I write this, the bank prime rate is 4.35% and HELOC loans are available at prime + 1.0%, so the cost of that loan is 5.35%, or $334.38 per month. The prime rate fluctuates, but at first you'd be saving $65 per month – which you could still use for prepayments on your personal mortgage.

Second, the situation assumes the investment property isn't generating positive cash flow, as it should. But as mortgage payments stay constant and rent can be increased each year, the amount of cash flow actually goes up annually – and anything the investment property generates could easily be paid towards your personal mortgage in the form of prepayments.

Third, the biggest benefit of owning investment real estate is the tax deductibility of all interest payments on your HELOC. Over the six years, this would equate to $24,075 in deductable interest (if the interest rate stayed the same). And, the interest portion of your investment mortgage is also tax deductable, which gives you a whopping $72,442 of mortgage interest deductions – an average of $16,086 per year, and who doesn't like tax deductions?

Of course, some parts of the country are better for investment than others. We invest in Calgary and find many properties with excellent cash flow, while still benefiting from the long-term economic fundamentals that will drive Alberta real estate up in price for years to come. But please be sure to educate yourself before investing in just any location.

Also, while leverage is a very powerful tool in investing, it's not for everyone and does come with its risks. And, as everyone's tax position is different, you must consult your accountant and tax advisor to determine the correct deduction plan for you, and – not least – how capital gains would apply to your situation.

David Sandbrand is vice president – business development, Cobblestone Investments, Calgary

Cash flow

Cash may be king, but cash flow built the kingdom. That is, the money left over from the incoming rent after all expenses are paid, when buying any real estate investment, should be the first consideration. Expenses like mortgage payments, property taxes, insurance, utilities, property management, an allowance for vacancy and another for maintenance should be budgeted for every month. If there's no money left over after all of those are paid, it's not an investment – it's a gamble that the property will go up in value.