Building wealth as rates fall down

Borrowing to invest a profitable strategy, if you can stomach risk

PERSONAL BAILOUT

INTEREST RATES

TIPS ON RIDING OUT THE RECESSION

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THE CANADIAN PRESS

When interest rates are low — particularly now with the Bank of Canada benchmark rate pegged at an historic low of .25 basis points — many think they should refinance their mortgage. This isn't surprising, since a home is the largest purchase most people ever make, with borrowed money in most cases.

This may or may not be a good strategy.

Whether you should refinance your mortgage in a period of low interest rates depends on how much it will cost you to break your existing mortgage compared to how much you will save in interest payments.

If you break an existing mortgage, you will have to pay the greater of three months' interest or the interest rate differential (IRD).

An IRD is a penalty for early prepayment of all or part of a mortgage outside of its normal prepayment terms. Usually, this is calculated as the difference between the existing rate and the rate for the term remaining, multiplied by the principal outstanding and the balance of the term.

For example, if you had a $100,000 mortgage at a 9 per cent interest rate with 24 months remaining and wanted to renegotiate your mortgage at 6.5 per cent for 24 months, your IRD would be $5,000 ($100,000 x 2.5% = $2,500 x 2 years = $5,000).

It may only make sense to refi-

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Mortgage refinancing can be a costly enterprise

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nance your mortgage if the interest rate savings over the remaining life of your mortgage exceeded the value of the IRD.

"The refinancing decision depends on the cost of breaking the mortgage versus how much you save," said Patricia Lovett-Reid, senior vice-president at TD Waterhouse. "You may find you should just stay where you are."

Another strategy is to take a variable rate mortgage. If interest rates go down and you keep your mortgage payments the same, you will be paying off more of your principal with each payment and will pay down your mortgage faster.

Debt is a destroyer of wealth in good times and bad and eliminating it is a good strategy.

Borrowing to invest when interest rates are low is another strategy. This is called leveraging.

Leveraging has a tax advantage because you can write off the interest on the money you borrow to invest.

If your investments perform well and earn a return high enough to make a profit, leveraging has great appeal.

But there is some risk if your investments go down. Just as your gains are magnified with leveraging, so are your losses.

"Investors should use leveraging prudently as part of an overall balanced financial plan," said Lovett-Reid.

Low interest rates can affect your investment portfolio as well.

Some stocks are more sensitive to interest rates than others.

Lower interest rates make companies with high debt loads — such as utilities — more attractive, as well as automobile manufacturers and real estate companies, whose products become cheaper for consumers to buy when rates are low.

Low rates also are affecting fixed income securities. As such, Lovett-Reid said investors after higher returns should consider investment grade corporate bonds, which are yielding around 4.50 per cent for a three-year maturity.