

## THE FOLLY OF LOW INTEREST RATE DECISIONS

Many of the financial decisions people make today are completely based on the current level of interest rates and have little consideration of long-term impact. "Rates are so low it just makes sense to refinance or purchase now". "We might as well do it or buy it now while rates are so low". "Everyone has some debt – no big deal – rates are low".

If you don't have a rock-solid, crystal clear vision, any idea, strategy, or immediate desire can be easily justified especially, when low interest rates are used to finance the decision. It's the vision of your life – the desired lifestyle, activities, home, friends, entertainment choices, etc., where you begin to make financial decisions – not whether rates are low, or because the object of your desire is "a good deal"!

For example, we are lead to believe that home ownership can be accomplished for the same monthly price as renting and are often told "why pay someone else's mortgage when you can build up your own equity"? Good point, but with ownership comes maintenance, extra tools, furnishings, taxes and responsibility. I often hear of young people, who have thought very little of financial matters except how to get by on the limited funds they have, wanting to purchase a home almost immediately after they get their first job. They do the responsible thing and speak to a mortgage broker or realtor about the possibility of buying a home. These young people often have student loans, or other debt, new income, active social lives and very little (if any) savings and financial savvy.

They are told that economically owning vs. renting, especially when rates are low is the best way to go. This is the obvious recommendation the brokers and agents make based on their area of expertise – helping people buy homes. If your friends and family have homes, you will expect to have a home so it logically makes sense to want one. The lifestyle you see your friends living is they lifestyle you expect for yourself. And, if it's not from your friends, then the media offers other lifestyles for us to desire. When credit is available (especially the perceived inexpensive credit), it is much easier to fall victim to the trap of immediate gratification with post justification. Perhaps our young couple might be better off to live their life without the extra responsibility and expense while they pay off other debt, cultivate their own unique lifestyle desires and establish some financial plans first.

This is why creating a strong vision, then purposely surrounding yourself with the people, circumstances, and situations that support that vision, is the first step to personal financial success. The long term impact of a financed lifestyle can be devastating if rates rise sharply, or if the low interest rate decision becomes habitual and means other more solid strategies with longer term, lasting impact are ignored or not even possible, because of the weight of debt. Debt at any rate is still debt and will negatively impact your ability to make financial decisions freely.

Consider the following home-buying scenario: A young couple buys a home in 1993. The value of the home is \$150,000. They put a minimum 5% down and take out a \$142,500 mortgage at 10%. Their payments on a 30-year mortgage would be \$1,229 per month. If in 1998 the value of their home had risen to \$225,000 and mortgage rates had dropped to 7%.

They had some important decisions to make--they could:

- a) Renew their existing mortgage, then at \$137,431 at the new rate and create a new payment (\$962 per month) thereby saving themselves \$267 per month; or
- b) Renew the existing mortgage at the new rate with their old payment (\$1,229) thereby saving themselves more than 10 years in mortgage payments or in excess of \$86,000 in interest charges; or
- c) Refinance the property and take out the maximum allowed based on the new property value (\$168,750) thereby having an additional \$31,319 available to renovate, pay bills, or use as desired. (For illustration purposes, we will assume that the additional money was not used to make other investments). Refinancing would still have provided them with lower monthly payments (\$1,181 compared to their original \$1,229) but would cost them in excess of \$34,000 in interest charges compared to maintaining the original mortgage amount. But, they would have the money to use right away to enhance their lifestyle.

There are other options too, but the point to consider is the impact of the decisions. In 2003, the likelihood would be that that same home could be worth over \$325,000 if it was located here on the west coast and could have been renewed again at lower rates. This same couple would have those same key decisions--lifestyle and immediate benefit, or longer-term independence.

You can say that if our couple used some of the refinanced money to renovate their home, they would be adding value; however, the point is that if they had a vision and plan for their life, they might have considered the long-term costs of their decisions. Simply renewing the existing mortgage and maintaining the mortgage payments at the original level would mean this couple would be mortgage free in less than 15 years and would pay 10's of thousands of dollars less in interest charges and only been out of pocket a couple hundred dollars more each month than the couple who renewed at the lower monthly payments, or refinanced more at each renewal.

If our young couple considering home ownership put themselves in a situation where they were financially stressed from month to month, there is a much higher probability they would consider a refinancing option, or other low rate alternative simply to keep supporting their lifestyle. There are so many strategies to use in personal finance, and more available each day. How does someone distinguish between what's best and what's merely good for the moment? The easiest is to develop your vision, set the goals and always use that as a guide when gathering information and making decisions before considering interest rates, fees, prices, and immediate desires. There really is no one perfect route to financial success – it will look completely different for each person, however, "if you don't know where you're going, you'll probably end up somewhere else".

