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Retiring Your Mortgage Early is the Fastest Way to Freedom 55

by Harry Koza

I was watching TV the other night, and a commercial comes on with this young couple sitting in their bank manager's office. She tells them they are richer than they think, because the friendly bank will consolidate all of their credit cards, their lines of credit, their car loans and their mortgage into one convenient, below-prime rate loan, and they will save (gasp) \$150 a month. There are several variants on this commercial, and they all have much the same theme. In one of them, a young woman even gets so excited about the extra few hundred a month that she destroys an office and uproots a tree.

I dunno, "you're richer than you think" doesn't quite cut it for me. The message I get out of these ads is that you're probably way more highly leveraged than you think. Now, debt consolidation can be a good thing, and I don't mean to disparage that particular bank (I bank there myself) but I don't ever hear those TV bankers in the ads telling these people that now they should apply that extra \$150 a month to their mortgage or credit card debt to pay it down faster, which should be the whole point of the consolidation exercise, and would likely be absolutely the best thing they could do with their windfall.

I keep reading about how the national savings rate keeps shrinking, and how personal indebtedness keeps growing. Yet at the same time, everyone seems obsessed with investing. People often ask me (lord knows why) what I think about the merits of this or that investment. I usually ask them if they have a mortgage.

"Yeah, sure," they reply, "what about it?"

Well, simply that for the average person, paying down your mortgage early is about the best investment you can make, and it is risk-free. Adrian Mastracci, of KCM Wealth Management in Vancouver, with whom I have been exchanging e-mails on this subject lately, was kind enough to send me an illustration of this.

He says that paying off debt slowly, especially when you can't deduct the interest expense, is just about the biggest impediment there is to accumulating that retirement nest egg. Forget about "Freedom 55," (that only applies to teachers and government workers with gold-plated pensions anyway), and start thinking about the Rule of 72.

The Rule of 72 is the basic principle of compound interest. Divide the interest rate you're earning into 72, and that's how many years it takes to double your money: at 10 per cent, say, your money doubles in 7.2 years. Of course, this cuts both ways -- if you're burdened with credit card debt at double-digit rates and you fall behind, the amount you owe can grow even faster.



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Let's assume you owe \$100,000 on your mortgage at 6 per cent, and that for comparison purposes, the same rate applies for the entire amortization period. For a 25-year amortization, which is pretty standard, you will pay \$640 a month, and over the life of the mortgage, you will pay \$91,400 in interest. If the couple in the commercial were in this situation and they were to take a little less than half of that \$150 a month in savings and increase their mortgage payment to \$712 a month, they could pay off their mortgage in 20 years. Over that 20 years they would have paid \$70,900 in interest, for total savings (compared to the 25-year amortization) of \$20,500. Jack the payment up to \$840 a month, and the house is paid off in fifteen years, for total interest payments of only \$51,200 and total interest savings of \$40,200. That ain't hay.

Since you can't deduct your mortgage interest, and you make your mortgage payments with after-tax dollars, prepaying a 6-per-cent mortgage is roughly equivalent (assuming a 50-per-cent tax rate, which in Canada isn't that presumptuous an assumption) to earning a pretax return of 12 per cent.

Now I don't know about you, but as far as I'm concerned, a 12-per-cent (or 10 or even 8 per cent) pretax, risk-free return on an investment is something that just doesn't exist in the market. So why would you even consider putting your money at risk in the market -- and it is at risk -- when you can get so much more bang for your buck by paying off your mortgage faster?

So, if you're one of the people that those ads target, and there's a lot of you out there, maybe before you visit your friendly banker you should visit this handy website provided by Industry Canada: <http://www.consumer.ic.gc.ca/debt>.

Ignoring the incongruity of the government department that makes those hare-brained Technology Partnership "loans" to companies that never pay them back thinking it is qualified to give you advice on dealing with your own debts, there's a lot of useful information there that can help you get the credit monster under control. It's worth a look.

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