

With many mortgages, 15 can outvalue 30

By Christian Gridley, president, Madison Financial

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With peak season for home purchases in our sights, many of our clients face large, complicated financial decisions. One is whether to choose a 15- or 30-year mortgage. It is our job to help them.

The traditional argument for the 15-year fixed-rate mortgage is that even though it costs more per month, it can save homebuyers thousands in interest compared to the 30-year mortgage. The argument for the 30-year mortgage is that clients should opt for the lower payment and invest the difference.

But there's more to the story of why people should seriously consider the 15-year mortgage. It provides them a risk-free-investment program.

Let's consider a couple who will finance \$200,000 on a \$250,000 home. When they decide between a 15-year or 30-year mortgage, they look at:

- **Comparative-interest rates:** Fifteen-year rates typically are about a half-point lower than 30-year rates.
- **Cash flow:** The 15-year rate will reduce clients' monthly cash flow because of a higher payment.
- **The value of extra money:** The extra money paid in the 15-year mortgage will generate value for clients. What would they do with that money if they opt for the lower-payment 30-year mortgage?

In reality, people seldom hold a mortgage full-term. Most homeowners will sell their home or refinance to cash out home equity. The timing of those conversions will impact the annual return.

For our purposes, we'll compare 15- and 30-year mortgages for this couple. We'll see what happens at the seven-year mark — the average amount of time people hold a mortgage — and at the 15-year mark, when the shorter-term mortgage will be paid off.

The results, using interest rates as of April, for an original mortgage of \$200,000:

Monthly payment:

- **15-year:** \$1,634
- **30-year:** \$1,199
- **Different in monthly payment:** \$435

Seven years

Total payment:

- **15-year:** \$137,256
- **30-year:** \$100,716

Balance of principal left:

- **15-year:** \$126,686
- **30-year:** \$179,279
- **Extra money paid for in 15-year:** \$36,540
- **Value of the extra investment (as measured by extra equity):** \$52,593 (\$179,279 – \$126,686) (comparable to an annual return of 9.99 percent)

15 years

Total payment:

- **15-year:** \$294,120
- **30-year:** \$215,820

Balance of principal left:

- **15-year:** \$0
- **30-year:** \$142,097
- **Extra money paid for in 15-year:** \$78,300
- **Value of the extra investment (as measured by extra equity):**


\$142,097 (\$142,097 - \$0) (comparable to an annual return of 7.35 percent)

By the seven-year mark, the couple will have paid an extra \$36,540 toward their principal, but their equity will increase at least \$52,593 (not accounting for an increase in home value). That's equivalent to a 9.99-percent return on the extra \$435 per month the couple paid — a risk-free gain.

By the 15-year mark, the couple will pay \$78,300 more than with a 30-year mortgage, but their equity will increase an extra \$142,097 — equivalent to a 7.35-percent return on the \$435 monthly investment. They also will save themselves another 15 years of payments.

The exact percentage of the comparable rates of return will depend on the interest rates and size of the mortgage. A 15-year mortgage will always generate a healthy rate of return. In addition, the relative rate of return will always drop over the life cycle of the loan — in this case, from 9.9 percent to 7.35 percent. That is because the 30-year loan starts to catch up as more of each 30-year-mortgage payment goes toward the principal.

Although not every homebuyer will be able to afford the higher payments required for a 15-year mortgage, you should help every buyer consider the option. Not only will your clients save the extra interest eaten up by a 30-year mortgage, but they also will make a solid, risk-free return on that investment — something that no other investment option can offer.

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