

The odds favour a variable rate, expert says

Buyers with a floating rate better off 90.1% of time, survey finds

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Nearly every decision when buying a new home hinges on money. The price of the property, the regularity of the payment, the mortgage term and the amortization period are all decisions dictated by money and being able to pay the mortgage on time.

There is one decision, however, that is influenced primarily by emotion and the tolerance for risk.

It's the choice between a fixed rate and a variable rate.

In the fixed-rate camp are the security seekers, those who seek comfort in the knowledge that their repayment will be the same, month in and month out, regardless of the terms of the mortgage.

In the variable-rate camp are those who are prepared to gamble, never knowing from one payment to the next -- although that paints it in its darkest terms -- how much the next payment will be.

While money plays a part in making this decision, the greatest motivator is the risk factor. It's the ultimate gamble and it's not for everyone, which is why an estimated 70 per cent of Canadians opt for the fixed-rate mortgage believing that not only will they sleep better at nights, but that they are making the soundest decision in this, the biggest investment of their life, and it is the safest and most financially prudent course to follow.

They are wrong. Not all of the time because interest rates have fluctuated widely in the past, but they're wrong nearly 85 to 90 per cent of the time. That makes their decision to opt for the more conservative fixed-rate option the wrong choice.

"A lot of Canadians like the psychology and the security that comes from a fixed-rate mortgage that is predictable and constant for the next five to 10 years," says Moshe Milevsky, associate professor of finance at the Schulich School of Business at York University, Toronto, who has studied the fixed-rate versus variable-rate conundrum extensively.

"They like the comfort of knowing exactly what their salary is, exactly what their expenses are, exactly what their mortgage is. For those people the fixed rate is the way to go. But if you are willing to take a little bit of a chance, and you can tolerate the fluctuations, then the odds favour the open variable-rate mortgage."

Advocating a variable rate mortgage is not based on a speculative or bearish bet on interest rates, he says.

"It should depend on a client's tolerance for risk -- the same concept used in traditional asset allocation -- and their ability to withstand increases in mortgage payments."

In the worst-case scenario, soaring interest rates could mean having to cough up an extra couple of hundred dollars a month. But this would be balanced by the fact that in previous months the mortgage expenditure was less.

In a subsequent study, covering the years between 1965 and 2007, Milevsky compared homeowners with outstanding balances of \$100,000 and three five-year terms remaining. The study showed that those with a floating rate mortgage were better off 90.1 per cent of the time, regardless of when their mortgage began.

Those who chose a variable rate and made the same repayment, benefited by paying off their mortgage between eight and 19 months sooner, depending on the amortization period.

Despite the studies showing that those with a variable-rate mortgage come out ahead, Milevsky is reluctant to recommend one option over the other when it's not his money at stake.

"This is a risk-versus-return decision that depends on a client's personal tolerance for fluctuating mortgage payments and interest rates. There's no one-size-fits-all-solution."

With central banks now leaning toward lowering their lending rates, the choice in the near term favours variable rates. But no one can predict with accuracy where rates will be over the longer term.

Milevsky is sure of only one thing. He has an open variable-rate mortgage and has no intention of locking it in.

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