PAY OFF YOUR BOND OR INVEST?

Conventional wisdom dictates that it is always better to pay off your debt before you start investing money. So, if you have a home loan, this means you should pay off your mortgage before starting an investment account. Whilst this is not the worst course of action, it may not be the best thing to do with your money. Sometimes, debt is good and using it wisely can make a big difference to your long term financial health.

GOOD AND BAD DEBT

You get two kinds of debt, the first is linked to an appreciating asset where the growth of the asset is higher than the interest you pay on the debt. This is considered good debt and can be very productive in your wealth creation. The second type of debt is not linked to a growth asset which means you are only paying interest and not getting any financial benefit. This is bad debt and should be avoided at all costs.

Examples of bad debt include: credit cards, personal loans, store cards and vehicle debt. If you have extra money and have bad debt then you should definitely pay off your debts as quickly as possible and avoid getting more bad debt in future. The only exception is related to vehicle debt where you get a tax benefit from vehicle debt but this does not apply to many people.

Good debt includes your home loan because it is likely that your home will appreciate in value by more than the interest that you will pay on the mortgage. That means it is not necessary to pay off this debt at an accelerated rate if you are prepared to invest your extra money in a high growth investment.

INTEREST VS. GROWTH

Some investments (like shares) grow at a higher rate than the interest on your home loan. As an example, over time, shares have averaged 15% growth per year which is substantially higher than the current interest rates on home loans. That means you will do better by investing your money in shares and not paying off your bond.

AFFORDABILITY OF THE BOND

Before deciding to start an investment instead of paying extra money into your bond, you need to determine how affordable your monthly payments are. When interest rates are very low, your monthly payments might seem very affordable, however what happens if interest rates jump by 5%? Can you still afford the monthly payments? It is easy to find out by doing a repayment calculation – most of the big banks have monthly bond calculators to help you on their websites. If you can still afford the bond repayments after a big interest rate jump, then your bond is affordable which means you can invest your extra money elsewhere. The only other factor to consider is your financial discipline. If you know that you are a bad saver and will probably spend the money (most people are bad savers) then rather pay the extra money into your bond. It is far better to have a paid off house!

Over time, if you are disciplined and patient, you can invest your extra money in shares and pay off your bond. Eventually, you will have a paid off home and an asset which generates income for you – this is the best of both worlds!