

Time to Refinance?

The home mortgage offers significant advantages for most people. One advantage is the release of capital, which would otherwise be tied up in a home, for investment or other purposes. For people in higher income tax brackets, the government may give you a refund of 35% to 50% on mortgage interest, due to the deduction of interest payments (for mortgages under \$1,000,000). Additionally, the fact that the mortgage is being paid down with progressively cheaper dollars reduces the effective cost of the house. These advantages may be enhanced if one can refinance at a lower interest rate.

Recently, interest rates on the U.S. 30-year and 15-year fixed-rate mortgages fell to their lowest levels since mid-July of 2003. The average U.S. 30-year mortgage rate stands at about 5.58%. The 15-year rate averages 4.87%. This creates a great opportunity for those who have not yet refinanced to do so, and for those that refinanced at a higher rate to consider refinancing again.

Depending on your current situation, deciding whether or not to refinance may come down to a basic calculation: Will your savings from reduced mortgage payments be greater than the costs of refinancing?

What Does it Mean to Refinance

Refinancing is actually the process of taking out a new mortgage and using the money obtained to close out, or "pay off," your current mortgage, leaving you with an entirely new mortgage at a new rate. The benefits of this new mortgage, if done

correctly, will be reduced monthly payments, potentially saving you thousands of dollars in interest over the life of the loan and increasing your discretionary income.

Refinancing involves many of the same steps that took place while applying for and obtaining your first mortgage – it can also involve many of the same expenses. Therefore, it is important to make sure that the amount you will be saving in monthly payments is greater than the cost to refinance. A great way to ensure that you save money is to go with a no-cost, no-fee loan. In some cases, you may be able to simply modify your existing mortgage, thus saving you the time and money of going through the refinance process.

Why Should I Refinance?

Save Money on Interest Rates

Refinancing at a lower rate will reduce your monthly payments. If you plan to stay in your home for a long period of time, these savings could be substantial.

Let us look at a very basic example. Suppose you have a 30-year fixed-rate mortgage for \$300,000. You originally financed this loan at 7.5% making your monthly payment \$2,098 a month. Take this same loan and assume you can refinance to obtain a new loan with a rate of 5.8%. Your new monthly payment would be \$1,760, a savings of \$338 a month.

Convert an Adjustable-Rate Mortgage (ARM) to a Fixed-Rate Mortgage

You may have chosen an ARM for its initial lower interest rate; but if current interest



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rates have dropped, you may decide to opt for the predictable monthly payments of a fixed rate mortgage. Even if your refinanced rate is higher than the current ARM rate, you are removing the interest rate risk associated with the ARM mortgage.

Time Value of Money

The Time Value of Money refers to the fact that a dollar in hand today is worth more than a dollar promised at some point in the future. For example, suppose you owe someone \$500. Would you rather repay that money right away, in one payment, or spread the payments out over four years? Considering Time Value of Money, you would want to repay the money over four years. This is because as time passes the value of money decreases due to inflation. You can instead take that money, invest it and earn a return in the meantime. If you were to repay the money immediately, you would be giving up the "opportunity" (called the opportunity cost) of using that money for other purposes. You would not be able to take advantage of repaying the loan at a later date with cheaper, inflation reduced, dollars.

The Cost of Refinancing

There are many costs associated with refinancing; therefore, it is impossible to give an exact cost. The actual costs will vary depending on your specific situation, but according to Freddie Mac, lenders presently charge an average of 0.6% in fees and points on 30-year mortgages, and 0.7% for 15-year mortgages. This means if you are refinancing \$300,000, you can expect to pay between \$1,800 - \$2,100 in costs depending on the length and terms of the mortgage.

The costs of refinancing usually include:

- Title Search and Title Insurance
- Application Fee
- Appraisal Fee
- Loan Origination Fee
- Discount Points
- Closing Agent and Review Fees
- Other Costs

Many lenders offer "No-Cost" and "Low-

Cost" refinancing. What this really means is rather than pay the traditional up-front fees, you will instead receive a slightly higher interest rate on your loan or a slightly higher loan balance. You are in effect paying for the refinancing costs over the life of this loan.

Which to Choose?

We typically recommend that you go with a no-cost refinance as it minimizes your immediate cash outlay. In addition, if you plan on moving fairly soon, the amount you will pay in additional interest will be less than the one-time up-front costs of a traditional refinance.

What Term Should I Choose?

Though you end up paying more in interest with a 30-year loan than a 15-year loan, you are generally able to deduct 100% of the interest payments for the term of the loan, thus reducing your after-tax cost. A 30-year loan with a 5.75% rate for someone in the 35% tax bracket costs 4.26% after interest deductions. With a 15-year loan, the monthly payment would be much larger, thereby significantly reducing your discretionary income. By increasing your monthly payment, you can reduce a 30-year mortgage to a 25-year, 20-year or 15-year mortgage, whichever may be appropriate for you at the time. However, it is important that prepayments be allowed on the 30-year loan. By comparison, the 15-year mortgage is inflexible in that you are committed to the larger monthly payment.

Over time, money is worth less due to inflation, which is the rising cost of goods and services. For example, in 1983 a first class stamp cost \$.20 and now it costs \$.37, an 85% increase. Similarly, by selecting the longer-term mortgage you will pay it off with cheaper dollars.

If you elect to invest the savings, the alternative opportunities presented might provide you with a return substantially greater than the cost of your mortgage. If you chose not to invest, then the savings can be used to immediately improve your lifestyle. A middle course can also be followed.



What's Next?

If you have decided to look into refinancing, the next step is to do research to find the best rate and the appropriate type of refinancing for your situation – traditional or no-cost.

The best place to start is with your current lender. If the lender is still holding your loan (meaning they haven't sold it to the secondary market, such as Freddie Mac or Fannie Mae), then you might be able to do a loan "modification." A loan modification is simply an adjustment to your current mortgage. Rather than taking out a new mortgage, the lender will modify your new loan by issuing a new rider allowing you to pay a lower interest rate for the remainder of the term. There is very little paperwork involved and usually very little cost. If the lender has already sold your loan to the secondary market, your current lender may be willing to waive some of the fees on a refinance, for such items as the title search or inspections, since the lender may already have most of this information.

After speaking with your current lender, continue to look around for the best rate. There are numerous resources that can help you find a good rate. A basic place to start on the Internet is Bankrate.com. They offer current rate information at the state and local level. You can also check out some of the online mortgage brokers such as eLoan.com and Lendingtree.com.

The Yellow Pages also provides a resource to find local lenders and mortgage brokers that can assist you with information on their loans. Try to make the calls within a short period of time (ideally within a few hours of each other) to ensure that you are making an even comparison, since rates change daily. You should receive all quote information free of charge.

There are also numerous refinance calculators available on the Internet that allow you to input data, such as current mortgage amount and rate, new mortgage amount, rate and length. These tools will give you a fairly accurate estimate of the possible reduction in monthly payments. A good refinance calculator can be found at

Yahoo Finance in the Mortgage Center (<http://loan.yahoo.com/m/e16.html>). All of the information needed for this calculator is also information you should have on hand when talking with a potential lender.

Things to Look Out For

Float Down Option

A float down option is essentially the opportunity to pay for the privilege of obtaining a lower rate if rates should fall while you're still refinancing. This may sound like a great option, but it really isn't. Often this option will end up costing you one-eighth of a percentage point on your interest rate, which would mean that rates would have to fall at least one-quarter of a point to make this deal worthwhile. Over a short-term period, this type of drop is not likely.

Prepayment Penalties

Some mortgages carry a penalty for paying off the loan before the stated term is up. If the penalty is large enough, it could offset the savings you gain by refinancing. Since by refinancing you are essentially paying off your current mortgage early, you will need to know whether or not you have a penalty. Your current mortgage documents will indicate if there is a penalty for prepayment. If you are not sure, ask your lender to clarify.

Contact Us

If you have any questions or would like more information on refinancing please contact your Portfolio Manager. They will be able to assist you in determining an appropriate strategy.

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