

## Balancing act - Security vs. Savings

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### *How much risk is there with adjustable-rate mortgages?*

Imagine you are a prospective homeowner, looking to purchase your first home in Palo Alto. But you work as a low-level employee at a local law firm, and you wonder just what you and your new spouse can afford.

A quick flip through the real estate section and your heart sinks: The answer is, not much, on your salary. With a hefty loan, you can just squeeze out the down payment on a two-bedroom bungalow. But a consultation with a mortgage broker leaves you more confused: Do you take the 30-year, fixed mortgage? Or do you risk it with an adjustable-rate mortgage, and pay only the interest for a few years before receiving that promotion?

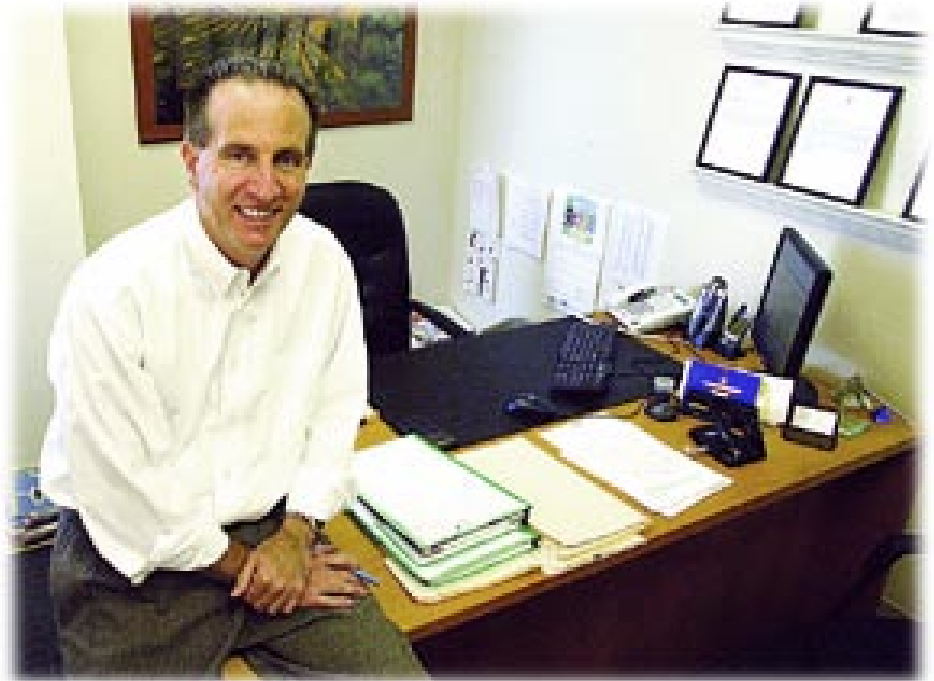
Choosing a mortgage, especially for a first-time homeowner, can be tricky business. An adjustable-rate mortgage can save more than \$500 per month, but a market plunge could spike the adjustable rates and leave your family in the red. A 30-year fixed plan might help you sleep at night, but may be unnecessary since you don't anticipate this house as a family-fixture for the next 30 years.

The question boils down to: security or potential savings?

Real estate and mortgage experts will tell you that right now may be a safe time to invest in an adjustable mortgage. Home loans look like they aren't going to rise anytime soon.

The consumer price index, a popular gauge of U.S. inflation, slid 0.1 percent in July, according to the Labor Department. What does this mean for interest rates? Wall Street traders guess the low readings mean the Federal Reserve won't need to push up rates to ward off inflation.

And, this may mean good things for homeowners shopping for a new mortgage



on their home. According to Joel Spolin, president of Absolute Mortgage Banking in Palo Alto, these numbers show that right now, adjustable-rate mortgages are an appealing option and a safe bet for buyers who aren't ready to make a 30-year commitment.

"Adjustable-rate mortgages are really popular right now," Spolin said. "They appear to be going up more slowly than people predicted a few months ago."

Paul Engel, a real estate agent for Coldwell Banker in Palo Alto, credits their popularity to increased protections and available options. Now these plans can be set for one, three, five or 10 years before they fall prey to market adjustments.

Adjustables make a few appealing guarantees. Unlike their more stable counterpart, these plans expire much more quickly, meaning that borrowers aren't wedded to a 30-year commitment. Also, rates rise for each additional year that a plan is fixed. While a one-year plan might be set at 4.5 percent, interest rates for a 30-year plan could be up to 6 percent.

"Adjustables help people get into houses that they would not normally be able to afford," Engel said. "By getting a lower rate than a fixed, 30-year mortgage, it helps people qualify for more. The idea is that sometime down the road, as their incomes grow, they will refinance and fix the rate for a longer period of time."

Spolin agrees that adjustables make it easier for more people to afford homes. He adds that the 30-year fixed loan is also often unnecessary.

"The average Californian moves in a 30-year period," he said. "Do they really need 30 years of fixed-rate payments?"

The flexibility of ARMs makes them an ever-increasing option for first-time homeowners. But, their volatility also makes them prone to drastic market variations.

Fixed payments are undoubtedly the more secure option. As the name implies, fixed rates won't change, even if the market does. But you pay for that kind of security.

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Mid-August of this year, the Federal Reserve set 30-year interest rates at 5.85 percent and one-year adjustable rates at 4.08 percent. These rates change on a weekly basis but haven't fluctuated much in the past few months. This June, 30-year rates were 6.3 percent while one-year rates were slightly less than the August figure at 4.14 percent.

"It really depends on what kind of person you are," Spolin said. "Some people want to eliminate all risk, some people are willing to take on that risk."

Engel maintains that ARMs are a good option for people who are monthly payment sensitive. Adjustable rates save payment money initially but "that doesn't mean you don't pay the piper, because you do," he said. In a year, rates for ARMs could skyrocket, leaving the homeowner with bigger rates than when they started.

Still, in an area with a lot of upward mobility, people who know they are going to get a salary raise or a promotion in the next few years are attracted to the lower initial payments, Spolin said.

Adjustables are much more temperamental because they can be directly affected by short-term market changes, said Gus Mendy, a mortgage loan consultant with Washington Mutual in Palo Alto.

The vulnerability of adjustables in the wake of short-term variations is exactly what makes these plans so risky. Banks borrow money from the government and when this rate increases, adjustable rates do, too. The bond market similarly impacts interest rates. When the bond market goes up, interest rates also rise and any loan fixed for a short period of time will be affected.

Mendy predicts calm waters in the coming months. In the wake of a national election, he doesn't think the government will

change rates before the election, he said.

He also stresses that adjustable rates could never rise like they did in the 1970s because there are more protections that shield adjustables from drastic spikes. Monthly rates, for example, are capped at about 9.95 percent. Similarly, short-term rates for three, five, seven or 10-year loans are capped at about 5 percent above their starting value.

Still, Mendy urges borrowers to trust predictions with caution.

"People might say that adjustables are going to go up," he said. "But, people need to weigh the situation individually because for a first-time home owner it's a good deal. Plus it's just really hard to look into the crystal ball and make an accurate prediction of the future market. No one knows what it will look like for sure, not even Wall Street. You could end up saving hundreds of dollars taking a risk with an adjustable loan."

ARMs aren't the only options available to first-time homebuyers. Loan packages range from interest-only payments to negative amortizations, and can be catered to a variety of needs.

How does this relate to Palo Alto real estate? Low rates increase potential buyers, said Engel. But, regardless of oil changes and Federal Reserve figures, Palo Alto real estate stays fairly stable.

"Palo Alto and surrounding environs is just a desirable place to invest," he said. Buyers will stretch beyond their means to buy a house here, and for many, adjustable rates are an essential element to affording a home in the area.