FIXED-RATE MORTGAGE vs. ARM?

FOUR QUESTIONS TO ASK WHEN COMPARING A FIXED-RATE HOME LOAN vs. AN ADJUSTABLE-RATE HOME LOAN

1 HOW DO ADJUSTABLE-RATE MORTGAGES (ARMs) WORK?

Most ARMs have an initial note rate that is fixed for a period of time... usually 5 years. After the initial fixed period, your interest rate would change based on market conditions. It's important to pay attention to the "caps" on your loan because these caps indicate how much your mortgage rate can change after the initial fixed period.

2 WHAT IS YOUR TIMELINE?

The main reason why people consider ARMs is because they often carry a lower interest rate than fixed-rate loans. In today's market, the difference is pretty significant. A 5-year ARM typically makes sense if your time horizon is 7 years or less. That's because you're saving money vs. a fixed-rate mortgage for 5 full years, and you're still ahead of the game even if your rate goes up in years 6 and 7. When considering your timeline, keep in mind that many people move or refinance within 7 years of buying a house. Your timeline could be shorter or longer than that based on your objectives.

3 WHAT WILL YOU DO WITH THE EXTRA CASH FLOW?

Here are three options if choosing an ARM will produce additional cash flow in your situation:

- **Invest the extra cash flow**. This could be worth considering if you're looking to build your retirement account or a child's college fund.
- **Make extra principal payments with the extra cash flow**. You could pay off the loan quicker by simply making the same payment as you otherwise would have made with a fixed-rate loan.
- **Use the extra cash flow to improve housing affordability**. You may be able to upgrade the price range of houses you're considering because the monthly payment on an ARM may be more affordable than a fixed-rate loan.

4 WHAT IS THE RISK INVOLVED WITH EITHER OPTION?

The main risk with an ARM is that your mortgage rate and monthly payment could go up after the initial fixed period. The main risk with a fixed-rate loan is that you're losing cash flow NOW in exchange for the chance of saving money at some point down the road if you keep the loan for more than 7 years. The bottom line is that paying the higher rate on a fixed-rate mortgage is like paying for an insurance policy that you may not need. Especially in today's market where the interest rates and monthly payments on 5-year ARMs could be significantly lower and can improve your housing affordability.

RULE OF THUMB

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7 years

A 5-year intermediate-term ARM typically makes sense if your time horizon is 7 years or less.

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