Fixing is not the best bet

Opting for a fixed interest rate seems like a safe move but it may cost you more in the long run.

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EDITOR'S DESK

QUESTION: What do a horse race and interest rates have in common – besides the fact both will be decided on Tuesday?

Answer: Virtually every Australian will gamble on each.

With interest rates up five times during the past three years – and almost certain to increase again next week – the dash to fix is on. Historically, less than 15 per cent per cent of mortgages have been fixed rate but Mortgage Choice says that amount now is nearly 30 per cent.

Of course, by fixing you are betting variable interest rates will be, on average, higher during that period than the rate you lock in. And you are making that bet against your bank, which decides what fix to offer you based on its expectations of the future direction of interest rates – and naturally factors in a bit of profit.

So who usually wins the wager? It will come as little surprise to hear that it's the banks by a country mile.

Research obtained by AFR Investor, conducted by QuickDirect Online Mortgages, shows in most cases during the 27 years data has been available you would have paid less interest with a variable product than with a fixed.

The analysis compares during rolling periods the average three-year fixed rate with the subsequent movement of basic variable rates – the rate lenders actually charge most borrowers (as opposed to the standard variable rate many advertise). It shows you would have been better off sticking with the variable rate 83 per cent of the time.

What's more, the result is worst if, as most people do, you fix right before an anticipated rate rise. This rise will already be priced in, as shown by the fact the average three-year fix has just moved back above data provider infochoice's benchmark variable rate for the first time in years (7.9 per cent versus 7.75 per cent).

QuickDirect managing director Hamish Carlisle says: "To actually save money by taking out a fixed-rate loan you need to be either better than average at predicting the future path of interest rates or just plain lucky."

So how should you deal with an impending rate rise?

It certainly helps to make sure you are on the best possible variable rate. Start by asking your lender if they will discount your interest – and, if you don't already have one, throw in the words "professional package" so they know you are aware some customers pay less.

The beauty of this approach is that it should cost you no money and little time. If it fails, though, do put in the effort to remortgage with another lender, provided you would not face a hefty break cost for doing so.

The infochoice table on page 9 shows that the best comparison rate, which includes fees, is 7.32 per cent from Electronic Loan Company, an online lender. (Incidentally, the top nine rates are now from online lenders.)

If you have a $400,000 mortgage and go from paying the standard variable rate of 8.32 per cent to 7.32 per cent, your repayments would drop by $264 a month and your total loan interest by $78,973.

However, you would do even better if you remortgaged to the better rate and then kept your repayments the same. This would save you almost $110,000 and cut five years off the life of your loan.

And that's where fixed rates really become a poor bet: the price of repayment certainty is generally the inability to put in extra. As such, the odds of saving interest are slim indeed.

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