MORTGAGE advisor™

ISSUE 1

How the Affluent Manage Home Equity to Safely and Conservatively Build Wealth

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If you had enough money to pay off your mortgage, would you? Many people would. If the "American Dream" of owning your own home outright with no mortgage is so wonderful, why do thousands of financially successful people—who have more than enough money to pay off their mortgage—refuse to do so?

Most of what we learned from our parents and grandparents about mortgages is no longer valid. They taught us to make a big down payment, get a fixed-rate mortgage, and make extra principal payments to pay off your loan as early as possible. Mortgages, they said, are a necessary evil at best.

The problem with this rationale is it has become outdated. The rules of money have changed. Unlike our grandparents, we will no longer have the same job for 30 years or depend on our company's pension plan for a secure retirement. Also unlike our grandparents, we will no longer live in the same home or keep the same mortgage for 30 years.

Statistics show that the average homeowner lives in their home for only seven years. According to the Federal National Mortgage Association, or Fannie Mae, the average American mortgage lasts 4.2 years. People are refinancing their homes to improve their interest rate, restructure their debt, remodel their home, or to pull out money for investing, education or other expenses.

Given these statistics, it's difficult to understand why so many Americans continue to pay a high interest rate premium for a 30-year fixed rate mortgage, when they are likely to just use the first 4.2 years of it. We can only conclude they are operating on outdated knowledge from previous generations when there were limited options.

Wealthy Americans—those with the ability to pay off their mortgage but who refuse to do so—understand how to make their mortgage work for them. They put very little money down, keep their mortgage balance as high as possible, choose adjustable-rate interest-only mortgages and, most importantly, integrate their mortgage into their overall financial plan. This is how the rich get richer.

The good news is that any homeowner can implement the strategies of the wealthy to increase their net worth.

Why You Shouldn't Fear Your Mortgage

Back in the 1920s, a common clause in loan agreements gave banks the right to demand full repayment of the loan at any time. When the stock market crashed on October 29, 1929, millions of investors lost huge sums of money, much of it on margin. Since the value of the stocks dropped, few investors wanted to sell, so they had to go to the bank and take out cash to cover their margin call. It didn't take long for the banks to run out of cash and start calling loans due from good Americans who were faithfully making their mortgage payments every month. However, there wasn't any demand to buy these homes, so prices continued to drop. To cover the margin calls, brokers were forced to sell stocks and once again there wasn't a market for

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stocks so the prices kept dropping. Ultimately, the Great Depression saw the stock market fall more than 75% from its 1929 highs. More than half the nation's banks failed and millions of homeowners lost their homes.

Out of this the American Mantra was born: Always own your home outright. Never carry a mortgage. The reasoning was simple: If the economy fell to pieces, at least you still had your home and the bank couldn't take it away from you. Since the Great Depression, laws have been introduced that make it illegal for banks to call your loan due. Additionally, the Fed is now quick to infuse money into the system if there is a run on the banks, as we saw in 1987 and Y2K. Also, the FDIC was created to insure banks. Still, it's no wonder the dread of losing their home became instilled in the hearts and minds of the American people, and they quickly grew to fear their mortgage. And because of this, for nearly 75 years most people have overlooked the opportunities their mortgage provides to build financial security.

Why You Shouldn't Hate Your Mortgage

Many people hate their mortgage because they know over the life of a 30-year loan, they will spend more in interest than the house cost them in the first place. To save money, it becomes very tempting to make a bigger down payment or extra principal payments. Unfortunately, saving money is not the same as making money. Or put another way, paying off debt is not the same as accumulating assets. By tackling the mortgage payoff first and the savings goal second, many fail to consider the important role a mortgage plays in our savings effort. Every dollar we give the bank is a dollar we do not invest. While paying off the mortgage saves us interest, it denies us the opportunity to earn interest with that money.

A Tale of Two Brothers

Ric Edelman, one of the top financial planners in the country and a New York Times bestselling author, has educated his clients for years on the benefits of integrating their mortgage into their overall financial plan. In his book, The New Rules of Money, he tells the story of two brothers, each of whom secures a mortgage to buy a $200,000 home. Each brother earns $70,000 a year and has $40,000 in savings.

Brother A believes in the traditional way of paying off a mortgage as soon as possible. He bites the bullet and secures a 15-year mortgage at 6.38% APR and shells out all $40,000 of his savings as a 20% down payment, leaving him zero dollars to invest. This leaves him with a monthly payment of $1,383. Since he has a combined federal and state income tax rate of 32%, he is left with an average monthly net after-tax cost of $1,227. Also, in an effort to eliminate his mortgage sooner, Brother A sends an extra $100 to his lender every month.

Brother B, in contrast, subscribes to the new way of mortgage planning, choosing instead to carry a big, long-term mortgage. He secures a 30-year, interest-only loan at 7.42% APR. He outlays a small 5% down payment of $10,000 and invests the remaining $30,000 in a safe, moneymaking side account that earns an 8% rate of return. His monthly payment is $1,175, 100% of which is tax deductible over the first 15 years, and 64% over the life of the loan, leaving him a monthly net after-tax cost of $799. Every month he adds $100 to his investments (the same $100 Brother A sent to his lender), plus the $428 he has saved from his lower mortgage payment.

Which brother made the right decision? After only five years, Brother A has received $14,216 in tax savings; however, he made zero dollars in savings and investments. Brother B, on the other hand, has received $22,557 in tax savings, and his savings and investment account has grown to $83,513.

Now, what if both brothers suddenly lost their jobs? Even though Brother A has $74,320 of equity in his home, he can't get a loan because he doesn't have a job. He can't make his monthly payments and has to sell his home to avoid foreclosure. Unfortunately, at this point it's a fire sale so he must sell at a discount, and then pay real estate commissions. Brother B, however, has $83,513 in savings to tide him over. He doesn't need a loan and can easily make his monthly payments, even if he remains unemployed for years.

Let's suppose neither brother lost his job and evaluate the results of their financing strategies 15 years after they purchased their homes. Brother A has now received $25,080 in tax savings, has $30,421 in savings and investments (once his home was paid off he started saving the equivalent of his mortgage payment each month), and owns his home outright. Not too bad, right?

Brother B has received $67,670 in tax savings and has $282,019 in savings and investments. If he chooses to, he can pay off the mortgage balance of $190,000 and still have $92,019 left over in savings, free and clear.

Finally, let's assume that Brother B decides to ride out the whole 30 years of the loan's life. While Brother A has still received only $25,080 in tax savings, his savings and investments have grown to $613,858, and he owns his home outright. Brother B, on the other hand, has received a whopping $107,826 in tax savings, has accumulated an incredible $1,115,425 in savings and investments, and also owns his home outright. He can start over fresh and enjoy the same benefits once again.

Unfortunately, the majority of Americans follow the same path as Brother A as it's the only path they know. However, once the path of Brother B is revealed, they realize it enables them to pay their homes off sooner (if they choose to), while significantly increasing their net worth and maintaining the added benefits of liquidity and safety the entire way. And that is just one way strategy used by the wealthy that will work for the rest of America as well. ■

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To arrange a mortgage planning consultation on strategies discussed in this article, please give me a call.