

# Turning Home Equity Into Wealth

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

### **How It All Began**

If you had enough money to pay off your mortgage right now, would you? Many people would. In fact, the “American Dream” is to own your own home, and to own it outright, with no mortgage. If the American Dream is to own your own home, and to own it outright, with no mortgage. If the American Dream is so wonderful, how can we explain the fact that thousands of financially successful people who have more than enough money to pay off their mortgages, refuse to do so?

The answer? Most of what we believe about mortgages and home equity, which we learned from our parents and grandparents, is wrong. They taught us to make a big down payment, get a fixed-rate mortgage, and make extra principle payments in order to pay off our loans as early as we can. Mortgages, they said, are a necessary evil at best.

The rationale has become outdated. The rules of money have changed. Unlike our grandparents, we will no longer have the same job 30 years. In many cases people will switch careers four or five times. Also, unlike our grandparents, we can no longer depend on our companies’ pension plans for a secure retirement. Many Americans who haven’t saved enough will face outliving their money in retirement and may become burdens on their children. A recent Gallup survey showed that 75% of workers want to retire before the age of 60, yet only 25% think they can.

### **Changing with the Times**

Also, unlike our grandparents, we will no longer live in the same home for 30 years. The average American homeowner moves every four or five years. According to the Federal National Mortgage Association, or Fannie Mae, even those who stay longer will refinance within 4.2 years. People refinance to improve their interest rates, restructure their debt, remodel their homes, or to pull money out for investing, education or other expenses. Given these statistics, it’s difficult to understand why so many American’s continue to pay a high interest rate premium for a 30-year fixed-rate mortgage when they are likely to use only the first 4.2 years of mortgage.

### **What do the Affluent do?**

Wealthy Americans, those with the ability to pay off their mortgage but refuse to do so, understand how to make their mortgages work for them. They go against many of the beliefs of traditional thinking. They put very little money down, keep their mortgage balances high, choose adjustable rate mortgages, and most importantly – they integrate their mortgages into their overall financial plan to continually increase their wealth. This is how the rich get richer.

### **It Started with a Crash**

In order to discover how our grandparents got the idea that a mortgage was a necessary evil, we must go back to the Great Depression.

In the 1920's, 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, largely due to margin. Back then, you could buy \$10 of stock for \$1. 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 calls. 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.

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, unable to raise the cash they needed to pay of their loans, foreclosed. Out of this, the American Mantra was born: *Always own your home outright*. The reasoning was really quite simple — if the economy collapsed, at least you still had your home and the bank couldn't take it away from you. Maybe you couldn't put food on the table, but your home was secure.

Since the Great Depression, laws have been passed that make it illegal for banks to call you up and say, "We're running a little short on cash and need you to pay off your loan in the next 30 days." The Fed is now quick to infuse money into the system if there is a shortage, as we saw in 1987 and Y2K. Also, the FDIC was created to insure banks. Still, it's no wonder the fear of losing their homes became instilled in the hearts of Americans. In the 1950's and '60s, families would throw mortgage-burning parties to celebrate paying off their homes. So for nearly 75 years, most people have overlooked the opportunities their mortgages provide to build financial security.

### **Paying Off Debt vs. Accumulating Assets**

Many people hate their mortgages because they know over the life of a 30-year loan they will spend more in interest than what the house originally cost. To save money, it becomes very tempting to make a bigger down payment or to make 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. Let's compare the two side by side for a better understanding.

Many people feel a house is "the best investment they ever made."  
But is it?

<b>Paying off Debt</b>	<b>Accumulating Assets</b>
➤ \$1,800 monthly fixed note on a \$300,000 mortgage	➤ \$1,800 monthly to an investment account
➤ 30 year fixed rate loan at 6.0%	➤ Conservatively safe rate of return at 8.0%
➤ After 30 years, with 4% appreciation, the house is worth?	➤ After 30 years, the investment account is worth?
<b>\$994,000</b>	<b>\$2,682,647</b>

By tackling the mortgage pay off 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 did not invest. While paying off the mortgage saves us interest, it denies us the opportunity to earn interest and avoid taxes with that money.

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### **Unwinding Decades of Misinformation**

Doug Andrew, a top financial planner from Utah, was the first to clearly articulate the strategy the wealthy have been using for decades in his book, *Missed Fortune*. The book is based on the concepts of successfully managing home equity to increase liquidity, safety, rate of return and tax deductions. Doug educates readers to view their mortgages and home equity through a different lens – the same lens used by the affluent. He shows how minor changes in home equity perception and positioning can produce monumental long-term effects in financial security.

Many Americans believe the best way to pay off a home early is to pay extra principal on the mortgage. Similarly, many finance professors think a 15-year loan saves you money by reducing the interest you pay. However, Andrew points out that this thinking is flawed. If you do the math, you'll find that if you set aside the monthly payment difference between a 15-year loan and a 30-year loan, as well as the tax savings, into a safe, side investment account earning a conservative rate of return, you will have enough to pay your home off in 13 ½ years. Chapter One in *Missed Fortune* talks about the \$25,000 mistake made by millions of Americans who choose the 15-year loan.

The Journal of Financial Planning (published by the Institute of Certified Financial Planners®) contained the first academic study undertaken on the question of 15-year versus 30-year mortgages. They concluded the 30 year-loan is better. Based on the same logic, wouldn't an interest-only loan be better than an amortizing loan? If mortgage money costs you 6%, chances are good that you can earn 6% on your money. Interest rates are relative. In the 1980's, mortgage rates were 15%, but people could earn 15% when invested in CD's. Due to the tax deductibility of mortgage interest and compound returns, you can borrow at a higher rate, invest at a lower rate and still make a significant profit.

Daniel C. Goodwin, a continuing education instructor in the Houston area, teaches a seminar for financial planners based largely on the *Missed Fortune* concepts. In the seminar, he breaks down the five key benefits of integrating your mortgage into the financial plan:

- 1. Increased Liquidity**
- 2. Safety**
- 3. Rate of Return**
- 4. Cash Flow Management**
- 5. Tax Efficiency**

His goal is to teach clients how to conserve home equity, not consume it, by securing debt in order to become debt-free sooner.

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### **Disadvantage of Home Equity**

By having cash available for emergencies and investment opportunities, most homeowners are better off than if their equity is tied up in their residence. Large, idle equity tied up in one investment is akin to ‘having all your eggs in one basket.’ This is a risky approach in the homeowner suddenly needs cash. While employed and in excellent health, borrowing on a home is easy, but most people, especially retirees, unexpectedly need cash when they are sick, unemployed or have insufficient income. Obtaining a home loan under these circumstances can be either impossible or very expensive.

How many of us feel when we go to the bank we almost need to prove we don’t need the money before they’ll loan it to us? The bank wants to know we have the ability to repay the loan. You can imagine how a conversation might go with your banker: “ I brought up your loan application to the board this morning and I explained to them you’re going through some hard financial times, you’re unemployed, your credit is not so good and maybe they could lend you some cash to get through these rough times. Their response was. . . “*Sorry!*”

When many people don’t realize is that even if they’ve consistently been making double mortgage payments for five years in a row, the bank still has no leniency. If suddenly they experience a financial setback, the bank will not care. They can go to the bank and plead “I’ve been paying my mortgage in advance for years, how about if I just coast on my mortgage payments for a few months?” They get the same answer every time. . . “*Sorry!*” Banks just don’t work that way. Regardless of how much you’ve paid your mortgage down or how many extra payments you’ve made, next month’s payment is still due in its entirety – no matter what.

### **Advantages of Separating Your Home Equity**

Why would you want to have the equity removed from your home? There are actually three primary reasons:

1. ***Liquidity***
2. ***Safety***
3. ***Rate of Return***

When evaluating a potential investment, experienced investors will ask the following three questions:

1. ***Can I get my money back when I want it? (Liquidity)***
2. ***Is it guaranteed or insured? (Safety)***
3. ***How much growth can I expect? (Rate of Return)***

Home equity fails all three tests of a prudent investment.

## **Liquidity – The Biggest Secret in Real Estate**

Your mortgage is a loan against your income; it is not a loan against the value of your house. Without an income, getting a loan can be challenging. If you suddenly experienced difficult financial times, would you rather have \$50,000 cash to help you make your mortgage payment or an additional \$50,000 of equity trapped in your home?

The importance of liquidity became all too clear when the stock market crashed in October of 1987. Those with other liquid assets were able to remain invested, avoiding the sell-off at rock bottom prices. They were rewarded as the market rebounded and recovered fully within 90 days. However, those without liquidity were forced to sell while the market was down, causing them to realize significant losses.

### **The Story of Doug and Sharee**

In *Missed Fortune*, author Doug Andrew tells the story of when he and his wife, as a young couple, learned what he calls, “The \$150,000 Lesson Liquidity.” In 1978, they built a home so beautiful it was featured in *Better Homes and Gardens* magazine. Their home appreciated in value, and by 1982, it was appraised for just under \$300,000. They had accumulated a significant amount of equity, not because they had been making extra payments on the property, but because the market conditions improved. The home valued at \$300,000 with first and second mortgages owing only \$150,000. They had “made” \$150,000 in four short years.

Then, a series of unexpected events reduced their income to almost nothing for nine months. They couldn’t borrow money to keep their mortgage payments current because banks don’t loan money to people with no ability to repay. In order to protect their \$150,000 of equity, Doug and Sharee would have to sell their home. As Murphy’s Law would have it, the previously strong real estate market turned weak. Although they reduced their asking price several times - from \$295,000 down to \$195,000 - they could not find a buyer. Sadly, they gave up the home in foreclosure to the mortgage lender.

In a time of financial setback, Doug and his wife lost of their most valuable assets due to a lack of liquidity. If they had separated their \$150,000 in home equity based on the appraisal value and repositioned it into a safe side account, they would have easily been able to make their mortgage payments and prevent their series of events.

Home equity is not the same as cash in the bank; only cash in the bank is the same cash in the bank. Being house rich and cash poor is a dangerous position to be in. It is better to have access to the equity or value of your home and not need it, than to need it and not be able to get at it. Keeping home equity safe is really a matter of positioning yourself to act instead of react to market conditions which you have no control.

### **Safety – Pay It Off or Fully Leverage It**

When oil prices fell to all-time lows in the early 1980’s, Houston, Texas was hit hard. Thousands of workers were laid off and ultimately forced to sell their homes. With a glut of homes on the market, housing prices plummeted. Unfortunately, there were far more sellers than buyers and homeowners were unable to sell *or* make their mortgage payments. As a result, 26,000 homes were foreclosed. Those without liquid funds who

escaped foreclosure either owned their homes free and clear or were so fully leveraged that the banks saw more risk for themselves by foreclosing than by waiting for the homeowner to recover.

As homeowners pay down their mortgages, they are unknowingly transferring the risk from the bank to themselves. When the mortgage balance is high, the bank carries the most risk. When the mortgage balance is low, the homeowner bears the risk. Assume you're a mortgage banker looking at your portfolio and you have 100 loans that are delinquent. All of the loans are for homes valued at \$300,000. Some of the loan balances are \$150,000 and some are \$250,000. Suddenly, there is a glut in the market and the homes are now worth \$200,000. Which homes does the banker foreclose on first? The ones owing the least amount of money, of course. After all, as a banker you'd make money taking back those homes, however, you're guaranteed to lose money trying to sell a home for \$200,000 that still owed \$250,000 on it. Better to let that homeowner shoulder his own risk.

It's interesting to note that during the Great Depression the Hilton chain of hotels was deeply affected by the stock market crash and couldn't make its loan payments. What saved them from financial ruin? The chain was so leveraged it owed more on its property than it was worth in the current market. The banks couldn't afford to foreclose it. The Hiltons understood the value of keeping high mortgage balances and keeping the risk of banks. The Houston homeowners would have been better off if they had removed a large portion of their equity and put it in a safe, liquid side fund that was accessible in a time of need.

### **Rate of Return – What Goes Up, Does Come Down**

What do you think the rate of return on home equity was in Houston for the last 3 years? What about Dallas? Careful, this is a trick question. The truth is, it doesn't matter where you live or how fast the homes are appreciating, the return of home equity is always the same. ZERO. We have a misconception that because our home appreciates, or our mortgage balance is going down, that the equity has a rate of return. It's not true. Home equity has NO rate of return. You're not making a dime off your equity; it's stagnant at best. Home values fluctuate due to market conditions, not due to the mortgage balance. Since the equity in the home has no relation to the home's value, it is in no way responsible for the home's appreciation. Therefore, home equity simply sits idle in the home. It isn't actively working for you; it merely exists.

### **Take a look at this example:**

Assume you have a home worth \$200,000 that you own free and clear. If the home appreciates 5%, you own an asset worth \$210,000 at the end of the year. Now, assume you had separated the \$200,000 of home equity and placed it in a safe, conservative side account earning 6%. Your side account would be worth \$212,000 at the end of the year. You still own the home, which appreciated 5% and is worth \$212,000. But by separating the equity, you created a new asset, which was also able to earn a rate of return. Therefore, you earned \$12,000 more than you would have if the money were left to sit idle in the home. To be fair, you do have a mortgage payment you didn't have before. However, since interest rates are relative, if we are assuming a rate of return of 6%, we can also assume a strategic interest-only mortgage would be available at 5%. Also, since

mortgage interest is 100% tax deductible, the net cost of the money is also 3.6%. This produces a 2.4% positive spread between the cost of money and the earnings on that money.

Going further, the story gets much more compelling over time, as the mortgage debt remains constant, however through compound interest, the side account continues to grow at a faster pace each year:

1. The earnings on \$200,000 in year one are \$12,000.
2. Then in year two, the 6% earnings on \$212,000 are \$12,720.
3. In three years, the earnings on \$224,720 at 6% are \$13,483.

Since the mortgage debt remains constant (remember, you're not paying any principal: this is an interest-only loan), the spread between the cost of the mortgage money and the earnings on the separated equity continues to widen in the homeowner's favor every year. If we allow home equity to remain idle in the home, we give up the opportunity to put it to work, to grow and compound. As Albert Einstein said, "The most powerful force in the universe is compound interest." After all, homes were built to house families, not store cash. Investments were made to store cash.

### **The Power of Leverage**

Buying a home can be a great investment. However, wealthy individuals buy homes with as little cash as possible, leaving the majority of their money in other investments where it's liquid, safe and earning a rate of return. For example, paying cash for a \$300,000 home that appreciates \$30,000 gives a 10% rate of return on your cash investment. But with equal appreciation on a house, you finance for only 20% down, your return on investment jumps to 50%. Returns like this become possible utilizing leverage. When we pay down or even eliminate our mortgages, we give away our financial leverage to the bank and mitigate our tax benefits. The reality here is that it's your *mortgage* that's a great investment.

### **Mortgages During Retirement**

Retirees are finding themselves paying through the nose in taxes with no shelters. Traditional financial planning has failed millions of Americans by advising them to pay off their mortgages and max out their 401 (K)s. Unfortunately, millions of Americans are beginning to realize the tax implications of this flawed ideas as they head into retirement. Many are finding that the kids have grown up and moved away. The mortgage is paid off, most of their money is in qualified plans, and now taxes are due. Many believe with baby boom trends they will be facing higher tax rates in the future. Also, most are not confident the government will be able to provide their Social Security benefits. The more astute retirees with wise financial advisors are learning advanced concepts whereby in retirement a mortgage can be your friend and not your foe. A mortgage that one's cash flow could easily support may offset qualified plans withdrawals. This strategy effectively gives retirees the opportunity to access a portion of their qualified plans "tax free." Moreover, their money remains invested, earning income in secure, liquid investments. Better planning equals more discretionary income in retirement.

## **Make an Extra Million Dollars for Retirement**

By repositioning \$200,000 into an equity management account, you can achieve a net gain of \$1 million over 30 years. Assume you separate the \$200,000 of home equity using a mortgage with a 5% interest rate. If the \$200,000 grows at a conservative rate of 6.75% per year, it will be worth \$1,419,275 in 30 years. After deducting the \$216,000 in interest payments and the \$200,000 mortgage, you still have \$1,003,275 left in your account – a net gain of over \$1 million dollars. This example simply shows a one-time repositioning of equity. Imagine how the numbers grow for individuals that harvest and reposition their home equity every 5 years as their home continues to appreciate! This is how the wealthy manage their home equity to continually increase their net worth.

## **Betting the Ranch**

Recently the NASD issued an alert stating, “We are concerned that investors who must rely on investment returns to make their mortgage payments could end up defaulting on their home loans if their investments decline and they are unable to meet their monthly mortgage payments.” The NASD is absolutely correct in advising against separating equity if the client must rely on the returns from their investment to make the mortgage payments. Home equity is **serious money**. We don’t gamble home equity. Liquidity and safety are key philosophies when separating home equity. Rate of return is a distant third benefit. Also, it is not necessary or recommended to invest in highly volatile or aggressive investments. You can make thousands of dollars simply by borrowing at 5% and investing at 5% in safe fixed investments. In general, individuals should not invest home equity for “current income” unless the investment is fixed and guaranteed. Per the NASD, “Brokers are not prohibited from making a recommendation per se, so long as the investment is reasonably suitable for investment in general, and it is suitable for the specific customer. In order to determine suitability, a broker should consider the client’s investment objectives, financial status, tax status and any other information a firm uses to make suitable client recommendations.”

## **Working with Uncle Sam**

Under tax law, you can deduct up to \$1 million dollars of mortgage interest subject to income restrictions. You can also deduct an additional \$100,000 from home equity loan interest. To take advantage of these deductions, be sure to secure a large mortgage when you buy. Mortgage interest is deductible only for \$100,000 over the original mortgage balance. Home improvements are the only exception. For example, if you sell your home for \$400,000 and buy a new home for \$400,000 and later decide to take out a home equity loan, only the first \$100,000 will be tax deductible. Instead, secure a \$360,000 mortgage (90%) when you buy the home and entire amount is deductible.

## **And Finally, Invest Wisely**

Home equity is serious money. We are separating it from the home to conserve it, not to consume it. Therefore it should not be invested aggressively. Rather, home equity is best invested in safe, conservative investment vehicles. Tax favored safe investments are ideal. You should consult your financial planner for the best investment vehicles for your specific situation. Many financial planners prefer the following tax favored products for investing home equity:

- Investment Grade Insurance Contracts
- Annuities (protected accounts)
- Real Estate Investment Trust (REITs)
- IRAs
- 401 (K) s
- Tax-free bonds
- 529 Savings Plans (for those with college bound heirs)

*“ I hope this article has been insightful and has encouraged you to examine new ideas in wealth accumulation, tax avoidance and leverage. A mortgage strategy emphasizing safety, liquidity, rate of return, cash flow management and tax efficiency can be the difference between retiring under financial stress of retiring with financial peace of mind.”*

Daniel C. Goodwin

For a free analysis to see how these concepts would apply to your specific situation, please contact Daniel Goodwin at 888.281.7011 or by visiting online at [www.weretirewell.com](http://www.weretirewell.com)

**TALE OF TWO BROTHERS** – adapted from the book *The New Rules of Money*, by Eric Edelman

<b>BROTHER A</b>	<b>BROTHER B</b>
Earns \$150,000 annually has \$100,000 in savings and is buying a \$500,000 home.	Earns \$150,000 annually, has \$100,000 in savings and is buying a \$500,000 home
<b>15-year</b> mortgage at 5.875% APR	<b>30-year</b> interest-only mortgage at 6.375% APR
<b>\$100,000</b> down payment (20%)	<b>\$25,000</b> down payment (5%)
<b>\$0</b> left to invest	<b>\$75,000</b> left to invest
<b>\$ 3,348</b> monthly payment (33% average tax savings)	<b>\$2,523</b> monthly payment (100% is tax-deductible)
<b>\$2,983</b> monthly net after-tax cost (33% tax bracket)	<b>\$1,690</b> monthly net after-tax cost (33% tax bracket)
Sends in <b>\$200</b> extra with every mortgage payment in an effort to pay mortgage off sooner	Sends in <b>\$1293</b> saved from lower mortgage payment, plus an extra \$200 to an investment account earning 8%

**Results after 5 years**

Received <b>\$33,796</b> in tax savings (33% tax bracket)	Received <b>\$49,955</b> in tax savings (33% tax bracket)
Has <b>\$0</b> in savings and investments	Has <b>\$221,439</b> in savings and investments (8% return)

**WHAT IF BOTH BROTHERS SUDDENLY LOSE THEIR JOBS?**

Can't get a loan – even though he has <b>\$185,562</b> in home equity – because he has no job or savings	Doesn't need a loan, he has <b>\$221, 439</b> in savings
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### RESULTS AFTER 15 YEARS

Received <b>\$60,517</b> in tax savings	Received <b>\$149,866</b> in tax savings
Has <b>\$51,832</b> in savings and investments	Has <b>\$764,654</b> in savings and investments
Owens his home outright	Has enough in savings to pay off his <b>\$475,000</b> mortgage and still have <b>\$289,654</b> left

### Results after 30 years

Received <b>\$60,517</b> in tax savings	Received <b>\$299,732</b> in tax savings
Has <b>\$1,052,877</b> in savings and investments	Has <b>\$3,045 286</b> in savings and investments
Owens home outright	Chooses to keep his mortgage in exchange for the liquidity, safety, tax savings and investment returns

*Brother A had a good plan. Brother B had a great plan. Per author, Jim Collins, “Good is the enemy of great.”*