

MORTGAGE advisor™

● ISSUE 23



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Control The Spread

How the Affluent Manage Equity as Leverage

Third in a Three-Part Series

Savvy investors always consider the rate-of-return that they get on their investments. Because a home is a typically a homeowner's largest investment, the rate-of-return should also be carefully considered. What do you think the return was on home equity in Seattle over the past three years? What do you think it was for Los Angeles? How about New York City? The answer is always the same, whether the home is in a quickly appreciating area or not. The truth is, the rate-of-return on home equity is always zero. Yes, zero.

Most homeowners mistakenly believe that because a home appreciates, or the principal balance goes down, that the equity has a rate-of-return, but this is not true. Home values fluctuate due to market conditions, not because of the mortgage balance. Therefore, the equity in the

appreciates 5 percent, the home will be worth \$105,000 at the end of the year. Now, let's say that the homeowner separates the \$100,000 of the home's equity and places it in a safe, conservative side account earning 8 percent. At the end of the year, that side account would be worth \$108,000. The homeowner will still own the home, which is still worth \$105,000, but now he or she will also have created a new asset that is able to earn a rate-of-return, therefore earning \$8,000 more than if the money were simply sitting idle in the home's equity. Of course, the borrower would also have a mortgage payment that he or she didn't have before, but since interest rates are relative, we'll assume that the interest-only mortgage rate is 5 percent. Also, since mortgage interest is 100 percent tax deductible, the net cost of the loan is only 3.6 percent, leaving a 4.4 percent positive spread between the cost of the money and the earnings on the money. Plus, because the investment account operates on compounding interest, the balance continues to grow at a faster pace each year. Earnings in the first year are \$8,000, but because of compounding interest, year two's earnings increase to \$8,640. In year three, because the principal balance has now grown to \$116,640, earnings at 8 percent total \$9,331. The original mortgage debt stays the same, and the earnings on the separated equity continue to grow in the homeowner's favor each year.

If that same \$100,000 was left idle in the home's equity, the homeowner would be giving up the opportunity to put that money to work, where it could grow and compound. The bottom line is that interest-bearing accounts enable the homeowner's money to compound and grow, but home equity doesn't allow for compounding interest. Plus, with home equity, the money is

home has no relation to the home's value. It does not earn a rate-of-return. Instead, it simply sits idle.

To illustrate this point, let's say an individual owns a \$100,000 home free and clear. If the home

not liquid, so it's not easily accessible to the homeowner. Homeowners would actually be better off burying the money in their back yards rather than paying down their mortgages, because that way at least the money would be accessible and safe. Either way, the money, whether in the home's equity or buried in the backyard, is not earning a rate-of-return, and is actually losing value due to inflation.

Homes were designed to house families, not to store money. Investments, however, were made to store cash. After all, it was Albert Einstein who said, "The most powerful force in the universe is compound interest." If you were offered an investment that would never increase in value, but might possibly decrease, you probably wouldn't be interested. Yet this is the exact picture of what home equity offers. It has no rate of return, so it cannot increase in value, yet it could possibly decline in value if the real estate market takes a downward turn, or if you experience an uninsured loss, such as an earthquake, flood or foreclosure. Appreciation has nothing to do with home equity. If your home is going to appreciate, you'll appreciate whether you have equity in your home or not. If you confuse appreciation with the rate of return, you could mistakenly put your money in one of the worst places possible.

The Power of Leverage

While purchasing a home can be a great investment, it can be an even greater investment when homeowners use their properties to their advantage and leverage their home equity. The wealthy purchase their homes with as little of their own money as possible, leaving the majority of their cash in other investments, where it is liquid, safe and earning a rate of return.

Consider the Johnson family of Charlotte, North Carolina. They purchased a home in 1990 for \$250,000 and sold it in June 2003 for \$600,000, realizing a gain of 140 percent. That sounds like a very good number. After all, they've more than doubled their money. During that same period, the Dow Jones grew from 2,590 to 9,188, representing a gain of 255 percent. If the

The Three Elements of a Prudent Investment

Creating Wealth vs. Consuming Equity

Smart investors take an entirely different approach to home equity. In his book, "Missed Fortune 101," financial strategist Doug Andrew strongly suggests that homeowners separate as much equity as they possibly can from their homes and place those assets into a cash position. He asserts that there are three primary reasons for moving equity away from the home: liquidity, safety and rate of return.

Remember that home equity is very serious money. Creating wealth through equity management requires dedication to saving and investing for the future, not cashing out and spending equity. A mortgage should not be a financial burden and investment income should not be used to make mortgage payments.

The truth is that investments don't need to be risky in order for mortgage planning to pay off. Individuals can make thousands of dollars by simply borrowing at 5 percent and investing at 5 percent in safe, conservative, fixed investments, without ever crossing over into securities. Investments must be safe and liquid consider investments such as investment-grade insurance contracts, annuities, real estate investment trusts, IRAs, 401(K)s, tax-free bonds and savings plans.

Three primary factors indicate prudent investments:

- 1. How liquid is the investment? They will want to know if they can get their money back if they want it.**
- 2. How safe is it? Smart investors will want to know if the investment is guaranteed or insured.**
- 3. What is the rate of return? Obviously, the higher rate of return, the better.**

Johnsons had invested only \$50,000 of their own money as a down payment, their profit on the initial \$50,000 would have jumped to 600 percent because that \$50,000 would have increased to \$250,000, far surpassing the 255 percent stock market gains. By putting down as little money as possible and leveraging their assets, they would have benefitted from a much higher gain and still have assets that they can use for other investments.

As aspiring affluent homeowners from Austin, Texas, the Hernandez family separated their equity and repositioned it in a safe, liquid side account. Their mortgage payment is considered the employment cost. If they had left their equity trapped in their home like the Johnsons, they would have incurred the same costs, but it's called a lost opportunity cost -- money sitting idle in the home, when it could be put to work earning interest.

By separating \$100,000 of home equity, with a mortgage interest rate of 5 percent, the Hernandez family paid \$5,000 per year. Assuming that they are in a 28 percent tax bracket, the net employment cost isn't actually 5 percent, but rather 3.6 percent after taxes, because mortgage interest is 100 percent tax deductible. The Hernandezes then turned around and invested that \$100,000 in tax-free or tax-deferred investments earning more than 3.6 percent -- something that is not at all difficult to do and the way many millionaires make their money. It is also the same way that banks make their money. They borrow our money at 2 or 3 percent, and loan it back to us at 5 or 6 percent.

Money Works for Everyone

Effective mortgage planning is not limited to those who have significant chunks of equity to separate and invest. Mortgage planning can be a highly effective cash flow management tool. Many homeowners can benefit significantly from simply transitioning to a more strategic mortgage that provides them with a lower monthly payment each month, leaving a resource to save or invest to begin building assets.



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