Mortgage Matters

Impact Mortgage Group

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[*How to Safely Manage Home Equity to Achieve Financial Freedom & Build Wealth*]

If what you always thought to be true turned out not to be true, when would you want to know?

Most of what we believe about mortgages and home equity is outdated.

We have been taught to make a big down payment, get a fixed rate mortgage and make extra principal payments in order to pay off our mortgages as quickly as possible. We have been taught that mortgages are, at best, a necessary evil. The problem with this belief system is that it has become obsolete.

You see, we can no longer depend on our company's pension for a secure retirement. We can no longer expect to have the same job for 30 years. We can no longer expect to live in the same home for 30 years. In fact, many Americans switch careers five or six different times and most move into a different home every five to seven years. With our life expectancy higher than ever before, health costs skyrocketing, pensions shrinking, social security on the brink of collapse and corporate America going through one bankruptcy after another, it is time to start taking a serious look at some alternative ways of managing our money, home equity and personal cash flow.

This report will reveal the truth about how you can safely manage your mortgage and your home equity to build and conserve wealth. You will learn how to become debt free sooner, achieve financial freedom and make a difference in the lives of others.

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Time to let go of the past...

Back during the 1920s and throughout the Great Depression, there was a common clause in mortgages that gave banks the right to demand full repayment of the mortgage at any time. In other words, the bank could legally require you to pay back the entire mortgage in full whenever they wanted their money back, even if you were making all your payments on time.

When the stock market began performing well during the "Roaring Twenties", banks began speculating and gambling in the stock market. Back then, you could buy $10 worth of stock with $1 of your own money and $9 of borrowed money. So, the banks took advantage of this opportunity and began borrowing large sums of money from each other and gambling it all in the stock market.

Well, as we all know, the party didn't last for long and the stock market crashed on October 29th, 1929. Not only did the market crash, but throughout the next several years, the market continued going steadily down until it lost nearly 80% of its original value.

When this happened, the banks had to repay all the borrowed money that they had gambled and lost. Where did they get the money to repay all these stock market losses?

You guessed it! They called up all our parents and grandparents who owned homes with mortgages and began demanding that they pay back their mortgages in full. Obviously, our parents and grandparents didn't have the cash to pay the banks back. So, many of our parents and grandparents lost their homes.

Why did they lose their homes? Not because they gambled money in the stock market; but because the banks gambled money in the stock market and the banks had the legal right to demand repayment of their mortgage loans at any time.

Today, the rules have all changed.

Not only are banks prohibited from borrowing heavily to gamble in the stock market, they are also prohibited from calling in their mortgage loans without cause. In other words, **you can never lose your home unless you stop making your mortgage payments.**

Therefore, the only thing to really fear is not having the ability to make your payments. With that in mind, the main goal would be to have a lot of money saved up in an emergency fund in case you come across hard financial times.

Consider this example:

Mary:

- $300,000 - Home
- $100,000 - Mortgage
- $200,000 - Home Equity
- $0 - Emergency Reserve Account

Martha:

- $300,000 - Home
- $200,000 - Mortgage
- $100,000 - Home Equity
- $100,000 - Emergency Reserve Account

If you came across financial difficulties in today's economy, would you prefer to be in Mary's situation or Martha's situation?

Martha is obviously in a safer financial situation than Mary even though she has a mortgage that is two times larger than Mary's mortgage! Mary is more in danger of losing her home if she comes across financial difficulties or if the economy collapses. Martha has the cash to weather the storm while Mary is house rich and cash poor. Remember, in hard times, cash is king!

You see, many people mistakenly assume that home equity is like cash in the bank. That is a false and very dangerous assumption. **Only cash in the bank is like cash in the bank**. It is far safer to have a large mortgage and a lot of cash in the bank, than to have little or no mortgage with little or no cash in the bank.

...Understand that Everything in Life is 100% Financed

Many people hate their mortgage because they hate paying interest. They make extra principal payments or a larger down payment because they think they are saving money and getting out of debt quicker. The truth is that **everything in life is 100% financed**.

This means that you are either paying interest to someone else, or you are losing the opportunity to earn interest on your own money. Consider the effect of using $100,000 of your own money to finance your home, versus using $100,000 of the bank's money to finance your home.

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	Self-Financed	Bank-Financed
Mortgage Interest Lost 6%	**-**	**$6,000**
Investment Interest Lost 6%	**$6,000**	**-**

As you can see from the illustration, you lose money if you have a mortgage, but you also lose money if you don't have a mortgage! If you finance the home with the bank's money, you are losing money by paying interest to the bank. If you finance your home with your own money, your investment of home equity is preventing you from otherwise earning interest on your money in another investment. In other words, **you are losing money by not making money**.

Therefore, the question really becomes, what is a better investment for your money - home equity or an alternative investment? Which strategy is safer and less risky? In order to answer this question, we need to recognize that **every investment and every choice in life carries risk**.

Most people fail to recognize the risks associated with home equity as an investment. Let's take this step by step and evaluate home equity as we would evaluate any other investment.

- What is the rate of return?
- How safe is the investment?
- How liquid is the investment? (Can you get your money back when you want it?)

How Profitable is the Investment that Has No Rate of Return?

Real estate values will go up ***or down*** regardless of the mortgage balance on the property. Therefore, if your home goes up in value, your investment of home equity did not cause it do so. In fact, your investment of home equity has nothing to do with it!

The fact that you own the property is really the investment that is making you money, not how much cash you are storing in the property by way of home equity. In fact, storing your cash in the property by way of home equity is really similar to digging a hole in your backyard and shoveling cash into the hole. The home will go up or down in value regardless of how much cash you bury in that hole! However, it would be safer for you to shovel the cash into that hole as opposed to storing the cash in your home equity because at least you'd be able to get to it if you need it. This concept of "liquidity" (access to your money) is covered in further detail as we move on.

How Safe is The Investment that Carries Risk of Loss?

Although home equity has no rate of return, it can go down in value if the property value declines. If you were offered an investment that could never go up in value, but might go down, how much of it would you want?

There are two ways you can lose your home equity:

1. Foreclosure

The risk of foreclosure can be avoided by understanding the example of Mary and Martha as illustrated above. The only way to protect your home equity from loss in a foreclosure is to have enough cash sitting in the bank to face financial emergencies. In other words, instead of making extra principal payments, contribute to an emergency reserve account.

The reason why real estate investors make money by buying foreclosed properties is because the homeowners who are losing their homes thought that it was smart to make extra principal payments on their mortgages. All the money that investors make with these opportunities is money that is being lost by homeowners who mistakenly assume that home equity is like cash in the bank.

Almost everyone who lost their home to foreclosure would have been better off carrying a larger mortgage and keeping a large amount of money in the bank as a "rainy day fund".

2. Property declines in value

If your property declines in value, the equity that you once had is no longer there. In order to recover your lost equity, you would need to wait until the property goes back up in value. If you need access to the funds sooner, you would need to either:

- Sell your home at a loss and lose the equity forever; or,
- Cash out your home equity with a mortgage with more restrictive lending guidelines. In this case, your personal employment, income and credit situation could prevent you from getting good loan terms; plus banks would be more reluctant to lend money on homes that are declining in value.

Consider the following example:

	Small Equity	Large Equity
Initial "Bubble" Home Value	$500,000	$500,000
Mtg. Balance	$400,000	$200,000
Home Equity	$100,000	$300,000
Cash in Bank	$200,000	-
New, Reduced Home Value	$400,000	$400,000
Equity Lost Due to Sale During a Down Market:	-	$100,000

As you can see from the example above, having a larger mortgage with more cash in the bank will better enable you to ride out the storm if home prices decline. In this case, you would have the cash and financial ability to wait for home prices to come back up versus being forced to sell your home at a loss during a down market. This is classic application of the wisdom of buying low and selling high.

How Liquid and Accessible are Trapped Investment Dollars?

The great secret of banking is that banks don't lend money to people who need it. They lend money to people who can prove that they don't need it!

In other words, if you come across financial difficulties banks are unlikely to lend you money, even if you have a lot of equity in the home. Chances are that you'll need to settle for a loan that will be smaller than you need and have terms and interest rates that may be more unfavorable than they would be otherwise.

If you suddenly experienced difficult financial times, how important would it be for you have cash to help you make your payments and pay your bills? How would you feel if you had a lot of equity trapped in your home that won't do you any good?

It is always better to have the cash and not need it; than to need it and not have access to it.

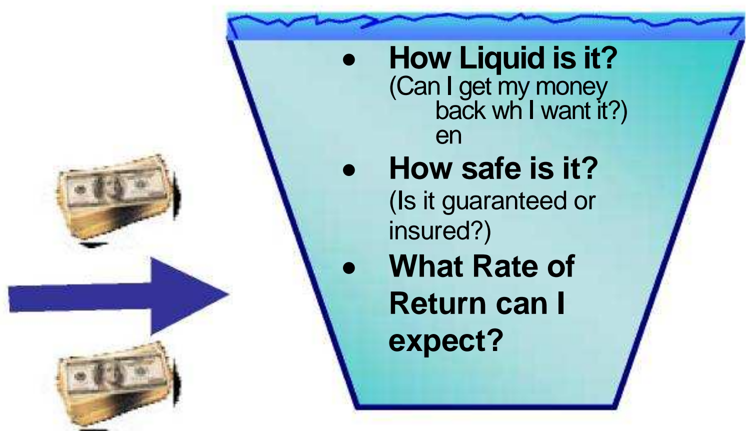
Be Financially Prudent: Increase Your Safety and Liquidity

According to a recent study, most Americans have more of their net worth in home equity than in all other investments combined. However, most financial advisors and savvy investors would agree that it is not very wise to have most of your wealth tied up in one single investment.

In fact diversification is the key to reducing risk and increasing the safety of principal. Holding large amounts of home equity puts you at unnecessary risk. Your risk could be greatly reduced by separating your equity from your home and diversifying into other investments.

When the mortgage balance is high, the bank carries most of the risk. As you pay down your mortgage and make extra principal payments, you are actually transferring the risk from the bank back to yourself!

Remember, homes are made to house families, not store cash. Investments are designed to store cash.



The Wise Way to Own a Home

Buying a home can definitely be a great investment. The key is to own the home, but keep your equity safely invested outside of the home. If your home goes up in value, you build wealth through home ownership while keeping your money safe and easily accessible. If your home goes down in value, you will have enough cash to weather the storm and wait for home values to come back up.

The rate of home price appreciation in the United States has averaged around 6% per year for the past 50 years. Some years and locations are better than others, and some years and locations are worse than others. In most parts of the country you can count on at least 3% annual home price appreciation (roughly the same rate as inflation in any given year).

If you buy a $300,000 home that goes up in value by 3% per year for 5 years, the home would be worth $348,000 at that time. This represents a gain of 3% per year or 16% compounded over 5 years. On the other hand, if you only use $60,000 of your own money and $240,000 of the bank's money to buy this home, your gain would be 8% per year or 47% compounded over 5 years!

Would you rather earn 3% per year on $300,000 or 8% per year on $60,000? The key to wise home ownership is to manage your investment by applying the same investment principles to home equity as you would apply to any other investment.

We can't honestly say that we believe in investment diversification if we don't diversify all our investments, including home equity! We can't honestly say that we are financially conservative if we take huge risks with our biggest investment by dumping it all into a single property!

With this in mind, where can you safely invest your home equity? Home equity is serious money. We are separating it from the home to conserve it, not consume it. Therefore, it should be invested safely and conservatively as part of a properly balanced and diversified investment portfolio. A properly diversified investment portfolio includes businesses (stocks), real estate, bonds, commodities and cash (money market accounts).

If you have good experience with direct ownership of real estate, you could reposition some of your home equity into other real estate investments including second homes or income producing properties. Many real estate income properties consistently provide a 15% - 25% annual rate of return via positive cash flow and/or appreciation.

The key with real estate investments is to never over-extend yourself. You should always keep enough cash in the bank in case you come across financial difficulties or if your investments don't perform as well as you anticipate.

Be Financially Conservative:

Avoid Risky Investments

Like Home Equity

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Examining the <u>Unconventional Wisdom</u>

Now that you understand that the traditional way of managing home equity by paying off your mortgage is unsafe and carries a lot of risk, let's explore some alternatives. Consider this comparison of a $400,000 Mortgage on a $500,000 home (80% bank financed; 20% self-financed); versus no mortgage on the same home (100% self-financed). The example assumes that you can earn the same investment return as your mortgage interest rate. In other words, if the mortgage is costing you 6% interest, you should be able to earn 6% in a properly diversified investment portfolio consisting of real estate, stocks, bonds and commodities. Remember, investments are designed to store money and homes are designed to house families.

<table>
<tr><th></th><th>100% Self-Financed</th><th>20% Self-Financed</th></tr>
<tr><td>Home Value</td><td>$500,000</td><td>$500,000</td></tr>
<tr><td>Mortgage Balance</td><td>-</td><td>$400,000</td></tr>
<tr><td>Mortgage Type</td><td>None</td><td>Interest-Only</td></tr>
<tr><td>Annual Home Appreciation</td><td>3%</td><td>3%</td></tr>
<tr><td>Invested Equity</td><td>$500,000</td><td>$100,000</td></tr>
<tr><td colspan="3">Your $500,000 invested home equity in column one becomes $579,000 in 5 years.
This represents a 3% annual internal rate of return or 15.8% total growth over 5 years.
Compare this to $100,000 of invested equity in column 2 that grows to $179,000 in 5 years.
This represents a 12% annual internal rate of return or 79% total growth over 5 years:</td></tr>
<tr><td>Home Value in 5 yrs @ 3%</td><td>$579,000</td><td>$579,000</td></tr>
<tr><td>Mortgage Balance in 5 yrs</td><td>-</td><td>$400,000</td></tr>
<tr><td>Invested Equity in 5 yrs</td><td>$579,000</td><td>$179,000</td></tr>
<tr><td>Annual Growth in Invested</td><td>3%</td><td>12%</td></tr>
<tr><td>Total Growth in Invested Equity</td><td>15.8%</td><td>79%</td></tr>
<tr><td colspan="3">If your mortgage interest rate is 6%, and your federal income tax bracket is 25%,
your after tax interest expense will be $18,000:</td></tr>
<tr><td>Mortgage Interest Rate</td><td>-</td><td>6%</td></tr>
<tr><td>Annual Interest Expense</td><td>-</td><td>$24,000</td></tr>
<tr><td>Tax Benefit @ 25% Tax Bracket</td><td>-</td><td>$6,000</td></tr>
<tr><td>After-tax Interest Expense</td><td>-</td><td>$18,000</td></tr>
<tr><td colspan="3">If you invest the extra $400,000 of cash that you've freed up by utilizing a mortgage at the exact same rate as your mortgage rate (6%), your annual investment yield will be $24,000:</td></tr>
<tr><td>Annual Investment Yield %</td><td>-</td><td>6%</td></tr>
<tr><td>Annual Investment Yield $</td><td>-</td><td>$24,000</td></tr>
<tr><td colspan="3">Your net profit in this example would be $6,000 ($24,000 after-tax investment yield minus $18,000 after-tax mortgage expense). If you reinvest the $6,000 at 6% compounded over 5 years, your net investment balance would be $434,000 at that time:</td></tr>
<tr><td>Investment Balance in 5 years</td><td>-</td><td>$434,000</td></tr>
<tr><td>Home Equity in 5 years</td><td>$579,000</td><td>$179,000</td></tr>
<tr><td>Net Worth in 5 years</td><td>$579,000</td><td>$613,000</td></tr>
<tr><td>Extra Wealth in 5 years</td><td>-</td><td>$34,000</td></tr>
</table>

As you can see from this example, you would build an extra $34,000 in wealth over a 5 year time frame simply by having a mortgage on your property! This is without making any out-of-pocket mortgage payments (the after tax mortgage interest expense is deducted from your annual investment yield).

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Now, what happens if you cannot earn the same after-tax investment yield as your mortgage is costing you? Or, what happens if your situation does not allow you to take full advantage of the mortgage interest tax deduction? In these cases, you may not be able to use this strategy to build *extra* wealth, but you could use the strategy to maintain control of your own money by keeping it safe and liquid. Remember, home equity is not safe (insured from loss) or liquid (accessible in case of emergencies).

On the other hand, if you are a business owner or real estate investor who consistently earns more than the cost of a mortgage in your business or real estate investments, this strategy can really accelerate your wealth accumulation. In the example above, if you repositioned the $400,000 into your business or other real estate investments earning 12% per year, you would build an extra $190,000 of wealth over a 5 year timeframe!

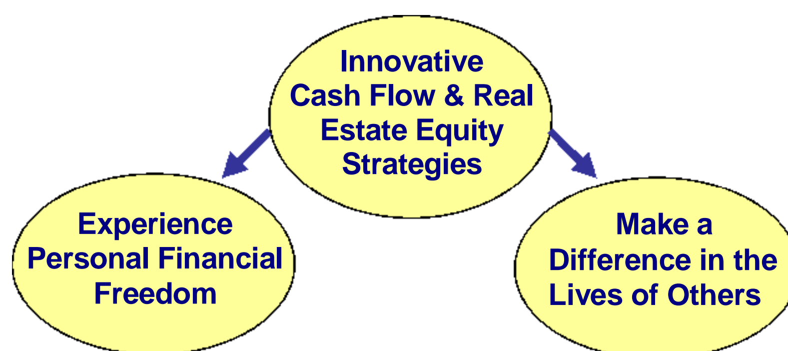
Remember, your $100,000 investment above (20% self financed; 80% bank-financed) is growing by 12% annually if the home only appreciates at 3% annually. If you repositioned the other $400,000 into four other similarly financed properties that also only appreciate at 3% annually, that $190,000 of extra wealth will become a reality in 5 years. Again, the key with investing back in your business or other real estate opportunities is to never over-extend yourself and always keep enough cash in the bank in case you come across financial difficulties.

As illustrated in this report, there are many different variations of how to safely and conservatively manage your home equity to build greater wealth, achieve financial freedom and make a difference in the lives of others.

For a complimentary analysis of how these concepts apply to your specific situation, please contact me today.

The *Mortgage*Matters System

Unique workshops, services and strategies to help home owners, home buyers and real estate investors build and protect wealth



- **Committed** to raising mortgage industry standards of practice, ethics and professionalism through individual membership, training and certification
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- **Equipped** to be a strategic resource to homeowners, first-time home buyers, move-up home buyers, senior citizens, real estate investors, Realtors, builders, attorneys, CPAs and financial advisors

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