Successfully Managing Home Equity to Increase Liquidity, Safety & Rate of Return

What's the biggest secret in real estate? Your mortgage is a loan against your income, not against the value of your house. Without an income, you often can't get a loan. If you suddenly experience financial difficulties, would you rather have $25,000 cash to help you make your payments or an additional $25,000 of equity trapped in your home? Anyone who ever lost their home to foreclosure would have been better off if they had their equity separated from their home in a liquid, safe, conservative side fund that could be used to make mortgage payments during their time of need.

In 2003, financial planner Doug Andrew was the first to articulate the strategy the wealthy have been using for decades in his book, *Missed Fortune*. Doug educates his readers to view their mortgage and home equity through a different lens—the lens used by the affluent. He shows how relatively 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 your mortgage. Similarly, many finance professors think a 15-year loan saves you money by reducing the interest you pay. However, Doug points out that this thinking is flawed. If you set aside the monthly payment difference between a 15-year and a 30-year loan as well as the tax savings into a safe side account earning a conservative rate of return, you will have enough to pay off your home in 15 years with $25,000 to spare!

In April 1998, *The Journal of Financial Planning* presented the first academic study undertaken on the question of 15-year vs. 30-year mortgages. They concluded the 30-year loan is better. Based on that same logic, wouldn't an interest-only loan be even better than an amortizing loan? And due to the tax deductibility of mortgage interest and compounding returns, you can borrow at a higher rate and invest at a lower rate and still make a significant profit.

The Importance of Separating Equity From Your Home

In *Missed Fortune*, Doug suggests that people strongly consider separating as much equity as possible from their home. These three primary reasons are often used as the test of a prudent investment:

1. HOW LIQUID IS IT?
2. HOW SAFE IS IT?
3. WHAT RATE OF RETURN CAN I EXPECT?

Let's see why home equity fails the tests of a prudent investment, and, more importantly, why homeowners benefit by separating equity from their home.

Separating Equity to Increase Liquidity

The importance of liquidity became all too clear when the stock market crashed in October 1987. If someone had advised you to sell your stocks and convert to cash, they would have been a hero. Those with liquid assets were able to remain invested and were rewarded as the market recovered fully within 90 days. Those without liquidity were forced to sell while the market was down, causing them to accept significant losses.

In *Missed Fortune*, Doug tells the story of a couple who learned what he calls: "The $150,000 Lesson on Liquidity." In 1978, this couple built a home that was featured in *Better Homes and Gardens*. It appreciated and by 1982, it was appraised for $300,000. They thought they had the world by the tail—a home valued at $300,000, with first and second mortgages owing only $150,000. They believed they had "made" $150,000 in four short years. Then a series of events reduced their income to almost nothing. They couldn't borrow money because without an income they did not have the ability to repay. They soon realized that to protect their $150,000 of equity, they would have to sell their home. And since the real estate market had turned soft, they reduced their asking price several times—down to $195,000—and still could not find a buyer.

Sadly, they gave up their home in foreclosure. The two mortgages were in the amounts of $125,000 and $25,000, respectively. The second mortgage holder outbid the first one at the ensuing auction, feeling it could turn around and sell the property to cover the investment.

It took nine long months to sell, during which time the lender was forced to pay the first mortgage and also accrued an additional $30,000 of interest and penalties. By the time the home finally sold, the original couple who owned the

house not only had a foreclosure appear on their credit report for seven years, the report also showed the deficiency balance owing $30,000 on a home they had lost nearly one year earlier. In a time of financial setback, they lost one of their most valuable assets due to a lack of liquidity. If they had separated their

$150,000 in home equity and repositioned it into a safe side account, they could have easily made their mortgage payments.

At this point in the story, Doug admitted the young couple was really him and his wife. He wanted his readers to know that he understood firsthand the importance of maintaining liquidity in the event of an emergency. And he learned never to allow a significant amount of equity to accumulate in his property. Being "house rich" and "cash poor" is a dangerous position. It's 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 over which you have no control.

Separating Equity to Increase Safety of Principal

Due to the hidden "risks of life," real estate equity is not nearly as safe as many other investments and assets. A home that is either mortgaged to the hilt or owned free and clear provides the greatest safety for the homeowner.

According to a recent study, 67% of Americans have more of their net worth in home equity than in all other investments combined. However, if 100 financial planners looked at a client portfolio that was 67% weighted in a single investment, 99 of them would immediately recommend that the client should diversify. Holding large amounts of home equity puts the homeowner at unnecessary risk.

When oil prices fell to all-time lows in the early 1980s, Houston was hit hard. Thousands of workers were laid off and forced to sell their homes. With a glut of homes on the market, prices plummeted. Unfortunately, with too many sellers and too few buyers, 16,000 homes were foreclosed. Did these families suddenly become bad people? No, they just couldn't pay their mortgages. Previously, many of these people had made extra principal payments. But they couldn't coast on those extra payments and with so many houses for sale, some people literally had to walk away from their homes. The equity these people had worked so hard to build up was completely lost. They learned the hard way that home equity is certainly not as safe as they once thought.

Separating Equity to Increase Rate of Return

No matter where you live, the rate of return on home equity is always *ZERO*. Home values fluctuate due to market conditions, not mortgage balances. Since home equity 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 and does not earn any rate of return.

Assume you own a home free and clear worth $100,000. If it appreciates 5%, you own an asset worth $105,000 at the end of the year. What if you had separated $100,000 of equity and placed it in a side account earning 8%? Your account would be worth $108,000 at the end of the year. You still own the home, which appreciated 5% and is worth $105,000. By separating the equity, you created a new asset that earned a rate of return. Therefore, you earned $8,000 more than if the money were left idle in the home. To be fair, you do have a mortgage payment you didn't have before. However, since interest rates are relative, by assuming a rate of return of 8%, 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 only 3.6%. This produces a 4.4% positive spread between the cost of money and the earnings on that money.

The story gets more compelling over time. Through compound interest, the side account grows at a faster pace each year. In year 2, the 8% earnings on $108,000 are $8,640. In year 3, the 8% earnings on $116,640 are $9,331. Since the mortgage debt remains the same, the spread continues to widen in the homeowner's favor every year. As Albert Einstein said, "The most powerful force in the universe is compound interest." If we allow home equity to remain idle in the home, we give up the opportunity to put it to work.

Taken from a different angle, suppose you were offered an investment that could never go up in value, but might go down. How much of it would you want? Hopefully none. Yet, this is home equity. It has no rate of return, so it cannot go up in value—but it could go down in value if the real estate market declines or the homeowner experiences an uninsured loss, disability or a foreclosure. After all, homes were built to house families, not store cash. Investments were made to store cash.

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Integrating your mortgage into your overall financial plan is one of the best ways to build wealth over the long term. A properly structured mortgage with regular annual reviews can be the difference between retiring early when you want or possibly not being able to retire at all.

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