The Power of Leverage

Buying a home can be a great investment. However, the wealthy buy homes with as little of their own money as possible, leaving the majority of their cash in other investments where it's liquid, safe and earning a rate of return.

One of the biggest misconceptions homeowners have is that their home is the best investment they ever made. The reality is that *financing your home was the best investment decision you ever made.* If you purchased a home in 1990 for $250,000 and sold it in June of 2003 for $600,000, that represents a gain of 140%. During the same period, the Dow Jones grew from 2590 to 9188, a gain of 255%. When you purchased the home, you only put $50,000 down, which produced a profit of $350,000. That is a total return of 600%, far outpacing the measly 255% earned by the stock market.

The Cost of Not Borrowing (Employment Cost vs. Opportunity Cost)

When homeowners separate equity to reposition it in a liquid, safe side account, a mortgage payment is created. The mortgage payment is considered the "employment cost." What many people don't understand is when we leave equity trapped in our home we incur the same cost, but we call it a lost "opportunity cost." The money that's parked in your home doing nothing could be put to work earning you something.

Let's say you had $100,000 of equity in your home that could be separated. Current mortgage interest is 6.25%, so the cost of that money would be $6,250 per year (usually 100% tax-deductible - consult your accountant to verify.) Rather than bury the $100,000 in the backyard and give up the "opportunity" to earn a rate of return on our money, we are going to put it to work, or "employ" it. By separating the equity, we give it new life. Assuming a 28% tax bracket, the net employment cost is not 6.25% but only 4.5%, or $4,500 per year after taxes. It's not too difficult to find tax-free or tax-deferred investments earning more than 4.5%. Using the tax benefits of a mortgage, you can borrow at one rate and earn investment returns at a slightly higher rate, just like banks and credit unions borrow our money at 2-3% and then loan it back to us at 6-8%. By using these principles, you can amass a fortune.

How to Create 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 $200,000 of home equity using a mortgage with a 6% interest rate. If the $200,000 grows at a conservative rate of 6.75% per year, it will be worth $1,506,649 in 30 years. After deducting the $232,000 in interest payments and the

$200,000 mortgage, you still have $1,074,649 left in your account—a net gain of over $1 million!

Imagine how the numbers grow for individuals who reposition their home equity every 5 years as their home continues to appreciate. This is how the wealthy continually increase their net worth. Conversely, if the same $200,000 were left to sit idle in the home for 30 years, it would not have earned a dime! The home appreciates based on market conditions, regardless of the amount of equity in the home. Whether that $200,000 is sitting idle in the home, or whether it's conservatively invested outside the home will have no effect on the appreciation rate of the home.

Home equity is the equivalent of stashing money under your mattress or buried in a tin can in your backyard. It's clear to us neither of these are efficient uses of money, as they are not earning anything but more likely actually losing value due to inflation. However, if you would not stash $10,000 under your mattress, why would you want to keep $200,000 sitting idle and dormant in the form of home equity?!?

Betting the Ranch: Risking Home Equity to Buy Securities

Home equity is *serious money*. Liquidity and safety are the key philosophies when separating home equity. Avoid highly volatile or aggressive investments. You can make thousands of dollars by simply borrowing at 6% and investing at 6% in safe, conservative, fixed investments.

In general, individuals should not invest home equity for "current income" unless the investment is fixed and guaranteed. Recently, the NASD advised against separating equity if the client must rely on the investment returns to make mortgage payments. Individuals interested in variable investments should ask themselves, "How will I make my mortgage payment if my investments decline? Do I have reserve funds or a secure income?"

Tax Deductions to Offset 401K Withdrawals

Most successful retirees have the bulk of their assets in their home equity and IRA/401Ks. As they start withdrawing funds from their IRA/401Ks, they are hit with a significant annual tax bill. When they could use the mortgage interest deduction the most, they no longer have it. As part of long-term planning, someone might want to have a mortgage going into retirement to help offset the annual IRA/401K tax bill and enhance their overall financial goals. For many, the mortgage interest deductions offset taxes due on retirement withdrawals, giving the net effect of tax-free withdrawals from their retirement account.

401K Vacation Condo

Many successful people dream of retiring and buying a second home. With $1 million or more saved in their IRA/401Ks, they decide to purchase the vacation home where they will spend their winters. What a surprise when they discover that to pay cash for a $350,000 condo they need to withdraw nearly $500,000 from their IRA/401Ks. What if instead they had purchased the condo 15 years earlier, when it cost $175,000, by using the equity in their home? Today their net worth would be $175,000 higher due to the condo's appreciation, and they would have the mortgage interest deduction to help offset their IRA/401K withdrawals. In addition, they would have enjoyed the lifestyle benefits of owning their vacation condo 15 years sooner than they had planned.

Making Uncle Sam Your Best Friend

Under tax law, you can deduct up to $1 million 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, make sure to secure a large mortgage when you buy. Under tax law, mortgage interest is deductible only for $100,000 over acquisition indebtedness (the mortgage balance when home is purchased). Home improvements are the only exception. For example, if you sell your home for $400,000 and buy a new home for $400,000 with the cash from the sale, you will lose the tax break and liquidity. But worse, if you 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 the entire amount is deductible.

Where to Safely Invest Home Equity

As we know, home equity is *serious money*. We are separating it from the home to conserve it, not to consume it. Therefore, home equity is best invested in safe, conservative investment vehicles. Many financial planners prefer the following tax-favored products for investing home equity:

- INVESTMENT-GRADE INSURANCE CONTRACTS
- ANNUITIES
- REAL ESTATE INVESTMENT TRUSTS
- IRAS
- 401KS
- TAX-FREE BONDS
- 529 SAVINGS PLAN

Case Study: Home Equity Management

One couple lived in a $550,000 home. They owed $360,000 on a 30-year fixed mortgage at 5.875% with a monthly payment of $2,130. They had $190,000 built up in home equity. After understanding the benefits of properly managing their home equity, they decided to separate $155,800 of their equity to invest in a side account. By using an interest-only ARM, they were able to increase their mortgage balance to separate this chunk of equity while *decreasing* their monthly mortgage payment to $1,656, a monthly cash-flow savings of $474 per month.

They conservatively invested the $155,800 lump sum and the $474 per month savings.

If we assume a 6% rate of return, their investment account will grow to $520,196 in

15 years. At the end of 15 years, they will have enough cash in their investment account to pay off their mortgage completely if they want to 15 years earlier than with their original 30-year mortgage. However, they plan to keep the mortgage well into retirement so they can maintain the tax-deduction benefits and keep the money in the investment account where it's more liquid and safe and will continue to grow.

Case Study: Cash-Flow Management

Many homeowners without a large equity balance have benefited by simply moving to a more strategic mortgage that allows them to pay less to their mortgage company each month. A second couple in Redmond, Washington, followed traditional thinking when they bought their $400,000 home. They put 20% down and obtained a $320,000 30-year fixed-rate mortgage at 6.00% with a payment of $1,919 per month.

However, once they understood the benefits of integrating their mortgage into their financial plan, they moved to a more strategic interest-only mortgage. They kept the same loan balance but were able to reduce their monthly payments to $1,133, a savings of $786 per month. They invest the $786 savings each month, and assuming a 6% rate of return, will have enough money in their investment account to pay off their mortgage in 19 years. Therefore, by simply redirecting a portion of their monthly mortgage payment, they were able to shave 11 years off their original 30-year mortgage. They also received the benefits of having their cash in a more liquid and safe position throughout the process.

Consult with One of our Professional Mortgage Consultants Today!

Interest only and deferred interest mortgages can be powerful tools to create wealth when used correctly. However, often times homeowners use these loans incorrectly and for the wrong reasons. 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. Consult your mortgage professional to find out what type of financing is right for you.

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