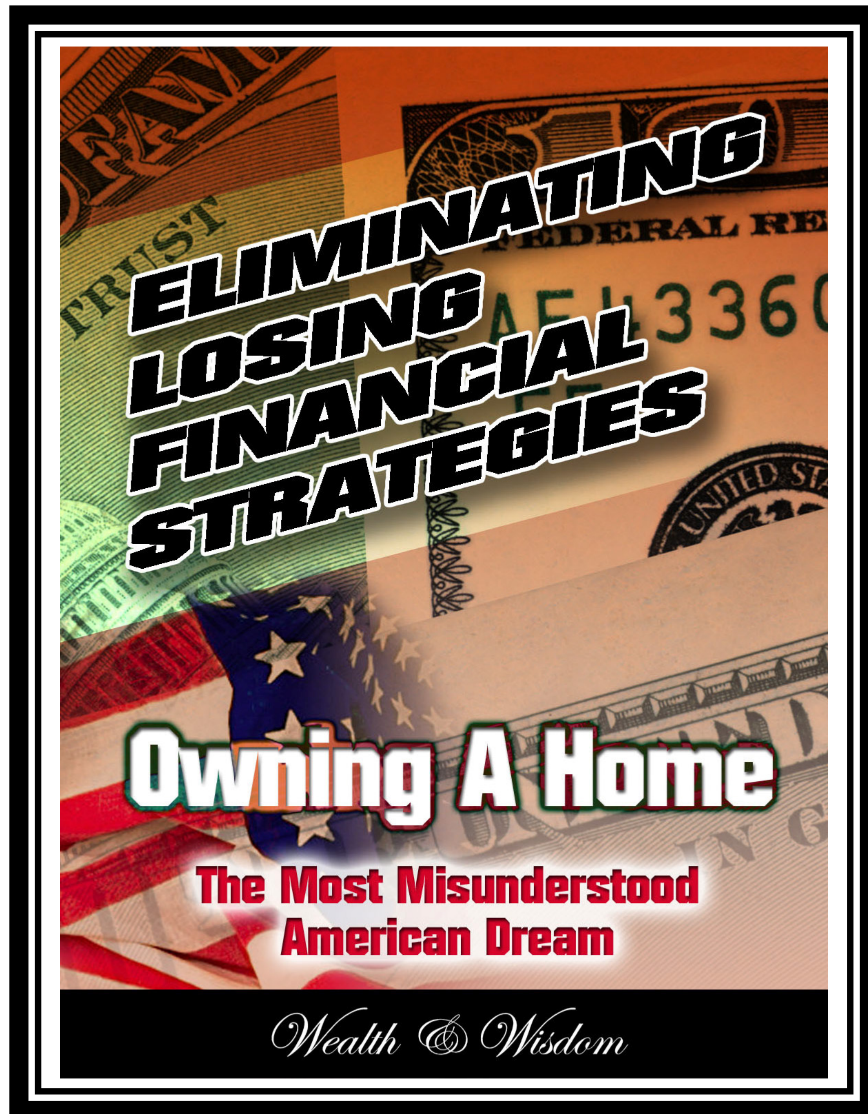
Owning A Home
The Most Misunderstood American Dream



Owning Your Own Home
The Most Misunderstood American Dream

One of the largest transfers one will ever encounter is the purchasing of a home. It is part of the traditional American dream. It can turn into a nightmare with sleepless nights and difficult decisions. Obtaining the maximum amount of house with the minimum price is the obvious goal. Also, a must when considering a home purchase, are things such as neighbors, the neighborhood, schools, property taxes, city services, maintenance, and upkeep. When you finally find this castle, there is excitement in the air and a commitment to purchase. My friend, you are now entering into an unchartered universe, the twilight zone of the banking industry called the mortgage.

Hello, I'm New On This Planet

All you know about the mortgage process is that you have worked your behind off, saved money for a down payment, and found a house you would like to buy. The next step, assuming you don't have your mattress stuffed with cash, is to try to get approved for a loan to purchase it. So you arrange to meet with your banker. Your first impression of the people in the mortgage department, is that on the outside they look just like you and me. They look friendly and seem polite. But underneath that normal exterior they serve only one master, the bank.

Their first appraisal of you is to decide whether to satisfy their needs of consumption. They want to see income statements, tax returns, lines of credit, and your credit scores. It's sort of funny that when you deposited $5,000 into one of their savings accounts they didn't ask you for any of this information. But let's face it, they just want to make sure you are not a credit risk. That's why, in the bank's eyes, every applicant is presumed to be a derelict and a liar. You must prove, beyond doubt, that you qualify financially so that you can afford any monetary abuse that they may throw at you. At the end of the first meeting, you sign an agreement allowing them to do this.

Dirt

Now as much as they <u>want</u> to give you a loan, by the time you walk to your car, they have started the process of making sure this won't be easy. The hunt is on for problems in your past. New or old, big or small they are fixed on the idea of finding any, and I mean <u>any</u>, financial problems you have had.

My personal experience is fairly common. I had purchased a home, sold it, and purchased another one. I lived in the new house about two years and decided to refinance it to lower the interest rate. All of these transactions were with the same bank and the same banker, all taking place in a seven year period. It was of no importance to them that

I held several lines of credit with them with no debt balances and that my business account deposits with them were greater than the amount I wanted to refinance. At my expense, they wanted my credit scores and an appraisal of my home's value. The funny thing was, they had done this five months earlier for the other lines of credit I established with them. What a con game!

I'll Take The One On The Bottom

Your credit scores will vary from company to company. Some banks and mortgage companies will get as many as six or seven credit scores on you. Now, do you think they will use your best score? Guess again. How about the second or third best credit rating? Try again. How about the lowest or second to lowest score they can find? Bingo! Although five of your credit scores were good, they found the one they were looking for. In the bank's eyes you are now "one of those kinds" of people.

Not So Perfect

You get the phone call about your questionable credit scores but are told not to worry. They are going to work this out for you so you can have this dream house. You are told any additional costs will be handled at the closing. They are now in control.

Now, have you ever heard of a credit rating company making a mistake? Perhaps the rating company's information was incorrect and they record a low score, but the bank is going to use that one anyway. Chances of trying to correct any scores from a credit company in time for your closing are remote; it takes a long time.

What Flavor Would You Like?

I am now entering into an area where you will really have to think from a different perspective. Home ownership and mortgages are confusing and emotional. As we discussed before, emotions are sometimes based on opinions not fact. I want to explore this confusion with you.

There is an array of different types of mortgages that you can select from. Banks and mortgage companies are becoming more creative in the packaging of these products. Why? They too see the ever-changing demographics of the country. They understand that buying a home is based on the affordability of the monthly payment, not necessarily the cost of the house. I can see how lending institutions would be considering extending the life of mortgages to 40 or 50 years. Why? More expensive homes, less future buyers of expensive homes, and retirees downsizing from larger homes. Banks and mortgage companies will want to create more buyers for these large homes while trying to maintain high values on these properties. The government also would like to see these larger homes maintain their values because this is a taxable commodity in the future. Property

values continue to increase creating higher property taxes whether your house is paid off or not. The possible solutions for lending institutions would be to extend the payoff time of mortgages. Their thinking could be, "Hey, as long as we're collecting interest, why not?" The dilemma here is that no matter what type of mortgage you decide on, you will experience major wealth transfers. The solution to reducing these transfers is understanding the opportunities that lie inside the mortgage itself.

Types of mortgages vary. There are 15-year and 30-year mortgages, bi-weekly mortgages, interest-only mortgages, adjustable rate mortgages, and balloon mortgages that will assist you in paying off your house. There is also the old standby of simply paying cash for your home. No matter what you decide to do, transfers will occur. If you get a mortgage, you are paying interest to the lender (a transfer of your money), and if you pay cash not only do you lose the money that you paid for the house, but also the ability to earn more money from that money (lost opportunity cost).

Which of these two situations will cause the least amount of transfers for you? Many financial experts, along with your parents and grandparents, will conclude that paying your house off as fast as you can or paying cash for it, will result in the greatest rewards.

If Something You Thought To Be True, Wasn't True. . .

Two lessons we talked about earlier come into play. Lost opportunity cost and liquidity, use, and control of your money will help you find the right solutions. By paying cash for your house, you must be of the belief that this is a great investment and you are certain of the rewards. After all, it's not every day that you will plop down that kind of money on one investment. Experts will try to convince you that this is a wise decision. Let's take a look.

Watch The Money Grow? Paying Cash

Let's assume you decided to pay cash for your home. You paid $150,000.00 cash for a house in an area where housing values grew. You bought the home six years ago and the current value of the home is now $200,000.00. You would look at that gain and conclude that your investment in your home netted $50,000.00. Simply put, that's over a 30% increase in the value of the home. So you go about telling all your friends how wise that decision was.

If you take the gain of $50,000.00 spread over six years, the real rate of return on that investment is 4.91%. The problem is during those six years, other payments were made to help increase the value of your property. New carpeting, painting, drapes, perhaps a new roof, furnace or air conditioner, possibly new windows and doors were improvements you made to increase the value of your home. Do not forget that you also pay property taxes that steadily increased with the value of your home.

Let's say that while you lived there you paid $2,000.00 a year in property taxes and paid $12,000.00 for improvements and maintenance. Over a six year period, that would be another $24,000.00 paid. The rate of return on your home, compounded annually, is now 2.35%. How does that compare to other investments available to you? In a down market, 2.35% sounds okay, but in a good market, that return sounds puny. Remember how everyone was impressed with your $50,000.00 gain?

No More Payments???

I have to explain the financial implications when someone pays cash for their home. In exploring this idea, I need you to really think deeper financially than you ever had to before. The lessons of lost opportunity costs, liquidity, use, and control and the Rule of 72 must be applied to your thinking.

Most people think they will save interest by selecting a shorter loan period. With that in mind then paying cash for your home would save the most interest that would have normally been given to the bank. The problem is, by paying cash you no longer have that money to invest, so you are losing earnings that you could have made from that money. Also, if cash is paid for the house, you forfeit the tax benefits on the interest deduction. By using the tax deduction, you can recapture dollars, which you couldn't do had you paid cash. You must understand that it costs you the same amount of money to live in your house whether you have a mortgage or you paid cash. Let's take a look.

If you have a mortgage of $150,000.00 at 7% for 30 years, the monthly payment would be $997.95. If the monthly payment of $997.95 was invested for 30 years at 7% it would equal $1,217,475.00. If, rather than paying $150,000.00 cash for the house, you invested it instead at 7% for 30 years, it would grow to $1,217,475.00. Presto, it's the same number!

Both of these scenarios are examples of transfers, whether you paid cash for your home or are making payments through a mortgage it is costing you money. The difference is that in the case of the 30 year mortgage at 7%, the mortgage would yield about $60,000.00 in tax savings in that 30 year period for someone in a 30% tax bracket. That is called recapturing some of your transfers.

15 vs. 30

The two most common types of mortgages sold today are the 15-year and 30-year mortgages. Once again, misinformation clouds the choice between these two types of mortgages. In the 15-year mortgages, people assume the shorter the loan period, the less they will have to pay. Secondly, they believe they will save interest payments. With this line of thinking, you must conclude that, once again, the best alternative would be paying cash for the house. Let's get out the microscope and take a look at these two mortgages.

Person A chose a 30-year mortgage for $150,000.00 with a 6.5% loan rate. She knows that under those terms her monthly payment will be $948.10. Person B obtained a

15-year mortgage for $150,000.00 with a 6.5% loan rate. He knows that his monthly payment for that loan will be $1,306.66.

Person A believes that her monthly payment at $948.10 is a good deal because it is $358.56 per month cheaper than the $1,306.66 payment for the 15-year mortgage. She is going to invest the savings of $358.56 per month into an account that averages a 6.5% return for 30 years. This grows to a tidy sum of $396,630.

Person B, who wasn't born yesterday, plans to save $1306.66 a month for 15 years after he makes the last payment on his 15-year mortgage. He too predicts a 6.5% average return for those 15 years, and his investment would grow to an impressive $396,630.00. NOTE: It's the same amount as Person A's account. I have to ask you: Which person would you rather be?

In making the above comparison, I assumed a 6.5% mortgage loan rate and a 6.5% rate of return on their monthly payments. What would happen if both Persons A and B thought they could get an 8% average rate of return over that period of time on their investments? Person A's $358.56 per month for 30 years at 8% would grow to $534,382.00. Person B's $1,306.66 per month for 15 years would total $452,155 at an 8% earning rate. That's a difference of $82,227.00 in the favor of Person A. The compounding of interest works in Person A's account, causing the money to grow to a larger sum. Remember, Person B's banker told him he would save money with a 15-year mortgage.

Hold on there, Kemosabe. You're thinking, "If I took a 15 year mortgage, my interest rate might be lower than that 6.5% 30-year note." You're right. Let's say the interest rate was 6.0% on that 15-year mortgage. Then both Person A and Person B invested the difference at 8% return just as we described above. You're probably thinking, "Ah hah! Got you!" Try again. Person A's savings still ends up $35,697.00 greater than Person B's account. Don't forget, Person A also received 15 more years of tax deductions that created an even greater savings.

Jimmy Carter

To continue our comparison of Persons A and B, we need to step into the WAYBAK time machine. Destination: the 1970's. It was a time of high inflation, hostages in Iran, and funny clothes. Mortgage rates were extremely high. It was not uncommon to see mortgage rates of 10%, 15%, 18%. To proceed with our comparison, we must agree that since interest rates have been much higher in the past than they are today, that it is possible for mortgage rates to go higher, and of course, possibly, lower. O.K., back to the WAYBAK machine. Destination: the present. Phew! What a trip!! I want to thank Mr. Carter for the lesson we learned.

Knowing that interest rates could go up or down, let's take a look at Persons A and B's 30- and 15-year mortgage. First of all, NOW READ THIS SLOWLY, there are more tax deductions in the first 15 years of a 30-year mortgage, than there are in the entire 15-year mortgage. Second, in Person A's 30-year mortgage, she knows for certain that her interest will remain the same for 30 years. Meanwhile, Person B has just made his last mortgage payment in the 15th year and is jubilant! My question is, now that he

has paid off his mortgage, if he wanted to borrow money from his paid-off home, what are the interest rates? If he had a 15-year mortgage at 6.5%, and the interest rates are now 10%, you would have to say he was in a hurry to pay off his house at a lower rate so he could use his money at a higher rate. You see, Person A knows what her rate will be in that 16th year of a 30-year mortgage and because you put that $358.56 a month away, she now has accumulated $124,075.00 in savings by the 16th year. She has enough money to pay off her house at that time, IF SHE WANTS TO. If economic conditions are favorable to do that, she can. If the stock market is yielding higher rates of return, she may elect to continue to pay on her mortgage and let her savings grow. Now, in the 16th year, Person B is just starting his savings program. Which of these two people would you rather be now?

Most people would want to be Person A. Person A has more control and more options and opportunities in the future. She also has retained some liquidity, use and control of her money. This allows Person A to be more flexible in ever changing markets. Person A has also been able to maximize the tax deductions in the 30 year mortgage. Remember, taxes are the largest transfer of your wealth that you will see over your financial life. Recapturing your money in the form of tax deductions is important.

From the bank's standpoint, they would love to see everyone choose a 15-year mortgage. They will also encourage bi-weekly payments and any additional mortgage payments you can make. Why? These payments create the velocity of money for the bank. That means, the more money and the faster the money comes in, the more they can lend it out, to generate more profits. They disguise these payments as "interest saving techniques." **THINK ABOUT IT . . .**A bank, whose sole purpose is to collect interest, telling you how NOT to pay interest? It doesn't make sense.

Changing Landscape

Banks continue to tweak ideas about mortgages. It is their most lucrative product. The idea of interest-only mortgages is fairly new. In these mortgages you pay only the interest, no principal. They require you to put money into an account that the bank controls. An example would be, for every $100,000 you want to borrow you would put $12,500.00 into a 7% account controlled by the bank for 30 years. So, if you had a $200,000 home to finance, you would put $25,000 into their account. That money, the $25,000.00 at 7% would grow to meet a balloon payment due in the 30th year.

Usually, the interest payments on this type of mortgage are higher than traditional mortgages.

Some mortgage companies tout a loan product that is totally flexible. You name the interest rate, and you name your monthly payment. They will tell you how many years it will take for you to pay it off. Hire a lawyer to read this contract. Of all these types of mortgages one thing stands out: The lending institutions are there to charge interest and make as much money as they can.

Insuring The Bank

Most banks and mortgage companies require down payments. If you don't have a down payment they will charge you points. This extra money, above and beyond your mortgage payment, ensures them that in the event of foreclosure, their losses are covered. The standard down payment on a house is 20%. Again, the bank feels comfortable, because should you not make payments and they must foreclose on your home, that 20% covers their losses. I consider that a 20% up-front failure fee. Don't take it personally, they require this from almost everyone.

Black Hole In Space

Where does this down payment money go? If you were to put $30,000 down for your new home, what is your rate of return on the money? THINK HARD. ZERO! It will be zero percent forever. Next question: Can you borrow this $30,000.00 from the bank as part of your loan? NO! Why not? It's not part of the mortgage. Now, the banks will argue that it lowered your monthly payments. That may be true on the surface, but let's take a look at what the bank got out of this deal. They now have the use of your $30,000 for the next 30 years. At a 7.2% rate of return, that $30,000 would grow to $240,000 in 30 years for the bank. Just from the down payment they have earned more from you than what you paid for your house. Is your down payment deductible on your taxes? NO. Someone please remind me why I would want to do this. Remember, the bank is telling you the more you put down on the mortgage, the more you will save. Part of the solution to this problem is to demand that all of your down payment money be accessible to you through an equity line of credit.

I've Hit The Jackpot

Meanwhile, back at the ranch . . . you just went through the meeting for the "closing" of your new home. You have signed 27 different documents, none of which you understood. What the heck . . . if you can't trust the bank, who can you trust?

Now you're a homeowner. You think you're happy. The people at the bank gave you that congratulatory pen and calendar. They have truly put themselves in control of your future. They are happy. The people who sold the house to you are also happy. They even share their story of success with you. They bought that house new 33 years ago paying $39,000.00 for it. They remember how low the property taxes were back then, but even though they increased through the years, they still only averaged $1,000.00 a year in taxes. They remember the additions and improvements they made over the years totaling about $20,000.00. They feel it was their greatest investment. After all, they think they made $111,000.00 on the property.

THE MATH	
Sale Price	$150,000.
Original Purchase Price	($39,000.)
Gain on Sale	$111,000.
Years you owned the home	33

If you have a gain of $111,000.00 over 33 years, the annual compound rate of return is 4.17%. But what really happened was this:

THE MATH INCLUDING TAXES AND IMPROVEMENTS	
Sale Price	$150,000.
Original Purchase Price	($39,000.)
Taxes and Improvements (33 years)	($53,000.)
Gain on Sale	$58,000.
Years you owned the home	33

If you have a gain of $58,000.00 over 33 years, the annual compound interest return is 1.49%.

Now these people also had that house totally paid off for a few years. Had they been able to invest this $150,000 they had in the house, at a 7% earning rate they would have made $10,500 a year without touching the principal. That again is called a lost opportunity cost. The last three years they lived there they would have almost another $31,500.00 in lost opportunities. Plus, in losing the interest deductions, as little as they were, they became even more perfect taxpayers, which created more tax transfers of their wealth.

You congratulate them on their success, wish them well, and now you're asking yourself: Will you have the same success they did? After all, they were happy that they made such a huge profit on the sale of their house.

Home Equity

If you have accumulated equity in your home, let me ask you one question: What's the rate of return on the equity built up in your house? I mean, if you built up $70,000 of equity in your home, the bank must be sending you a hefty dividend check, right? WRONG! The equity inside your house is growing at <u>zero</u> percent. The

argument here is, "Well my house increased in value therefore, my equity went up." Well, whether you have $70,000.00 or $1.00 of equity, the value of your property would still have gone up. If property values went down, would you rather lose $1.00 or $70,000.00 of equity? Although we have been taught that our home is a safe place to park our money, we really have to take a look at this situation.

Who Is In Control

It is important for you to understand how to get liquidity, use and control of the equity in your home. This is not money that you would invest, gamble, or spend foolishly. But, it can open up a great number of opportunities for you in the future.

Be The Bank

If you do have equity in your house, it is important that you establish an equity line of credit. Be advised, this is NOT used for investing. This credit line should be used to establish your own personal "bank." Current tax laws may allow you to deduct the interest paid on your equity line of credit. Consult with your accountant to make sure you qualify for these interest deductions. Under most mortgage situations you will. The government really doesn't care what you purchase with your equity line of credit. You will receive an interest-paid statement from the bank at the end of the year. It is similar to your mortgage interest statement. The rate of interest on equity line of credit may even be lower than your mortgage interest rate.

As previously stated, an equity line of credit should not be used to make investments, but can be used to eliminate interest payments that are not deductible. If you could take $5,000.00 of credit card debt at 18% with a $300.00 monthly payment and reduce it to a 6% interest rate with a $100.00 monthly payment and be able to deduct the interest off your taxes, would you be interested? That's what an equity line of credit can do for you. If you have $12,000.00 balance on your car loan and you are paying $350.00 a month for it, how would you like to pay $250.00 a month and deduct the interest from that loan off your taxes? As you can see, there are many ways this could be favorable to you.

Tax-Free Money

The equity inside our homes, under current tax law, is tax-free money. Now, I don't know what they were smoking when they passed that law, but whatever it was, I'd like to send them some more. But, there are also things that could negatively impact the tax-free equity in your home.

Hello Bubba!

You're sitting in your home, looking out the window at the new landscaping project you just completed. There's a knock at your front door. There, standing on your porch, is a guy you have never seen before. You crack the door open and he says:

> *"Howdy! My name is Bubba. I'm your new neighbor. I've got six dogs, they're all pretty friendly except for that one with no hair. . . if I were you I wouldn't try to pet him. I've got four kids. Aren't kids a hoot? I'll tell you, between parole officers and social workers, kids sure keep you busy. My wife, now there's a fine woman. You might see her from time to time. She's gonna re-upholster furniture right out there on the front porch, to make extra money. Me, why I'm a work at home kinda guy. I'll be rebuilding truck engines right here in the driveway. If you ever need my help, just let me know. See you, buddy!"*

This is more like, see you later property values. Now, that example may seem a little extreme, but such a neighbor would dramatically affect the value of your house, and the tax-free equity in your home. Just some neighbor who didn't maintain their property very well could affect your values.

Once, while my wife and I were searching for a home, we found a property that we really liked. I happened to walk out into the backyard and a little dog next door started barking. Barking and barking, followed by more and more barking. I looked at the real estate person and said they would have to lower the price of the house quite a bit if I was going to spend the rest of my life trying to convince that dog to be quiet. What is the price of peace and quiet in your own backyard?

Federal Reserve

Another situation that affects your tax-free equity in your home is the Federal Reserve. The Fed sets the interest rates that affect the bank loan rates. Your ability to afford a house is based on your ability to make that monthly payment. If interest rates are low, housing values are high, because less of the monthly payment goes to interest. If interest rates rise, home values fall. More money, on a monthly basis, would have to go to interest. The seller might have to lower the price of the house so that it is affordable, on a monthly basis, to attract buyers. Remember Jimmy Carter; interest rates skyrocketed, housing values plummeted. There go the house values and the tax-free equity again.

You're Dead

We're just pretending here, but if you and your spouse die in a common accident, what becomes of the tax-free equity in your home? It can magically become taxable again, this time at a higher rate, in your estate. Let's review quickly: You're breathing, it's tax-free; You're not breathing, it may be taxable! Enough said.

Not Dead, Just Disabled

We just discussed situations that could affect your home's value, and affect that tax-free equity that's earning a whopping zero percent. Without liquidity, use and control of this equity you may also be facing another danger. Let's say one of the breadwinners in a household is involved in an accident or has a mild heart attack and survives. Now medical insurance covered most things, but the on-going therapy isn't covered. The spouse, needing financial help, goes down to see the friendly banker for help. "I need some of the $70,000.00 equity I have in my home for medical reasons." The banker musters up enough dignity and tells the spouse this: "Unfortunately, your mortgage payments were based on two income earners, not one. We feel you don't have the ability to pay back (YOUR) tax-free equity to us with interest. Thank you, good luck."

48 percent of all foreclosures in the United States are caused by a disability. Having proper liquidity, use and control of your money would prevent some financial calamities.

3000 Days

When it comes to your home, the country's demographics could play an important role. At a time when builders are building mega-homes for $300,000.00 to $500,000.00, we have to take a look at our aging population. With two-thirds of the now-working population 60 years old or older in 3000 days, consider this: A large portion of the population will be downsizing their homes. As people get older, they don't need these 6000 square foot homes. Keeping up the payments and maintenance of these mega-homes will be a drain on retirement incomes. There may be a time when there is an over-abundance of these homes on the market. Prices lowered to attract more buyers, means loss of home values and lower equity values in the house. Once again, it's not a good place for your money to be when experiencing a down housing market.

Solutions

We have discussed the many aspects of home ownership and mortgages. It is important to establish as much liquidity, use and control of your money as possible. As previously discussed, a 30-year mortgage is more favorable than most other options. Further, you should limit the amount of down payment paid at purchase as much as

possible. Establishing an equity line of credit on your home can give you liquidity, use and control of your equity. Refrain from paying cash for your home, as neighbors, interest rates, property taxes, and death taxes affect the value of your home. You create unintended consequences when you live in a home that is paid-off, without understanding your options. Failing to understand your options leads to lost opportunity costs, which in turn will create major transfers of your wealth.

Paying Yourself Back
The Velocity Of Money

If you are the owner of your "bank," your equity line of credit, you have created liquidity, use and control of your money. If you purchased a car for $25,000.00 at 5% interest for 48 months, the payments would be $575.13 a month. You borrow the money from your "bank" to buy the car, and pay yourself back the $575.13 a month for 48 months. What happened here? You charged yourself the loan company interest rate, replaced the money into your "bank" in 4 years, and took tax deductions on the interest. After 4 years, the money has been replaced and it's time to buy another car with the same money. There is still some value in the old car to assist you on your next purchase, possibly $6,000.00 or $7,000.00. Does it feel a little better being the owner of the "bank?"

Remember, a car is a depreciating asset. Paying cash up front on something that will lose money is a losing strategy.

Our Goal

The objective of these exercises is to show you how to take back the liquidity, use, and control of your money. We also want to reduce or eliminate transfers of your money that are unnecessary. Recognizing these transfers and dealing with them can save you thousands of dollars. We want to create other "banks" of money for you that are tax efficient and help you retain monetary control. We will create these other "banks" by using the money you saved when you have eliminated and reduced unnecessary transfers of your wealth. Thus, you will not spend one more dime than you are already spending. By doing this, you will have more knowledge and money to make better financial decisions that profit you, not others. This will be an exciting change in the way you think about money!

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