MORTGAGE advisor™

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Interest Rates Can Make or Break Your Financial Security

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If you're like 67 percent of Americans, you have more wealth in your house than in all your other investments combined. The question is, do you really understand how your interest rate is affecting your short and long term financial situation? According to "Borrow Smart, Retire Rich" author Todd Ballenger, a few concepts go a long way in securing your financial future.

There's a saying in the financial world that those who understand interest earn it, and those who don't, pay it. If you're looking to build your net worth or establish some financial security, it's time to become more knowledgeable about interest, and specifically about how your home's interest rate can be working for you--or against you--in your long term financial plan.

If you're like most Americans, you probably haven't put much thought into how your interest rate will affect your long term net worth. That's because most consumers lose focus at the point of sale. At the time you were getting a mortgage, you probably focused on loan approval rather than on loan suitability, just like most borrowers do. Most borrowers are often so consumed with getting a lender's approval that it doesn't occur to them to evaluate their current financial situation or their long-term financial goals, let alone the effect that their new mortgage will have on both. Most people have no idea how their interest rates will factor into their long term financial plans, whether a down payment is better invested elsewhere, or how appreciation or tax brackets can impact their investment.

In short, because they don't understand interest, they're probably paying it, rather than earning it.

America's #1 Investment

Financial planners have not traditionally included homes in their clients' financial strategies, and have instead have focused on stocks, bonds and other investments as a way of building a solid financial future. A mortgage has been seen as a necessary evil, rather than a component in a wealth-building plan. Recently, however, consumer trends seem to indicate that Americans believe that buying a house can be the best way to build a secure financial future. Thirty one percent of America's total net worth is inside the primary residence, and 67% of Americans now have more wealth in their houses than in all their other investments combined. Recent research also indicates that the number one reason--cited by 84 percent of homebuyers surveyed--for buying a home is that consumers believe that it's the best long-term financial investment.

In order to fully capitalize on your house as an investment, you'll need to understand a few basic concepts.

When a House Is Not a Home

The first concept that you'll need to grasp is that your house is not always a home. In fact, if you're considering your house as an investment, it is imperative that you stop viewing it simply as a home. A home is the experience that people have living inside their houses. They may think of holiday gatherings or

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time spent with friends and family. Thinking of your house as a home will probably conjure up emotional images, something that you will want to avoid while considering your long term financial plan.

Instead, you should think of your house as the physical property in which you are investing. A house is about appreciation, investment and return. If you're going to use your house as an investment vehicle, you'll need to view it as one, and not as the cozy place where you have family gatherings. Remember, 67 percent of Americans have more wealth in their houses than in all other investments combined. That means you should have no more emotional attachment to your house than you do to any of your other investments. This may sound difficult to do, but it's worth the effort.

Paying Interest, Earning Interest and Gaining Appreciation

Another very important concept of house ownership as it pertains to building wealth is appreciation. Familiarize yourself with the concept. Appreciation occurs when the monetary value of something increases, and it's also the only way that a house can build wealth for you. The 84 percent of homebuyers who believe buying a house is the best long term financial investment are all banking on appreciation, whether they know it or not. Remember, there is no other way that a house can bring a return aside from appreciation.

If you'd like to know how interest rates and appreciation work together in homeownership, consider this example. A $400,000 home purchased at 20 percent down, with an interest rate of 7 percent over 30 years will yield a monthly payment of roughly $3,000 per month. Over the course of 30 years, the borrower will pay much more than the remaining principal balance of $320,000. At $3,000 per month, the total cost of the loan over 30 years will be roughly $1 million. The question is, in 30 years, will that $400,000 house be worth over $1 million? At an annual rate of 4 percent appreciation, that home will be worth roughly $1.3 million.

Now take for example that same $3,000 per month. If that $3,000 per month were invested at a rate of 8 percent, at the end of 30 years the value of the investment would be about $4.3 million.

This is a powerful example of why it's so important to understand how interest works. Knowing the long-term results of interest rates can help you to better determine where to invest your money. Talk to your mortgage professional and ask him or her to help you compare the rate of return on each of your potential investments. Once you do the simple math, you'll be better equipped to determine which type of mortgage or other investment is appropriate for you.

The Down Payment

Plain and simple, your down payment does not affect your appreciation one bit. Rather, your down payment does directly impact your cash flow. Let's take for example that $400,000 property again. At 20 percent, the down payment is $80,000. If the borrower were to put zero down and appreciation stayed at 4 percent,

the house would still be worth roughly $1.3 million in 30 years. However, that same $80,000 at 7 percent interest would result in about $292 per month. If the borrower puts $80,000 down, the mortgage payment is reduced by $292 per month. In other words, your down payment cash is an investable asset. That same $80,000, if not put into the house, has a cost of $292 per month. These are concepts you'll want to understand when considering the size of your down payment.

If you do choose to utilize your liquid assets as a down payment, remember that there are only three ways to lose wealth in a house: depreciation, foreclosure and lawsuits. While you'll want to discuss the legal options to protect against loss of wealth due to lawsuits or depreciation with a qualified professional, your loan officer can assist in protecting you against potential loss due to foreclosure. By putting a liquidity plan in place prior to necessity, you will safeguard your down payment and additional equity you've accumulated. Your loan officer can do this by securing a HELOC (home equity line of credit) right away--even before you'll ever need it--so that you'll have access to your equity and will therefore be protected against total loss.

Tax Brackets and Interest Payments

If you're going to make sound and knowledgeable financial decisions, you'll need to know which tax bracket you fall into. This is because your tax bracket will determine your effective percentage rate. For example, if you are borrowing at 7 percent, and you are in a 37.5 percent tax bracket, 37.5 percent of your interest rate--or 2.625 percent, in this case--is going to be paid by the government.

The way to calculate this rate is to multiply your interest rate by your tax bracket. In this case, we multiply 7 (percent interest) by .375 (for 37.5 percent), which comes out to 2.635 (percent interest). When you subtract the amount of interest paid by the government by the original interest rate, you'll get your effective percentage rate, something very important to understand when determining when and where to borrow and invest.

A qualified loan professional, a Mortgage Planner, can help you to implement a plan for the highest and best use of your money, one that utilizes your house to put you on the path to financial security. By learning, understanding and employing these concepts, you'll be on your way to earning interest, rather than simply paying it. ■

Many of the concepts discussed in this article were derived from a seminar by Todd Ballenger, author of "Borrow Smart, Retire Rich." Ballenger has over 15 years of experience in the financial services industry, and is CEO and founder of KendallTodd.

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