

**YOUR MORTGAGE,
YOUR RETIREMENT
YOU HAVE OPTIONS!**

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Conventional Wisdom

We have been conditioned to believe that we must have a free and clear home before we can retire. This conditioning comes from our parents, who survived the depression and from many financial planners, who have been taught that all debt is to be eliminated. Because different individuals have different wants, needs, and goals, the best approach is to carefully weigh the advantages and disadvantages of using your capital to retire your mortgage at or before retirement. While the best approach, for some, may be to leave the mortgage intact and invest the money elsewhere, for others, the advantages of an unencumbered house are more important than the opportunity for investment gain.

1. Simplicity. For many of us life appears to become more complicated each day. As we grow older, this complexity can become increasingly burdensome. Eliminating the task of making a monthly mortgage payment has a great deal of appeal from a simplicity standpoint. You can reduce the inconvenience of having to write a check every month by utilizing automatic withdrawal from your checking account, but even that is more complex than no payment at all. While it may be possible to invest funds at a higher rate than the cost of mortgage debt, many homeowners, particularly the more affluent, don't want to be bothered.
2. Risk. Without question, all debt adds risk to your life. Retiring debt reduces that risk. In addition, the return you get from paying off your mortgage is usually 1-2% higher than you can get from other risk-free investments. One thing to remember is that, in most states, having your house free and clear doesn't preclude a forced sale by other creditors. In fact, unsecured creditors may be more likely to attempt to force the sale of an unencumbered house than one encumbered by debt, the reason being that the mortgage creditor has a preferred position in a forced sale and must be paid before unsecured creditors can claim any of the proceeds from sale of the asset.

Developing a Plan to Pay off your Mortgage

If your goal is to have your home free and clear but you still have a mortgage, it is important to decide how you intend to retire the mortgage. Many borrowers look towards 15-year mortgages and equity acceleration programs to provide them with the discipline to make higher mortgage payments and repay their mortgage early. These programs often suffer from two major flaws.

1. They don't really provide the added discipline. While its true that a contractual obligation to make the larger mortgage payments will force the conscientious borrower to make those payments, it is all too easy to acquire secondary financing with the intent of utilizing it for a short term. Secondary financing, along with the accompanying higher interest rates defeats the purpose of having a short-term or accelerated mortgage payoff. The borrowers' good intentions often fall short resulting in carrying both the primary and secondary financing into retirement.

2. They follow the borrower into retirement. Too many borrowers go into retirement with 6-8 years remaining on the short-term mortgage. This hurts the borrower's retirement cash flow during the early years of retirement. Since these are usually the best years, a good rule to follow is to pay off the mortgage within a short time of retirement or not at all.

Mortgage acceleration programs usually add extra fees for the privilege of paying off the mortgage early. These fees add unnecessary costs resulting in a higher effective interest rate.

Example: The mortgage banking division of a major financial institution has an "equity acceleration" program offering its customers the "opportunity" to convert their current mortgage to a biweekly program which reduces the repayment term by six years. The cost of this program is a \$295 initial charge and an additional \$5.42 per month. The biweekly program represents a technique by which the borrower pays 26 payments per year, each of which is 50% of the required monthly payment under the original contract. This results in an additional principal payment each year. You can make this extra payment on your own without paying these fees which add approximately 0.1% to the effective interest rate.

You can custom design your own equity acceleration plan in fifteen minutes with the aid of a financial calculator. You simply enter your current mortgage rate, the principal balance, and the current payment. Then enter the repayment period desired and solve for the new payment. For example, if you have a \$120,000 loan at 7% with 28 years and three months remaining, your current payment is \$831.21 per month. If you want to repay the loan in 120 months, the new payment is \$1393.30. This means that you need to make an additional principal payment of \$562.09 per month to accomplish your goal. If the additional \$562.09 per month is impractical, you might compromise by adding a smaller amount such as \$300. The result is a loan balance of \$43,360 at the end of 10 years. If this is your anticipated retirement date, you will have to continue paying \$1131 per month for an additional 4 years, you can drop back to the minimum payment level of \$831 per month for 66 months, or you can convert \$44,360 of other assets to eliminate the debt entirely. Again, the trouble with any method that doesn't result in complete repayment on or before retirement is that it requires relatively high payments during the first few years of retirement. This represents a cash flow drain during what should be the most enjoyable part of retirement. This is the reason that our philosophy is one of repayment by the retirement date, or shortly thereafter, or not at all.

You Have Choices

If you are approaching retirement with your mortgage still intact, you need not be alarmed. There are no compelling financial reasons why your mortgage must retire when you do. In fact, there are several advantages to continuing to use mortgage credit after you retire.

1. Liquidity. A cash reserve for liquidity has value even if it earns less than the cost of the mortgage debt. The financial flexibility is often considerably more beneficial than a free and clear house.

Example: Katherine, age 63, a retired army nurse with adequate pension income, was considering paying off her \$120,000 mortgage with part of her \$150,000 savings. This would save her almost \$200 per month since the principal and interest payments on her 30-year mortgage were \$798 and she was only earning \$600 per month on her savings. While Katherine was in the process of making the decision, her 90-year old mother died leaving only a free and clear house. The home was valued at \$210,000; however, there was a claim for \$110,000 against the estate and creditors were seeking to force sale of the asset to satisfy their claims. Through her attorney, she contacted the creditors, who were willing to accept \$80,000 in return for an immediate payoff. In addition to the \$30,000 savings, she was able to obtain full value on sale of the home instead of the discounted price she would most likely have received as a result of a forced sale. Had Katherine used the bulk of her savings to retire her mortgage it wouldn't have been available to settle her mother's estate.

Katherine's situation is typical of those who haven't had the benefits of high salaries during their career but have excellent guaranteed pension benefits. These retirees may not have had an opportunity to accumulate huge investment accounts but they have adequate income to service mortgage debt. While the opportunity in this example is unusual, the \$2,400 annual cost of maintaining the liquidity reserve is small compared to the ability to fund emergency expenses and take advantage of opportunities for exceptional gain which may periodically arise.

2. Quality of Life Issues. Retirees often believe that they must be exceptionally prudent in making their financial decisions since they will not be able to earn additional income to replace funds used for less than sound financial reasons. While we don't recommend a totally cavalier approach to post retirement financial management, we do view retirement as an opportunity to do some of the things you've always dreamed about. The early retirement years are particularly valuable in this regard since the retiree has energy to undertake adventures that might not be practical in later years.

Example: Roger and Alice, both 62, had been retired for five years. One of Roger's fantasies was to own a motor home and travel around the country. The cost of the motor home he wanted was \$80,000. While Roger and Alice had sufficient liquid assets to pay for the home, these assets were invested in qualified plans and the state

and federal tax costs of liquidation were 36%; therefore, they would have to sell \$108,000 worth of investment assets to net \$80,000 after paying the taxes. They could also borrow the \$80,000 from Roger's credit union. The cost of the loan was 9.5%, amortized over 10 years with monthly payments of \$1035. Roger was so motivated to experience his fantasy, he was willing to borrow the funds and worry about how to pay them back later. His plan was to make the payments by withdrawing extra money from his retirement account for a year while he embarked on an extensive tour of the country. He then planned to resume part-time work at the end of the year in order to earn at least half of the payment amount. Roger needed to consider another idea: A cash-out refinance on his residence to obtain the necessary funds. Three years prior to retirement Roger had taken out a 160,000 loan, amortized for 15 years at 7.125% with payments of \$1450 per month. His objective was to make extra payments and have a free and clear house by his anticipated retirement at age 65. Unfortunately, a forced early retirement interrupted these plans and his loan balance eight years later was \$95,600. He had seven years remaining on his mortgage and would be almost 70 years old before it would be retired. Roger decided to add \$80,000 to the current mortgage and increase the repayment period to 30 years. The new interest rate was 7.375% and the monthly payments were \$1,213. This accomplished Roger's goal of \$80,000 in cash and also reduced his monthly payments by \$237 per month.

This example is interesting in that Roger accomplished his goal in a manner that is counter to what we might consider to be prudent financial practice. He raised his interest rate, he increased his loan amount, and he extended the time required to repay to the point that he would be 92 before owning a free and clear house. The issue here is one of whether or not Roger is willing to trade his goal of a free and clear home in 7 years in order to experience his dream of owning a motor home. If so, this method allows him to do so without disturbing his current quality of life. Too often we focus on the wrong issues in making decisions of this type. Although Roger didn't want to ignore the interest rate and the repayment period, the more important issues were cash out, monthly cash flow, and quality of life.

3. Tax Benefits. The tax reform act of 1986, left mortgage interest deduction intact, making it the most common tax shelter available to the average taxpayer. Despite these tax deductions, it makes little sense to hold a mortgage strictly for tax purposes. A taxpayer in a combined state and federal tax bracket of 33% is spending a dollar in interest to save 33 cents in taxes unless a strategy is developed which takes advantage of these tax benefits. One possible strategy is to invest the funds that could have been spent in retiring the mortgage in a portfolio of investments expected to produce the bulk of the returns in the form of capital gains.

Example: Richard and Joan were nearing retirement and were fortunate to have company funded pension plans that more than provided for their retirement needs. In addition, they had just inherited \$155,000 which they were considering using to repay their current mortgage of roughly the same amount. The mortgage had 12 years

remaining at 7.25% with payments of \$1,823 per month. Another option was to refinance that mortgage and take advantage of the lower interest rates available in the market at that time. They could then invest the proceeds from the inheritance in a portfolio of growth stocks. The new loan was at 6.875% for 30 years with monthly payments of \$1,018. Over a 10-year holding period, cost of the mortgage payments would be partially offset by the interest deduction. In a 33% tax bracket, tax savings would amount to an average of \$274 per month, resulting in a net cost of \$714 per month. The loan balance at the end of 10 years would be \$132,615. Ignoring taxes, in order to justify taking out the mortgage and investing the proceeds in growth stocks, the portfolio would have to produce a return greater than the cost of the mortgage. Taking tax consequences into account, the scenario changes. If the portfolio earned only 6.875% (much less than the historical average return on a diversified growth portfolio), the total sum accumulated at the end of 10 years would be \$307,650 before taxes. The 20% capital gains tax would reduce this by \$30,530 leaving net after tax proceeds of \$277,120 or \$144,505 more than the mortgage balance. In effect, Richard and Joan invested \$714 per month (the after-tax cost of the mortgage payment) and increased their wealth by \$144,505. This equates to a 9.79% after-tax return, the equivalent of a 14.61% before-tax return.

The example illustrates the fact that, even with a much smaller rate of return than historically available for a portfolio of growth stocks, you can utilize the tax-advantaged status of mortgage interest to build wealth. The capital gain accumulates with no current tax obligation while the mortgage interest is deductible each year. This allows us to accumulate gains on money that would have gone to taxes. At the end of the holding period, the capital gain is taxed at the preferred rate of 20%. In effect, we have converted our interest deduction, which saves 33% ordinary income taxes to capital gains, taxed at 20%. If their objective was to build a legacy for future generations, they could avoid the capital gain entirely by leaving the portfolio intact and allowing the heirs to take advantage of the step up in basis upon their death.

4. Cash Flow Issues. Some retirees are not in a position to utilize the previously described technique because they lack the cash flow to comfortably service the debt. Due to the lower interest rates available on most fixed income investments and the low dividend rates offered by many common stock investments, it is often difficult to generate enough cash flow from investments to provide debt service. That said, there are times in which market opportunities are available to provide more than enough current income to service the debt. Such opportunities have recently been available via real estate investment trusts (REITs).

Example: Mike and Nancy had grown weary of climbing stairs and caring for the yard on their 2-story home so they decided to sell it and acquire a patio home. After paying sales costs, the net proceeds from the sale were \$200,000. The new home they were buying was \$300,000 and they were going to take out a \$100,000, 30-year mortgage at \$6.75% with payments of \$649. Their reasoning for using the entire \$200,000 as a down payment was that they didn't want to be obligated to make the

higher mortgage payments required by a larger loan. An alternative strategy was to acquire a diversified portfolio of REITs with a yield of 11%. By taking out a \$200,000 loan with payments of \$1,297 and investing \$100,000 at 11%, they were able to obtain \$917 in average monthly dividend income to make the mortgage payments. This left them with a net payment of \$380 instead of \$649 and the increased dividend gave them considerable added financial flexibility.

The markets occasionally present us with opportunities to enhance our cash flow by taking advantage of inefficiencies. The downside in the previous example is that REIT dividends are not guaranteed and income from the portfolio is subject to variation. Using a diversified portfolio and analyzing each company to select those in which dividends appeared to be likely to increase rather than decrease can mitigate this risk. Tax laws mandate that, in order to avoid corporate tax, REITs must distribute at least 90% of their net income to shareholders; therefore, a decrease in dividends is unlikely unless accompanied by a decline in earnings. Statistical studies show us we should receive a slight increase in the yield from this portfolio each year. In this example REITs were the preferred investment vehicle. Other options for high-current yields vary with the marketplace.

All techniques involving investing the proceeds of a mortgage involve risk. Before these techniques are utilized, it is best to consider a worst-case scenario and develop a strategy for dealing with the consequences.

The examples described in this article are but a few of the opportunities that might arise from using capital for purposes other than retiring a mortgage. Undoubtedly, some may consider that the risks of these opportunities outweigh the potential benefits. That decision is purely a matter of personal choice and there is little room to argue with investors who choose not to take those risks; however, the decision is sometimes more psychological than logical. Before making the decision to tie up capital in your home, the best approach is to carefully consider the alternatives in light of your risk tolerance and financial objectives. This will allow you to make fully informed choices.

About the Author

Phillip Storms entered the financial services business in 1979 after a 20-year career as a research chemist. He started his own real estate firm in 1980 after receiving his real estate broker license. During the past 20 years, he has been involved as a broker or principal in over 5000 real estate transactions. These transactions vary in size from a \$10,000 building site to \$5-million office-industrial building. He has been involved in continuing education activities through out his career and has been designated as a Certified Planning Practitioner (CFP), and a Certified Commercial Investment Member (CCIM). In 1994, he was awarded a Masters degree in applied communications from the University of Denver.

Currently, he is President of Westmont Companies, a diversified financial services company offering real estate, mortgage, and financial planning services.

He has been an active writer through out his career, publishing several articles, newspaper columns, and a 60,000-word volume on real estate investing for CCH Publishing. The Journal of Financial Planning has appointed him to their editorial review board and he writes a quarterly column for the journal on real estate issues. He is also the real estate advisor for Real Money, a Sunday morning call in show on 760 KTLK.

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Our mission is to help you make informed real estate decisions. These may range from simple decisions involving refinancing or purchasing a home to complex investment decisions such as constructing a real estate investment portfolio.

For a copy of our monthly newsletter also written by Phil Storms please contact us by phone or email to be added to our mailing list. Keep an eye on our website at www.WestmontCompanies.com for frequent financial tips, market commentary, FAQ's and dates and times for other seminars or speaking appearances.

Of course, if you have any questions about the issues raised in this publication or any general real estate questions feel free to call us at 720/449-0200.

Who Is Westmont

Westmont Companies is a family-owned company, founded by Phillip Storms, CFP, CCIM in 1988. Our mission is to help our clients make effective real estate decisions. We have worked with clients in a variety of real estate endeavors from acquiring a personal residence to buying an office-warehouse. Susan Storms is in charge of our mortgage operation and qualified to help you make decisions as to the most suitable financing instrument for your home or 2-4 family residential property. James Gerhart is in charge of our real estate and property management company and is a registered appraiser. He can help you determine the value of residential properties you are considering buying or selling. Phillip Storms serves in a consulting capacity to all these operations and specializes in the acquisition, disposition, or financing of commercial-investment properties.