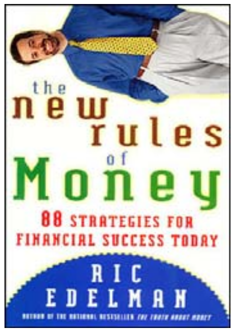
Never Own Your Home Outright. Instead, Get a Big 30-year Mortgage, and Never Pay It Off — Regardless of Your Age and Income



By Ric Edelman
From The New Rules of Money

Last year, Wal-Mart sold several hundred thousand drills to people who didn't want them.

What these people wanted was a hole in the wall, but to get one, they first had to buy a drill.

The same is true for your mortgage: You didn't want that, either. What you did want was a house - but to get a house, you first had to obtain a mortgage. If you're like most folks, you hate your mortgage, and you'd love to get rid of it as soon as possible. You consider every monthly payment you make to be a waste of money, and you know that, over 30 years, you'll spend more on interest on the loan than you paid to buy the house in the first place. That's why you put down as much money as possible - to keep the mortgage as small as possible. You also chose a 15-year loan - to get the loan paid off in half the time, compared to a conventional 30-year mortgage - and you make extra payments whenever possible to further accelerate the payoff. In fact, you might even have signed up for one of those new bi-weekly loan programs, which have you make half the payment every two weeks instead of a single, full payment once a month. You do all these things because your parents taught you that mortgages were expensive and dangerous, and the key to achieving financial success was to own your home outright.

Although their advice was once correct, it is now completely wrong. All wrong.

The New Rules of Money are clear: A big, 30-year mortgage is the best thing you can have. You should get as big a loan as possible, and never pay it off. Forget about 15-year loans, never make extra payments, and forget about those bi-weekly mortgage payment plans.

Before you dismiss all this as craziness, read on - because I'm about to save you (and make you) incredible amounts of money.

First, understand that everything you know about mortgages - and particularly what you fear about them - was told to you by your parents and grandparents. They told you that mortgages are dangerous, that having one means you can lose your home. They told you this because they remember the Depression, when millions of Americans lost their homes. But by learning why your elders were correct to pay off their mortgage, you'll come to understand why you'll be right to keep yours.

The story begins with federal law. In the 1920s and 1930s, banks were permitted to cancel mortgage loans at any time. During the Depression - when banks ran out of cash and needed more - that's exactly what they did: Messengers bicycled around the nation carrying Western Union telegrams informing homeowners that they had 120 days to pay off their mortgage - or face foreclosure. The result: Millions of Americans lost their homes and the lesson - that you must own your home without a mortgage to make sure you'll never lose it - was burned into the American psyche.

What you and your parents have failed to realize, though, is that Congress has changed the rules. Now, The New Rules of Money are in place. That means banks are no longer permitted to call mortgage loans prematurely. If you have a mortgage, you have no risk that the bank will make you pay off the loan any quicker than is demanded by your regular payment schedule. Therefore, carrying a mortgage is not the risky tactic that it once was.

Fine, you say. So the bank can't call the loan. That doesn't mean that carrying a big, long mortgage is a good idea.

No, but what it does mean is that mortgages are not as scary as you thought they were.

Is your apprehension over mortgages is weakening? Well, hey, I'm just getting started.

You say you don't want a mortgage because it costs you so much money. That's why you send in extra money every month - to get the loan paid off more quickly. You know that by paying off the mortgage early, you'll save a ton of money in interest charges.

While that is correct, you need to turn that coin over, because there's another side that you have completely overlooked. It's a critical point, too: Every time you send an extra $100 to your mortgage company, you deny yourself the opportunity to invest that $100 elsewhere.

In business school, this is called opportunity cost. It means, essentially, that every time you turn left, you deny yourself the opportunity to turn right. So while paying off the mortgage saves you interest, you deny yourself the chance to earn interest. And with mortgage rates so low, it is relatively easy today to earn more from an investment than what the loan is costing you.

Think about it. Your mortgage is probably costing you 8% or less. Over the next 30 years, can you earn (on average) at least that much from investments? Absolutely: Even long-term government bonds pay nearly that amount, and stocks have been averaging more than 10% since 1926. While "past performance is no indication of future success," these long-term performance records do provide some comfort that at least it's been done before. I don't know about you, but I'm happy to pay 8% out of my left pocket if I can earn 10% with my right pocket.

In fact, keeping that mortgage allows you to earn money two ways: First, you get to invest the money that you otherwise would have spent on extra mortgage payments. Second, your home will grow in value even if you have a mortgage. Think about it. Your home's value will rise or fall whether there's a mortgage or not. Therefore, owning your home outright is like having money buried under the mattress: None of that cash, in effect, is earning any interest. You wouldn't stuff ten grand under your mattress, so why stash two hundred thousand into the walls of the house?

Carrying a mortgage gets to be more fun, too. Yes, fun. My father used to love to talk about his mortgage - all $98 per month of it. You see, he and my mom bought their home in 1959 for the whopping price of $19,500! Yet, my Dad tells how his father - my grandpop Max - thought Dad was crazy. How in the world was my father going to be able to handle such a huge mortgage payment, Max wondered? After all, my dad was earning less than $3,000 a year back then. To spend $1,200 a year on mortgage payments - well, Grandpop Max thought my Dad was nuts!

Of course, by the 1970s, Dad was laughing about it. Why? It's simple: He had obtained a fixed-rate mortgage. That means his monthly payment would never rise, and in 1974 he was paying the very same amount that he paid back in 1959. Yet during that time, of course, Dad's income steadily rose. Thus, by the 1970s, Dad's mortgage payment had become insignificant when compared to his income - not to mention that his house had grown in value substantially.

That's lesson number two in carrying a big, long mortgage: The payments get cheaper over time, even though they never actually change. This is possible because the payments are fixed, while your income grows with inflation.

Your defense of mortgage apprehension just took a big body blow, but you're still not convinced. Okay, try this: It's a given that you are going to borrow money during the course of your life, right? So doesn't it make sense to borrow money as inexpensively as possible?

That translates to a mortgage. Why carry 18% credit card debts - which are not tax-deductible - when you could instead carry an 6% mortgage that is tax-deductible? Ditto for auto loans, school loans and personal loans. Your mortgage is the cheapest money you'll ever buy, so it makes sense to use it as much as you can. The next time you buy a car, finance it with a home mortgage instead of a car loan.

There I go again, talking about carrying debt. That's what scares you. You know that if you owe $5,000 to credit cards and then lose your job, VISA can't reclaim that sweater you bought. But if you have a home equity line of credit which you fail to repay because you're out of work, the bank can take your house. That's why you don't want to borrow against your house - in case you're out of work and money gets tight; it sure would be a relief knowing that you don't have a big mortgage payment to make.

That's wrong again, I'm afraid. First, it's unlikely that you're going to find yourself in such dire straights. But then, that's what financial planning is all about, so let me do some effective planning for you. Let's look at Pat and Ed. They both earn $50,000 a year. Both have $20,000 in savings. Both buy a $120,000 house.

Pat wants to minimize his mortgage, so he uses his $20,000 in savings as a down payment, and he opts for a 15-year loan at 5.5%. His monthly payment is $817, but only 55% of that payment is tax-deductible interest; the rest is principal. Therefore, Pat's net after-tax cost for his mortgage is $669. And to pay off his mortgage even quicker, Pat sends in an extra $100 with every payment. Of course, these payments are devoted entirely to principal, and therefore provide no tax deduction.

Ed listens to me, and therefore obtains a 30-year mortgage at 6%, putting down just 5% and financing the rest. Even though his mortgage balance is bigger than Pat's ($114,000 compared to $100,000), his monthly payment is just $683. That's not all: A full 83% of the payment is interest, meaning that Ed's after-tax cost is just $496 a month - $173 less than what Pat has to pay! Ed invests this savings of $173 each month for five years, earning 8% after taxes per year. And instead of sending an extra $100 a month to his mortgage company, as Pat does, Ed adds it to his savings. Result: Over five years, Ed accumulates nearly $19,000. Because he kept $14,000 from his original $20,000, he's able to keep that money invested, too. Now, that money has grown to $21,000. All told, Ed has accumulated $40,000 in savings and investments.

Suddenly, both men find themselves out of work. Because Pat used all of his money as a down payment, he has no savings to tide him over. True, he's got $48,000 worth of equity in his house, but he can't access it. He tried, but the bank turned him down for the loan. "But I've got all this equity in my house!" Pat exclaimed. It didn't matter, the loan officer said, because banks only lend money to people who can repay the loans. With no job, Pat has no income and therefore he cannot qualify for a loan.

Indeed, Pat has fallen victim to the biggest misconception in real estate: That a mortgage is a loan against the house. It isn't. A mortgage is a loan against your income. Without an income, you cannot obtain a loan. If Pat doesn't fix his income problem in a hurry, he'll lose his house. How ironic: Pat, who never wanted a mortgage in the first place, is now in financial jeopardy because he was trying to get rid of one too quickly, and now can't get another!

Ed, though, is in much better shape. With $40,000 in savings, he's easily able to make his payments each month. In fact, even if he doesn't find work for a long time, his home is not in jeopardy. At the rate of $586 a month, Ed won't run out of money for nearly eight years!

And that's really my point: When you have a mortgage, you are required to make only that month's payment. As I explained at the beginning, you are never required to pay off your loan immediately. You might want to do so, but that doesn't mean you must do so.

Face it. You're beaten. You're just lying in the sand, begging me not to pummel you with any more great reasons to carry a big, long mortgage. Sorry, but I like to kick people when they're down. So, let's make sure you heard the morals to our story of Pat and Ed.

1. **You must no longer send extra payments to your mortgage lender.** Invest that money instead, just as Ed did.

2. **Never prepay your mortgage payments like Pat did**. Once you give money to a lender, the only way you'll ever get it back is if you re-borrow the money or sell the house. Selling your home is the last thing you want to do, and you will probably be unable to borrow it when you need it most. Besides, if you're simply going to borrow it back later, why bother giving the money to the lender in the first place?

3. **Stop participating in bi-weekly loan programs.** This is nothing more than a marketing gimmick by firms that capitalize on your hatred - and fear-of mortgages. Somebody figured out that if you make half the payment every two weeks, you can pay off a 30-year loan in about 21 years. It sounds harmless - after all, what's the difference between making a full payment on the 30th and paying half on the 15th and the other half on the 30th?

There would be no difference - if that's how bi-weekly mortgages work. But that's not how they work. You don't make two payments a month, you make half a payment every two weeks. There's a big difference between those two statements. With a bi-weekly mortgage, you make 26 half-payments a year. And 26 half-payments is the same as 13 regular payments. In other words, bi-weekly mortgages require you to make one extra payment per year - 13 instead of 12. Therefore, you're merely making extra principal payments, which you've learned by now is the wrong thing to do.

4. **Recognize that agreeing not to pre-pay your mortgage actually can earn you a lower interest rate, which will save you a lot of money**. Given the choice, most people would prefer a loan that does not have a "pre-payment penalty" over one that does. In fact, until recently, you couldn't even find mortgage loans that contained pre-payment penalties. But today, such loans not only exist, they can be excellent choices.

Today's "pre-payment penalty" clauses typically allow the lender to charge you a penalty if, in any 12-month period of the first 36 months of your loan, you pay more than 20% of the outstanding principal balance. If you did make such a large pre-payment on your mortgage, under the most common penalty clause, you would be required to pay the lender the lesser of 2% or six months' worth of interest on the amount paid over 20%. Say you obtain a $300,000 mortgage, with a monthly payment of $2,400. Let's also say that, soon thereafter, you get a $90,000 inheritance, and you decide to use it to reduce your mortgage balance. Because that $90,000 is equal to 30% of your loan balance, you exceed the 20% threshold - and that means your lender will charge you $600.

It's easy to avoid this penalty, you say. You simply won't pay off the mortgage prematurely.

But that might not be so simple. What if you want to refinance or sell the house? Doing so, of course, requires you to get rid of (or pre-pay) your mortgage, thus subjecting you to the penalty. Some lenders, though, waive the penalty if you are required to move due to a job change or relocation.

But why tolerate this potential problem? Even though more and more mortgage companies are attaching pre-payment penalties to their loans, wouldn't it make more sense to simply avoid a loan that has a pre-payment penalty?

Not necessarily. To entice you to accept the penalty clause, lenders will give you a rate that's 0.25% less than what you'd get otherwise - and that savings can really add up. In fact, the difference between 6% and 6.25% for a $300,000 loan is $50 a month! To get those savings, all you need to do is not pay more than 20% of the balance due during any 12 consecutive month period for only the first three years.

Okay, you're convinced. You agree that a big, long mortgage is best. But how do you act on this advice? It's simple. Just:

1. **Go get a new mortgage!** Either refinance, replacing your current loan with a new, bigger mortgage, or get a second mortgage to supplement your existing loan. Which is best? It depends on whether you can get a new loan with better terms than your current loan.

Either way, get the equity out of the house. Your goal is to increase your mortgage balance by up to $100,000. (When refinancing or obtaining a second mortgage, as of this writing, mortgage interest is tax-deductible only for the first $100,000 of new debt. This limit does not apply when you are obtaining the mortgage in order to purchase a home, or to use the money for the purpose of home improvements. Talk with your tax advisor before proceeding.)

2. **Invest the proceeds of your refinancing carefully**. Do not spend the money on vacations, furniture, cars or college. This is your home we're talking about, so you must invest these assets prudently. If you don't know how to do that, hire a professional advisor to do it for you.

3. **If you need help with the new payments, let your new investments help you**. Worried that you won't be able to handle the big, new mortgage payments you'll now have? Here's an easy way to solve that problem: Arrange for your new investments to send you a monthly check equal to your increased mortgage payments. If your mortgage costs you 6% and you earn at least that much from your investments, then you can easily generate enough income to help you handle the new mortgage payments. Over time, you'll probably discover that:

1. Your investments will earn more than what the mortgage is costing you (enabling your account to grow in value despite your withdrawals, as discussed earlier);
2. You'll have access to the cash in the meantime if it becomes financially necessary (as also discussed earlier); and
3. Eventually, you won't need this help because as your income grows over time, the loan will be easier to handle on your own (also as discussed earlier).

So, what are you waiting for? Tip your hat to your grave-spinning grandfather, and call a mortgage broker today!

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