



UNION WEST
Financial

Homes are Designed to **House Families**, Not Store Cash

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The Power of Leverage

Let's be clear, buying a home can be a great investment. However, the wealthy buy the home 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. 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%. The reality here is that financing your home was the best investment decision that you ever made. When you purchased the \$250,000 house in 1990, you only put \$50,000 down. The \$50,000 cash investment 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 6.5%, so the cost of that money would be \$6,500 per year (100% tax deductible). Rather than bury the \$100,000 in the backyard, we are going to put it to work, or "employ" it. If I were an employer, why would I be willing to hire an assistant for \$35,000 per year? The expectation is I am going to be able to grow my business and earn a profit on it. As a business owner, I believe that by investing in an assistant I will earn a return that's greater than the cost of employing that assistant. If we choose to leave the \$100,000 of equity in our home, we incur almost the same cost. The only difference is, instead of referring to that cost as employment cost, it is referred to as an opportunity cost. By leaving the equity in the home, we give up the "opportunity" to earn a 7 percent return on the money.

By separating the equity we give it new life. We give ourselves the opportunity to put it

to work and earn something on it. Assuming a 34 percent tax bracket, the net employment cost is not 6.5%, but 4.29%, or \$4,290 per year after taxes (mortgage interest is 100% tax deductible). It's not too difficult to find tax free or tax deferred investments earning more than 4.29%. Using the tax benefits of a mortgage, you can create your own arbitrage by borrowing at one rate and earning investment returns at a slightly higher rate. It's what the banks and credit unions do all the time. They borrow our money at 2% and then loan it back to us at 7%. It's what makes millionaires, millionaires! Learn to be your own banker. By using the principles that banks and credit unions use, you can amass a fortune. A bank's greatest assets are its liabilities. You can substantially enhance your net worth by optimizing the assets that you already have. By being your own banker you can make an extra \$1 Million for retirement.

How to Create an Extra Million Dollars for Retirement

By repositioning \$200,000 into an equity management account with a financial

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advisor you can achieve a net gain of \$1 million over thirty years. Assume you separate the \$200,000 of home equity using a mortgage with a 6.5% interest rate. If the \$200,000 grows at a conservative rate of 7% per year, it will be worth \$1,623,299 in 30 years. After deducting the \$257,400 in interest payments and the \$200,000 mortgage, you still have \$1,165,899 left in your account. A net gain of over one million dollars.

This example simply shows a one time repositioning of equity. Imagine how the numbers grow for individuals that harvest and reposition their home equity every 5 years as their home continues to appreciate! This is how the wealthy manage their home equity to 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.

Case Study: **Buying a Rental Property**

A couple recently asked me how they could buy their first rental property. Their primary residence had substantial appreciation and they understood that over the long-term homes in San Diego appreciate at an annual rate of 7-10%. At the time they owed \$312,000 on a 30 year fixed mortgage at 6% with a payment of \$2,398 and they have a 34% tax bracket.

They were paying \$400 a month extra to the principal to have it completely paid off

in another 14 years. A very common (Brother A, The Old Way) scenario. After understanding that equity in real estate earns a rate of return of ZERO this couple decided to separate \$120,000 of their equity to invest in a \$525,000 rental home in North San Diego County. We used a 6.5%, 7 year fixed, interest only, debt instrument which gave them a net after tax payment of \$1,573, which decreased their net payment by an average of \$959 per month. They used their \$120,000 for a down payment of 20%, closing costs and a 6 month rent cash reserve for the rental property. We used a 6.625%, 5 year fixed, interest only, debt instrument. They decided to use a professional property management company so their total monthly costs were \$3,083, the rent was \$2,000 and they reduced their primary mortgage payment by \$959, so their overall monthly cash flow decreased by only \$124 and they added a \$525,000 asset to their balance sheet. In 14 years, they still have a mortgage on the primary residence with a projected net payment of \$1,573 but their rental property appreciating at 7% annually would be worth \$869,000 more than they paid and the rent would have increased enough to cover the monthly costs. Their wealth is projected to grow even faster than this one dimensional scenario because they now own TWO properties that will appreciate over time so they can harvest the appreciation every five years and replicate the wealth building multiple times.

I am one of the few financial advisors who will recommend buying a rental property that negatively cash flows. I do so without hesitation, provided the client has a strong financial rating (my proprietary scoring system), because I have lived in San Diego since 1970 and even though we have had several complete real estate cycles the market averages 7-10% appreciation. Optimizing real estate assets using leverage, low payment debt instruments, and harvesting equity as it builds to invest in other assets, is a terrific plan to build wealth. So I simply refer to San Diego properties as "Cash Cows."



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About the author: Eric R. Union is President of Union West Financial a company that specializes in helping clients strategically manage their home equity and their mortgage to build wealth. Union West's unique mortgage planning approach has helped hundred of families.

For a free analysis to see how these concepts would apply to your specific situation, please contact Eric R. Union at 858.454.5343 or via email at ericunion@unionwestfinancial.com.