



For Rent

Leverage
Trapped
Equity
to Grow
Wealth

by Eric
Union

Let's be clear, buying a home can be a great investment. However, the wealthy buy their homes with as little of their own money as possible, leaving the majority of their cash in other investments where it is liquid, safe and earning a healthy rate of return. What many people don't understand is that when we leave equity trapped in our homes, we pay a price called Opportunity Cost. Here is an example:

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, Southern California homes appreciate at an annual rate of 7 - 10 percent. At the time, they owed \$312,000 on a 30-year fixed mortgage at 6 percent with a payment of \$2,398. They were in a 34 percent tax bracket.

When they met me, they were paying \$400 a month extra to the principal with the goal of giving it completely paid off in another 14 years. I explained to them that equity in real estate earns a rate of return of zero. Very wisely 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 percent, seven-year fixed, interest-only, debt instrument. This 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 equity cash out for a down payment of 20 percent, closing costs and a six-month rent cash reserve. We funded this with a 6.625 percent, five-year fixed, interest-only loan. They decided to use a professional property management company so their total monthly costs were \$3,083. The rental income was \$2,000. Combined with the reduced primary mortgage payment, their overall monthly cash flow decreased by only \$124. And they added a \$525,000 asset to their balance sheet.

In 14 years, they will still have a mortgage on the primary residence with a projected net payment of \$1,573, but their rental property appreciating at 7 percent annually would be worth \$869,000 more than they paid and the rent would have increased enough to cover the monthly costs.

Their wealth could grow even faster than this because they now own two properties that will appreciate over time. They can harvest the added equity every five years and replicate the wealth-building multiple times. ■



Eric Union
is president at
Union West
Financial. You
can find out
more at [www.
unionwestfinan
cial.com](http://www.unionwestfinancial.com).