

Three Principles To Structure Your Mortgage

IT'S NO SECRET. A MORTGAGE IS THE largest single investment most homeowners undertake in a lifetime. Few, however, spend sufficient time determining the best strategy for positioning housing debt within the context of their overall investment portfolio, assets, and liabilities. To make matters worse, many loan officers don't look beyond interest rates to help a client determine the best strategy. These shortcomings cause homeowners to rely on traditional thinking, age-old adages, and online market information.

There are three primary obstacles to a sound mortgage decision.

Avoid random decisions – Most homeowners make decisions at random. Generally a perceived need presents itself, and they jump at the chance to satisfy it in a fragmented and unstructured manner. Little thought is given to how one financial decision may affect other variables on the personal balance sheet.

Don't be vulnerable – Our free enterprise system, accented by open competition, can leave homeowners vulnerable to biased, self-serving opportunists who place their own financial growth over the client's: case in point - rampant late night television infomercials, radio spots and Internet sites. Rely, instead, on a trusted mortgage advisor who works in concert with other financial, accounting, and legal advisors to collaborate a custom and integrative game plan.

Don't roam with the herd – Mortgage-related media noise is targeted at the 85 percent of the population that have already failed financially or can't make ends meet. The information is based more on how financial products and services work empirically rather than collectively and uniquely for individuals.

In contrast, a small percentage of mortgage advisors considered "best of breed" in their

field educates clients on three uncommon principles for sound financial planning.

Baseline to Beat™ – This data point is defined as the after-tax borrowing cost of debt on an annualized basis and a measure by which all other investment decisions should be made. Assume a borrower is in the 31 percent tax bracket and considering a 30-year fixed mortgage at 6 percent. The after-tax cost of the debt is 4.14 percent (note rate x (1.00 minus tax bracket)). This baseline now becomes a barometer to determine whether a homeowner should use disposable dollars to pay down debt in the short term or apply funds to other diversified investments to achieve greater long-term wealth.

Simple Interest Debt vs Compounding Interest Investments – What an eye-opener to view the side-by-side comparative effect of these two factors. Homeowners often make knee-jerk decisions to pay down mortgage principle based on a perception the after-tax borrowing cost (Baseline to Beat™) could not be reached in an investment alternative without taking on an uncomfortable level of risk. In reality, the required after-tax return should be viewed over a pre-defined period to estimate the specific result. Assume a \$100,000 mortgage at 6 percent amortized over 30 years. First year interest costs equal \$5,966.60; second year \$5,890.86. A \$100,000 investment in a 12-month CD at 6 percent compounded annually will generate the same \$6,000 in interest the first year but \$6,360 in year two. Notice how both have the same note rate over a specific period. Yet one generates more interest due to the compounding nature of the investment as compared to the simple interest cost of the debt. While a 6 percent return may not be realistic in today's market, it does demonstrate the concept and need to evaluate options.

Ordinary Mortgage Interest Deduction vs Long-Term Investment Capital Gains – Mortgage inter-



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est is generally deductible at the same rate as a homeowner's federal income tax bracket. Long-term capital gains - returns on investments held more than 12 months - are taxed as low as 15 percent based on specific tax brackets. Thus, opportunities may exist to retain investments that otherwise might be targeted for a down payment on a new home. Suppose a move-up buyer's new mortgage will be \$200,000 more than the current one. The initial reaction may be to liquidate sufficient capital from their investment portfolio to offset the higher priced property. However, the investment to be liquidated may be common stock that is subject to long-term capital gains (maximum 15 percent) and may pay qualified dividend income to the investor (dividends are generally taxed at 20 percent). Through careful calculations, the after-tax cost of the mortgage debt may be far less than what the homeowner is earning through the tax-favored treatment of the investment. In other words, why uproot an investment that is earning more than the cost of borrowing the debt? U