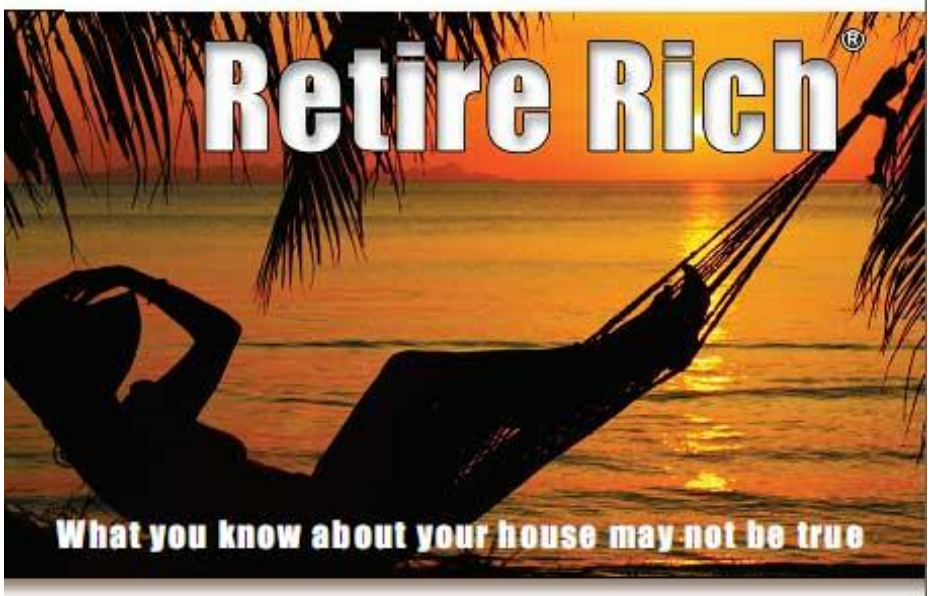
A 7-STEP GUIDE

Borrow Smart



Todd K. Ballenger

Jim Kuhner

Borrow Smart Retire Rich

Borrow Smart Retire Rich

HOW CAN YOU PAY OFF YOUR HOUSE EARLY, OR INCREASE YOUR WEALTH BY $1 MILLION?

A 7-STEP GUIDE

Todd K. Ballenger
Jim Kuhner

ISBN 978-1-934818-57-2

Printed in the United States of America.

This book is a work of fiction. People, places, events, and situations are the product of the author's imagination. Any resemblance to actual persons, living or dead, or historical events, is purely coincidental.

Published by: BSRR Publishing, LLC

CHAPEL HILL, NC

U . S . A.

Ver 1.10

For Our Clients and Their Families

Acknowledgments

Many thanks to those who directly influenced the writing of this book... the many advisors, lenders, clients, and curious onlookers with whom I've had the good pleasure of meeting, lecturing, listening, understanding, debating, and integrating over the years.

Contents

Part 1

Part 2

Moving Ahead

The composition of this book has been for the author a long struggle of escape, and so must the reading of it be for most readers if the author's assault upon them is to be successful, — a struggle of escape from habitual modes of thought and expression...

The difficulty lies, not in the new ideas, but in escaping from the old ones...

John Maynard Keyes,
from his preface to The General Theory of Employment, Interest and Money, 1935

"Those who understand interest – earn it.
Those who don't – pay it" -- Albert Einstein

Part 1

Foundations

As you read this book, your "thinking" on borrowing will be challenged. Thomas Alva Edison, the self-educated inventor who was awarded more than 1,000 patents, clearly understood the challenge of thinking. Edison, in *They Won't Think* says, "The brain that isn't used rusts. The brain that is used responds." Part 1 of this book will remove the rust and awaken you to explore the role of the house in the creation of wealth. Part 2 offers a 7-Step Borrow Smart technique that will allow you to respond to help you Retire Rich.

There is a difference between house and home. A home provides a place to raise a family, sleep, relax, and so forth. A house is the physical shelter, the brick, windows, the doors, and the shingles. The ability to separate in your thinking the house from home will enable you to view the house as a tool for wealth creation. You will discover a new "location, location, location" that now incorporates not only the physical location of the structure but also the location of your house wealth.

In recent years a major shift in wealth occurred. The shift resulted in house equity becoming the overwhelming asset class for many Americans. As a result, house equity – the net value of a house-related investment -- became a critical yet very misunderstood component of wealth management. Since house equity can represent your largest asset, outdated thinking (rust) became challenged with new ways (responses) to manage the relationship between house equity and mortgage selection.

> Trying to manage your assets without learning to manage your liabilities can be like heating your house with the windows open. - Todd Ballenger

As a result, a new thought process surfaced: "managing liabilities into assets." At the core of the process is house equity, or possibly the lack thereof. How house equity relates to personal net worth might surprise you. You will learn how to manage house equity to maximize wealth creation. During wealth creation many questions can arise. To help you make the proper decisions, Part 1 introduces a simple concept – Effective Percentage Rate (EPR). No other single investment asset or debt is as misunderstood as the house. Part 1 discusses how to approach the house as an investment. Like any investment, it needs to be approached from the perspective of Safety, Liquidity, and Return.

Safety is minimizing the potential loss of the house investment by understanding key investment risks. The two biggest Safety risks for the house are depreciation and foreclosure.

Liquidity is the speed and ease with which you can convert your house wealth to cash. You either sell the house or borrow against the house to provide liquidity. We will look at obstacles to borrowing and the four Cs: Character, Capacity, Collateral, and Credit. The house can be a Liquid investment, but the timing and conditions of selling or borrowing against it can make the house one of your least Liquid investments. In fact, life events such as a job loss that can increase the need for cash in your house are typically the same events that block such access.

Return is as important as Safety and Liquidity when choosing an

investment that will produce wealth. The Return on the house as an investment is more difficult to understand than many other investments. Most people believe the wealth in their house grows at the rate their house appreciates. When we discuss Return on wealth in the house we will bring clarity between one's net worth and the "return" on house equity.

> The money (house equity) you have inside the house doesn't earn a specific Return separate from the appreciation or depreciation of the house.

After we examine Return in the house, we will look toward hidden costs associated with the house investment. There are two ways house ownership will influence your net worth: one, appreciation or depreciation, and two, the approach you take to borrowing. You can control your approach to borrowing. We will show you how to use the Effective Percentage Rate concept to make informed decisions.

The final three concepts in Part 1 pertain to taxes, leverage, and diversification. By applying the earlier learned concepts, you will see how decisions regarding these three concepts can work together in building house wealth.

Part 1 of the book establishes the foundations for Borrowing Smart. In Part 2 we show you how to take action with the 7-Step Borrow Smart Solution. This step-by-step approach will guide you through the decision making process to identify a clear strategy in managing your liabilities.

I would like to thank Todd Ballenger, who I met at Borrow Smart University, for allowing me to participate with this book. Todd's transformative strategy, content, and tools remove the rust…and engage your brain to respond to how you think about the House and Wealth.

- Jim Kuhner

Chapter 3

Location, Location, Location

"We're not lost. We're locationally challenged." -- John M. Ford

If you were asked how the investment in your house compares to a 401(k), a checking account, an insurance policy, cash in a sock drawer, stocks, and stock or bond mutual funds, could you explain the difference? How can you compare your house with other investment products?

A financial advisor would seek to balance your tolerance for risk by selecting different investment products based on your desire for Safety, Liquidity, and Return. You can use those same three criteria to help understand the investment in your house. Additionally, to fully understand how the house compares, you should consider the house relative to taxes, leverage and diversification.

In my personal experience detailed in Chapter 1, I chose to prepay my liabilities first. In other words, I chose to invest in my debts before investing in my assets. My initial decision to invest in credit card debt was simple,

but once those higher-interest-rate debts were paid off, it was unclear to what extent I should continue to repay my mortgage debt. It took me years to fully understand the financial impact of prepaying my mortgage and see how it might ultimately lead to various unintended consequences.

Dispatching Your Wealth

The checking account is a transit hub for your income. Money is constantly dispatched to various locations via checks, ATM transactions, debit cards, bill pay services and automated withdrawals. You, as the dispatch manager, direct the flow of these funds to meet various needs and wants. Any money left over at the end of your month can be used to reduce current liabilities or increase future savings to build your net worth. Net worth is your assets minus your liabilities.

Assets	-	Liabilities	=	Net Worth

Whenever you relocate funds from your checking account, it is a balance sheet neutral decision. It has no immediate impact on your net worth. You don't create new wealth when you pay down your mortgage. The wealth in your checking account is already reflected in your net worth, it merely awaits your direction.

A Sample Balance Sheet			
Assets		**Liabilities**	
Checking	$10,000	Mortgage	$160,000
Savings	$15,000	Auto Loans	$35,000
Investments	$175,000	Credit Cards	$5,000
House	$200,000		
Total	**$400,000**	**Total**	**$200,000**

In the above sample balance sheet, the net worth is $200,000. Should

there be a move of $5,000 from the checking account to the investment account, the net worth remains the same. Money was simply moved from one asset to another. When you move assets from one asset to another, it is like moving money from your front pocket to your back pocket.

Moving $5,000 From Asset to Asset			
Assets		**Liabilities**	
Checking	$5,000	Mortgage	$160,000
Savings	$15,000	Auto Loans	$35,000
Investments	$180,000	Credit Cards	$5,000
House	$200,000		
Total	**$400,000**	**Total**	**$200,000**

Should there be a move of $5,000 from the checking account to the credit cards, the net worth remains the same. Even when money crosses the balance sheet, from an asset to a liability, the net worth remains the same. When you move an asset to a liability, it is like moving money from your pocket to someone else's pocket.

Moving $5,000 From Asset to Liability			
Assets		**Liabilities**	
Checking	$5,000	Mortgage	$160,000
Savings	$15,000	Auto Loans	$35,000
Investments	$175,000	Credit Cards	$0
House	$200,000		
Total	**$395,000**	**Total**	**$195,000**

While the immediate decision to move money around on the balance sheet has no immediate visible impact, the long-term consequences of your decisions about the location of wealth are another matter. These decisions

will only be realized later. Many of us come to learn that financial problems, like interest, compound over time. A small leak in the pipes may not become apparent until it requires a great deal of energy (time and money) to resolve. In essence, we want to find any leaks before they become a problem.

You probably understand that leaving your money in a checking account is not the best place to hold your long-term wealth. Why? At a basic level we know that there is an opportunity cost of leaving that money there based on other possible uses. The decision to relocate that money is sophisticated, whether you realize it or not. That money in the checking account was safe (guaranteed by the FDIC), it was liquid (you had complete use and control) and it was earning a Return (varies with banking institution). When the money is relocated to a person, company, or government, we understand that regardless of whatever benefits we receive, we've lost other possible uses of that money.

- *Relocate your checking account to a savings or money market account. The Safety and Liquidity is almost identical, but interest paid is often 3 times higher. Compare rates at www.bankrate.com.*

Throughout this book we'll consider the location of wealth related to the house. When you invest (locate your money) in liabilities, this is typically done by paying off outstanding auto, credit card, student, mortgage, personal or business debt. When you invest in assets, this is typically done through financial products (savings accounts, CDs, money market funds, bonds, life insurance, stocks, annuities and mutual funds). Each location, whether an asset or a liability, has by its very nature aspects of Safety, Liquidity, and Return that can be measured.

When investing in assets or liabilities, you typically want the highest possible Safety (lowest risk of losing money), the highest Liquidity (highest use and control of your money), and the highest Return (highest earnings on your money). As you invest over time, you learn that there are gives and takes required to balance your ideal mix of Safety, Liquidity and Return based on your current specific goals and long-term financial needs.

Many of us pay a lot of attention to asset-oriented investments and receive a great deal of advice and information pertaining to asset products. Typically, we focus much less attention on the decisions related to our liabilities. Most of us have a choice of two different types of liabilities where we can locate our money: personal debt and investment debt.

Personal Debt

Personal debt is money borrowed to purchase an asset that will most likely depreciate in value. It is the most costly type of debt a person can have, because the asset will eventually depreciate to $0. If you borrow $30,000 at 6% interest to buy a new auto, what will it actually cost you? Your car payment of $579.88 over five years will return the $30,000 you borrowed with $4,799 in interest. At the end of five years, the car may be worth $10,000. Your investment of $34,799, less the car's five-year value of $10,000 would result in a net cost of $24,799.

Other types of personal debt include most credit card purchases, personal loans, and other unsecured debts used to invest in an asset that will depreciate in value. Because this debt is typically for something that will decrease in value, it is unsecured debt, so it will also require a higher interest rate.

Investment Debt

Investment debt is money borrowed to buy something that will typically appreciate in value. Although we refer to this as a form of debt, it often increases a person's net wealth. For example, consider the purchase of a house for $200,000 with a 30-year mortgage of $160,000 at a 7% interest rate. If the house itself were to appreciate at 4% per year, it would be worth $662,700 in 30 years. The interest you pay during this 30-year period would add up to $223,214. Thus, your payment for the house ($200,000) plus interest ($223,214) would total $423,214. However, you would have a house worth $662,700. Thus, you would gain $239,486 in wealth related to this debt, not adjusting for inflation.

Investment Assets

The alternative to investing in debt is investing in an asset. This is typically done by selecting a specific investment product. When you buy an investment product you are loaning the use of money you do not need today to someone else, providing them use and control of that money in exchange for interest they pay you through direct interest, dividends, or appreciation.

When you invest in liabilities you are repaying money that you have borrowed from others. When you invest in assets, you are allowing others to borrow from you – they are borrowing the use and control of your money. In other words, when you invest in an asset, you are letting someone else use your money, based on an expectation that the money will be there for you in the future (Safety), when you want or need it (Liquidity) and with increased buying power (Return). Understanding that basic concept can have a lifelong impact on your ability to create wealth.

Investing in Assets Versus Debts

When you pay off a debt or invest in an asset, it is crucial that you understand its impact on your total wealth over time.

If you have a $3,000 credit card balance with interest at 12.49%, you have borrowed money from a company that will receive a 12.49% Return from you. When you pay off that investment debt, you are making a debt investment that you can view through the lens of Safety, Liquidity, and Return.

The Safety of an investment in credit card debt is high, because there is little risk of losing money. If you write a check for $3,000 to pay off a $3,000 credit card debt, you can be sure that your new balance will be $0.

The Liquidity of paying off credit card debt is also high. Liquidity involves the use and control of your investment. Paying off the personal debt does not eliminate your use and control of the $3,000; you still have access to the money should you use the credit card for 'convenience'.

The Return on an investment in personal debt is also high. Your Return on the investment in your credit card debt would be 12.49%.

The following chart helps compare hypothetical investments in personal debt, investment debt, and investment assets. Remember, the Return on a personal or investment debt is the interest you are paying for money you borrow. The Return on an investment asset is what you earn for allowing others the use and control of your money.

Class	Type	Safety	Liquidity	Return	Rate
Personal Debt	credit card	high	high	high	**18%**
	personal loan	high	low	high	**12%**
	unsecured loan	high	low	high	**10%**
	car loan	high	low	medium	**8%**
Investment Debt	house mortgage	medium	medium	medium	**7%**
	student loan	high	low	low	**4%**
Investment Asset	mattress	medium	high	low	**0%**
	money market	high	high	low	**1%**
	CD	high	medium	low	**2%**
	bond	medium	high	low	**4%**
	insurance	medium	medium	medium	**7%**
	moderate stock	medium	low	medium	**8%**
	aggressive stock	low	medium	high	**10%**
	real estate	medium	low	high	**12%**
	loan shark	low	low	high	**18%**

**these rates are hypothetical*

This book will help you think clearly and confidently when faced with a decision about investing in debts or assets. Any time you have money available, you face an investment decision. Whether you save $100 each

month, receive $2,000 from a tax refund, gain $50,000 from the sale of a house, or earn $500,000 from the sale of a business, you need to decide where to locate your money. The above chart provides a general comparison of a few of the many products available, but selling a specific product is not what this book is about.

The decision to locate wealth inside the house is a unique investment product consideration. For most Americans, the house represents a person's largest single asset (% of net worth) while also representing the largest single debt (% of monthly expense). Therefore, management of the house asset and mortgage debt can have a huge impact on one's ability to create wealth over time.

My own decision to refinance, as described in Chapter 1, is an example of managing investment debt. It yielded a savings of $261 per month. Over a time span of 50 years as a house owner, a savings of $261 per month could grow to more than $2 million at an 8% Return. That is serious money.

No other single investment asset or debt is as misunderstood as the house. If you own your house free and clear, it could still be costing you a great deal of money. If you own your house with a mortgage, you could be focusing too much of your investment savings toward the repayment of your mortgage debt, or leaving too much in CDs or savings accounts that could have repaid debt. The house is a wonderful investment, but like any investment, it needs to be approached from the perspective of Safety, Liquidity and Return.

If you pick dates for a one-week family vacation, would that vacation be relaxing and enjoyable if you packed up the car and drove to the airport with no flight reservations, planning the trip as you went? A successful vacation is often the by product of careful planning to arrange crucial details and reservations so that you will have the freedom to simply enjoy yourself along the way.

When you are buying or refinancing a house, there are so many details and considerations involved that it's hard to focus on wealth creation.

However, taking time to plan this important financial move is well worth the effort. Working with a lender, financial advisor, Realtor—or all three—helps put maximum wealth creation within your reach. Not doing so can have expensive hidden costs that compound later in life.

Even without much planning, owning a house over an extended period of time is usually more lucrative than renting. With good planning and execution, the wealth in your house, and your management of this wealth, could allow you to pay off your mortgage early, or add $1 million or more to your future wealth. That decision of where you locate your wealth is one of the most important decisions you can make.

Summary of Key Learnings

- When you look at your house investment, you should look at your investment risk tolerance relative to Safety, Liquidity, and Return.

- You should consider your house investment as it compares to other investments in three areas: taxes, leverage, and diversification.

- When you pay down your mortgage, it is a balance sheet neutral transaction; you merely transfer money from your checking account to your "house account"…there is no impact on your net worth.

- Investment debt is money borrowed for appreciating assets. The increasing value in the underlying assets reduces the cost of the debt. It may even create new wealth.

- If you own your house with no debt, the lost opportunity costs on tax savings and leveraged opportunities could be transferring away a great amount of wealth, unknowingly and unnecessarily.

Chapter 5

Liquidity

"It is the city of mirrors, the city of mirages,
at once solid and liquid, at once air and stone." -- Erica Jong

If you have money in a 401(k) or IRA, you probably view it differently from your other investments. You know it is your money, but you also know there are conditions that regulate your ability to access that money, including how and when you spend it.

Your view of your retirement savings relates to the Liquidity of the investment. Investment products have different degrees of Liquidity for different reasons. The government provides tax benefits as an enticement to invest in "qualified" retirement plans. The bank offers a higher rate on a CD than for a checking or savings account. A lender may offer a reduced rate for a prepayment penalty. In each of these cases, an institution is seeking to limit use and control for its own purposes.

We'll define Liquidity as the speed and ease with which you may convert your wealth to cash. If you pay $200,000 in cash for a house, you have

use and control of the house, but you give up the use and control of $200,000. Your $200,000 is now inside the house.

"Money in the house" means house equity. This is a conceptual term, as there is no real money in the house. The house has value. The value that exceeds any current borrowing is house equity. The house equity is money in the house that could be borrowed through a loan product that we call a mortgage.

Suppose that instead, you kept your $200,000 in cash and took out a $200,000 mortgage loan to buy the house. You would have use and control of the $200,000. You would then make monthly interest payments for the use and control of the house.

Lenders are willing to lend against the house value for several reasons:

- *They can make a profit.*
- *They believe you can and will repay the money.*
- *They expect the house value to increase.*

Your ability to convert that value of the house to cash determines the Liquidity of your house investment. Your individual Liquidity of the wealth in your house is relative to your individual strength as a borrower.

Why Borrow Money?

There may be many reasons that you choose not to borrow money, but there are only two reasons to borrow money: (1) you need to, or (2) you choose to.

If you want to buy a house for $200,000 and you have $40,000 to invest, you must borrow at least $160,000 to complete the transaction. Debt is necessary. You are a debtor.

If you want to buy a house for $200,000 and you have $200,000 to invest, you could buy the house without borrowing. Or, you could invest $40,000

and borrow $160,000. You are still a debtor, but the debt is optional. You have the opportunity to act as a creditor.

A debtor borrows money out of basic necessity. A creditor is a debtor who borrows money based on financial opportunity. Whatever your situation today, it will pay to understand and maximize your ability to use Liquidity to create new wealth. Smart borrowing can help you move more quickly from borrowing out of necessity - to borrowing out of choice. If you are already borrowing based solely on opportunity, smart borrowing can help you further amplify your future wealth.

Accessing House Wealth

There are only two ways to convert the wealth in a house to cash: sell the house, or borrow against the house. Selling the house provides complete use and control of the cash, but one loses the use and control of the house. Borrowing against the house provides complete use and control of the cash *and* complete use and control of the house as long as one makes monthly interest payments on the debt. Let's compare the Liquidity of house equity to other investments.

Investment	Time To Convert To Cash		
	<30 days	<60 days	>60 days
cash	X		
bonds	X		
stocks	X		
House Equity	**<30 days**	**<60 days**	**>60 days**
equity line	X*		
cash out refinance		X*	
house sale			X
			**assumes you can qualify to borrow*

1. House Sale

When you sell a house, you end up trading the use and control of the house for cash. To list, market, sell, finance, move, and close on a house with usable cash in hand might take 45 days to a year, depending on market timing and the condition and location of the house.

How soon you need to convert the house to cash may affect the amount of cash you receive. If you need to complete the process quickly, you may sell it at a lower price. The cash you receive is the selling price at closing minus real estate commissions, fees, and any outstanding liabilities secured by the property.

2. Borrowing against the House

Imagine that you are living in a house, and you want to convert your house equity into cash while maintaining ownership. Your best bet would be to borrow against the value of the house. Any borrowing against the house will be based on the appraised value of the house at the time you borrow.

There are several different ways to borrow against the value of a house. You can use a first mortgage, an equity line of credit, or a second mortgage. If you are over age 62, you could also use a reverse mortgage.

No matter how you borrow against the value of a house, you will use the house as collateral. With most financing options, the process of converting the value of the house to cash takes about 30 to 60 days. The timing depends on market conditions for application, processing, appraisal, approval, and closing.

To better understand the Safety of the wealth in the house, we looked at the two key threats to the wealth: depreciation and foreclosure. To understand the Liquidity of the wealth in the house, we examine the four primary obstacles to converting the wealth in the house to cash through traditional borrowing (does not apply to reverse mortgages).

Obstacles to Borrowing

Borrowing is always subject to the guidelines and eligibility requirements set by the lender. The current rules governing how and when you are eligible to access money through borrowing change frequently based on various agency guidelines, market conditions, interest rates, market capacity, and other factors. Once a loan has closed, however, the repayment terms are reflected in a written contract between you and the lender.

Typically, a borrower must overcome four key eligibility obstacles to convert house equity to cash through borrowing. In the lending business we call these obstacles the four C's: Character, Capacity, Collateral, and Credit.

Four Obstacles to Borrowing	
Character	Capacity
Collateral	Credit

Each of the four C's includes many different sub elements, but there is one chief obstacle associated with each. Most people learn about these obstacles by running into them at full speed while in the middle of trying to borrow against the value of the house for a specific need. This is probably the most painful way to learn a lesson in Liquidity.

Let's explore the four obstacles and look at the chief obstacle associated with each.

Obstacle 1 - Character

Your "Character" on a loan application includes your rental history, the number of years you have owned a house, your marital status, the number of children you have and their ages, your employment history, any lawsuits you have been involved in, back taxes owed, and other personal and

financial matters. In a standard loan application, most of the first and third pages focus on matters related to Character.

The key obstacle related to Character eligibility relates to your current and future ability to repay the debt. Remember, the lender wants a predictable payment stream from you each month. A lender will believe you are more likely to make monthly payments if you can show your ability to earn steady income in a career. To meet the primary Character obstacle, you want to be able to provide at least a two-year employment history in a particular profession or line of work.

Consider this example: A high school teacher leaves after 15 years to study and become a contractor. He studies during the summer, successfully secures his contractor license, and decides to build a house. To finance it, he decides to use wealth in the house he already owns. He meets with a lender to set up an equity line of credit.

Since he has no history of earning income as a contractor, the lender will probably not provide a loan against his house. The lender would prefer not to risk the loan without a history of the borrower earning income as a contractor. Had he understood this while he was still a teacher, he could have set up an equity line of credit before making the career change.

I have spoken with hundreds of prospective borrowers who believed the value of their house would be there for the asking – only to realize that a career change, retirement, or other major change caused them to fail the "Character" test for accessing the wealth in their house.

- *Before retiring or making a career change, you should set up access to wealth you expect to need from the house.*

- *The primary obstacle for Character is a job history of two or more years in the same line of work or profession.*

Obstacle 2 - Capacity

Most of the second page of a standard loan application focuses on

Capacity, which pertains to income from jobs and investments. Maybe you've heard the old saying, "Cash is king." Unless you can pay cash in full for a property, however, *cash flow* is king.

Most debts have a monthly balance and monthly payments, either contractually with the same amount due each month (as in a car payment), or contractually with a percentage due each month (as in a credit card payment). The lender wants to know that your income will exceed your debts with a margin that offers assurance that you will keep your promise to repay any debts.

The key obstacle to Capacity relates to a specific ratio of debt to income. Lenders use a Capacity guideline which requires that you have income to cover your mortgage liability and your other liabilities based on a certain ratio. A common guideline ratio used by lenders is 28/36.

The top number is the percentage of income available for loan repayment. With a 28/36 ratio, your maximum monthly payment would be 28% of your monthly income. If you make $100,000 a year, 28% of that, or $28,000 ($2,333 per month) would be the most you could "afford" to pay for your mortgage loan, including taxes and insurance if the lender held tight to that guideline.

The bottom number is the percentage of your verifiable income that would have to be used to make all your debt payments in a timely manner. With a 28/36 ratio, your mortgage payment plus all other debts combined should not exceed 36% of your total gross income.

If you earn $100,000 a year, the 36% guideline would say that 36% of $100,000, or $36,000 ($3,000 per month) would be your maximum total monthly payments for your mortgage (including taxes and insurance), your car, credit cards, and any other debt payments, all combined.

You can see how interest rate fluctuations affect Capacity guidelines. If interest rates decrease, your payment will be a lower percentage of your total gross income, which could allow you to buy a more expensive house. As interest rates rise, a decreasing portion of the population can afford to buy a house, and fewer people can afford to enter the market.

A simple rule of thumb is that you can figure on borrowing up to four times your verified gross annual income. ("Verified" means income you report to the IRS.) For example, imagine that John and Mary Smith have a combined gross annual income of $100,000. Typically, they would qualify for a $400,000 mortgage if they have no liabilities. However, if their annual income is $50,000 and they own a house valued at $400,000, there is probably a Liquidity gap between the wealth in the house and the amount they can access based on Capacity.

Each lender uses its own criteria for loan approvals, but Capacity serves a role in determining how much the lender will allow you to borrow against the value in your house. Therefore, a rise or fall in your income affects your Liquidity.

To reduce the burden of Capacity, a lender may have "stated income programs" that require you to state the income you make without proof of current tax return. When one C is relaxed, expect a tightening of requirements for the other C's that could increase the interest rate cost, or reduce the amount of wealth available.

Here is an example: John Smith earns $25,000 per year, and Mary Smith earns $75,000. John's income is barely enough to cover the couple's childcare expenses, so they decide that John will quit his job to stay home with the children full time. Their combined income of $100,000 had been enough to qualify them for the $400,000 mortgage on their house. A year after John quits his job, a health emergency requires extra cash, and the Smiths need access to wealth in their house. The Capacity obstacle would limit their ability to access the wealth in the house, since their income has decreased to $75,000. Making payments on their current loan would be difficult, and a larger loan would be impossible.

- *Any change to income or expenses will change your Capacity ratio, and increase or decrease your ability to convert your house value to cash.*

- *The key obstacle for Capacity is the ability to show income that will support the mortgage and debt payments at a ratio suitable to the lender.*

Obstacle 3 - Collateral

Collateral is your down payment—the amount of money you invest in the house at the time of a purchase or refinance. The Collateral tied to a house is the value of the house minus any mortgages against the house. If the house is appreciating and the mortgage is being paid down, the lender's Collateral will continue to increase until the loan is paid off.

Lenders also consider Collateral outside the house—i.e., Collateral that is not tied to the house but that would support your ability to repay the loan. This is money you have available in your investments, non-qualified retirement accounts, checking and savings accounts, insurance cash value, and other liquid holdings. Collateral in the house and Collateral outside the house serve two different purposes.

The Collateral in the house helps protect the lender in the event of a foreclosure. Should you default on your payments, the process of foreclosure would give the lender use and control of the house and any Collateral in the house. The lender would sell the house to recover its money loaned to you.

Collateral outside the house helps you maintain use and control of your house indirectly. You can use it if needed to make house payments. The lender likes to see that you have Collateral outside the house to weather any financial storms that might come your way. If you exhaust your external Collateral and stop making mortgage payments, the lender will look to Collateral in the house to resolve the shortcoming through the foreclosure process.

Thus, a lender will look first at your job stability (Character), then at your income (Capacity), and, thirdly, at your down payment or equity (Collateral inside the house). Your Collateral outside the house is discretionary savings that would support your ability to make your mortgage payments.

If there are flaws in your job history (Character) and your income (Capacity), then a lender might require additional Collateral inside the house as a condition for loan approval. If you have great job history and great income, then a lender may require little to no Collateral inside the house. In that case, you would be free to decide how much to locate inside the house as a down payment.

Collateral in the house is more valuable to the lender. Collateral outside the house is more valuable to the borrower. If you were to default on your loan, the lender would have control over Collateral in the house. You and the lender share some of the same threats to Safety: (1) foreclosure (as the lender becomes the owner) and (2) depreciation (the value of the lender's collateral decreases).

Lenders look for balance among the C's. Having plenty of Collateral can help offset lack of Character and Capacity. High Character and Capacity ratings can help offset lack of Collateral inside the house. If you are retired and own a $200,000 house with no mortgage loan, you have 100% Collateral inside the house. Even without good Capacity, you might be able to convert 50% of the value of the house into cash through a new mortgage if you were seeking greater Liquidity.

- *The Collateral inside the house protects the lender first, while the Collateral outside the house protects you first.*

- *The 4 C's can help offset one another. Having plenty of Collateral can help offset lack of Character and Capacity. High Character and Capacity ratings can help offset lack of Collateral inside the house.*

- *The key obstacle for Collateral is a down payment located inside the house for direct security of the loan, or outside the house for reduced risk of default.*

While each of these three obstacles is important, the fourth obstacle, Credit, has become the most important single factor for Liquidity of wealth in the house.

Obstacle 4 - Credit

Your ability to repay mortgage debt on time is the lender's greatest single concern in approving a new mortgage loan or refinance. Credit is the greatest indicator of your ability and your willingness to repay in a timely manner.

The higher your Credit score, the lower the risk of payment default or delayed payment. Typical credit scores range from 400 to 900, with key milestones at 500, 620 and 720. The higher your score, the lower the statistical risk to the lender that you will not make your payment. The lower the risk, the lower the interest rate a lender may offer.

Credit measures your ability and willingness to repay your debts on time. Willingness is even more important than ability to repay, but both impact your Credit score. Many wealthy borrowers who have low Credit scores don't realize that making occasional late payments, over time, shows an unwillingness to pay in a timely manner. This can do great harm to their Credit. Someone with $1 million sitting in a checking account who forgets to pay on time can expect to receive the same Credit treatment as someone who has lost his or her job and missed a payment because he or she lacked the ability to pay on time.

Identity theft or a dramatic financial setback can also lower your Credit score enough to make borrowing difficult or impossible.

These days, it is more important than ever to monitor your Credit score on a regular basis if you want to borrow at the lowest possible interest. A good Credit rating helps maximize your use and control of the wealth in your house. High Credit scores translate to lower loan rates.

- *A decrease in your Credit score can be a primary obstacle to your use and control of the wealth in your house.*

- *Missed payments can hurt your Credit score over time.*

- *Identify theft or a dramatic financial setback can quickly reduce one's score to a level where borrowing is difficult or impossible.*

- *You should review your Credit score at least once a year.*

- *The key obstacle for Credit is a score that meets the minimum requirements of the lender.*

Chief Obstacles

If we look at life events that lead to a lack of Liquidity, we can focus on the four C's. The following is a list of common threats that can become obstacles to accessing wealth in the house.

Life Event*	Liquidity Obstacle:
Job Loss / Career Change	**Character**
Lawsuit Against You	
Forced Early Retirement	
Income Changes	**Capacity**
Disability	
Death	
House Value Changes	**Collateral**
Tax Lien	
Marriage / Divorce	
Identity Theft	**Credit**
Collection	
Judgment	
**some events impact several liquidity obstacles*	

Ironically, many of these life events accompany an increased need for Liquidity. Events that make accessing the wealth in the house a priority make it more difficult to access this wealth. John F. Kennedy is famous for saying, "The best time to repair the roof is when the sun is still shining." Your ability to get access to the wealth in your house when you most need it is challenged by guidelines that are designed to prevent access to money in the event of financial hardship that would create more risk to the lender.

From the perspective of Liquidity (the speed at which you can convert the wealth in your house to cash) there are conditions governing when, how, and even how much of the wealth in the house you can convert to cash. Wealth in the house is much less liquid than most other investments, and various life events can cause it to become totally illiquid. It is important to understand the obstacles to accessing that wealth for either necessity or opportunity.

The house is a safe investment, but not a guaranteed investment. The house is a Liquid investment, but the timing and conditions of selling the house, or borrowing against it, make the house one of your least Liquid investments.

Summary of Key Learnings

- Liquidity can be defined as the speed and ease in which you may convert your wealth to cash.

- Institutions control liquidity of different investment products based upon their desired purposes.

- There are only two reasons to borrow money; you need to or you choose to.

- A debtor borrows money because of necessity. A creditor is a debtor who borrows for financial opportunity.

- There are two ways to access wealth in a house; sell it or borrow against it.

- You lose use and control of the house when you sell it in exchange for cash.

- There are four primary obstacles when converting wealth in the house to cash by borrowing, referred to as the four Cs.

- Character can be an obstacle based upon your current and future ability to repay the debt.

- Capacity looks at specific ratios of debt to income. A common guideline is 28/36; the first being the ratio of the monthly mortgage payment to income and the second representing all monthly debt payments to income.

- Interest rate fluctuations can affect capacity.

- Collateral is the third obstacle. Collateral inside the house and collateral outside the house serve two different purposes.

- The lender is protected by the collateral inside the house. Collateral outside the house helps you maintain use and control of your house indirectly.

- Credit is the final obstacle to borrowing; the higher the credit score the lower the loan rate.

- Credit is the greatest indicator of your ability and your willingness to repay in a timely manner.

- A decrease in your credit score can be a primary obstacle to your use and control of the wealth in your house.

- Events in life can increase the need to access wealth in the house. These same events can also make it more difficult to access wealth in the house.

- The house is a safe investment, but not a guaranteed investment.

Chapter 7

Hidden Costs

"It is not from the benevolence of the butcher, or the baker, that we expect our dinner, but from their regard to their own self interest." -- Adam Smith

There are two primary ways owning a house will influence your net worth over your life time. The first is the appreciation or depreciation of the house itself, over which you have very little control, and the second is the approach you take to borrowing, over which you have a great deal of control.

One of the fundamental decisions of borrowing relates to whether to locate wealth inside or outside the house. The initial decision has no immediate impact on net worth, but the long term decision could have a tremendous impact on your future wealth. Wealth located inside the house saves you interest at the current net after tax cost of borrowing. Wealth outside the house earns interest or grows at some relative net after tax return on the investment. Ultimately, the decision to pay down principal

on your mortgage or take cash out can be driven by short term cash flow needs, or by a longer term desire to maximize wealth.

How can you manage the principal in your house to maximize wealth creation? We must examine the cost of wealth that is located either inside or outside the house. We must also explore two associated concepts, which we'll call Market Risk and Discipline Risk. Understanding these concepts will help you answer the following questions:

- *Should I pay off my house using bi-weekly loan payments instead of monthly payments?*
- *Should I convert from a 30-year to a 15-Year fixed mortgage?*
- *Should I use my inheritance to prepay all or a portion of my mortgage?*
- *If I own a house with no mortgage, should I take out a mortgage on the house and invest the money elsewhere?*
- *Should I pay cash for a house?*
- *Should we use house equity to help pay for our children's education?*
- *When buying a new car, is it better to use house equity, pay cash, or use dealer financing?*

All of these questions involve decisions about locating wealth inside or outside your house. To help you make those decisions, I offer a simple concept called EPR™, or Effective Percentage Rate.

Understanding EPR™

The wealth in the house does not earn a specific Return based on appreciation or depreciation, as appreciation or depreciation operate independently of the wealth located in the house. However, wealth in the

house reduces current borrowing needs, and as such, it reduces lender interest charges. This is where EPR™ comes into play. EPR™ is the net cost of interest based on the location of the money. Remember it's all about location, location, location.

If you borrow money on a credit card at a 12% annual rate of interest, the credit card company will earn a 12% Return. You are paying the credit card lender 12% interest in exchange for the use of their money. The EPR™ for using credit card debt is 12%.

When you borrow money using the house as collateral, the interest you pay may be tax-deductible. When you borrow money against the value of your house at 7%, the lender will earn a 7% Return. If you are in a 32% federal and state tax bracket, and your interest is tax-deductible, then the government will subsidize 32% of your interest burden. Thus, the net amount of interest you pay is reduced by 32% of the 7%. Since 32% of 7% is 2.24%, your actual cost of borrowing is 7% minus 2.24%, or 4.76%. In effect, paying 7% interest costs you only 4.76% on an after tax basis. The government provides these tax benefits to encourage house ownership.

EPR™ of Borrowing				
	Nominal Rate	**Tax Bracket**	**Tax-Favored**	**EPR™**
Credit Card	10%	32%	No	10%
Auto Loan	8%	32%	No	8%
Mortgage	7%	32%	Yes	4.76%

Wealth located inside the house eliminates interest that you would pay the lender for the use and control of the lender's money. The interest you save can be measured through EPR™. If your EPR™ is 4.76% for your current mortgage, money you locate inside the house saves you the 4.76% in annual interest cost. In this way you can understand that while wealth in the house earns no direct Return based on the appreciation or depreciation of the house investment, it does have a Return based on your individual interest rate and tax situation. This also means that money that

you locate outside the house carries a 4.76% cost.

By using EPR™ as a guide, we can more readily identify a hidden cost that might have been otherwise difficult to see.

A Hidden-Cost Parable

Nineteenth-century French economist Frederic Bastiat published a parable that describes a shopkeeper whose window is broken by a young boy. The people sympathize with the man whose window was broken, but soon they start to suggest that the broken window makes work for the glazier, who will then buy bread, benefitting the baker, who will then buy shoes, benefitting the cobbler, and so on. Finally, the onlookers conclude that the boy was not guilty of vandalism; instead he was a public benefactor who created economic benefits for nearly everyone in town.

Such benefits to the town were an illusion, in the way that someone without a mortgage believes that they are significantly better off financially than someone with a mortgage. This may not be the case. We would ideally locate our wealth relative to the highest and best use. A decision based on many things, but one that includes EPR™. This allows us to create a simple, repeatable process for borrowing decisions. The concept of using EPR™ will make it easier to quickly determine the cost of locating our money inside or outside the house. This can be very helpful when you need to make complex decisions quickly related to your borrowing.

In Bastiat's parable, imagine that the shopkeeper spends $20 to repair the broken window. After the window is replaced, his net gain is the same window he had originally. If the window hadn't been broken, the $20 could have purchased bread and shoes, benefitting both the baker and shopkeeper, resulting in true economic benefit. Or, the shopkeeper could have invested the $20 to earn interest over the years to come. Therefore, the townspeople misunderstood the Hidden Cost of replacing the window.

In much the same way, many of us with a mortgage believe that the mortgage should be paid off before we start getting serious about saving. However, that approach has some hidden costs. For one thing, it means

losing time to allow investment earnings to compound.

What can the parable of the broken window teach us about the Hidden Cost involving wealth in the house?

Through The Fog

Is it possible for you to borrow at 7% and invest at 7% and still increase your wealth? The answer depends on your individual situation. If your net (after-tax) cost of borrowing is 7% and your net (after-tax) benefit of investing is 7%, then the benefit of borrowing is purely one of Safety and Liquidity – having wealth where you want it and available when you need it. If your net (after-tax) cost of borrowing is 5% and your net (after-tax) benefit of investing is 7%, then the benefit of borrowing would increase your net worth over time.

Imagine that you invest $1,000 each month over a 30-year period and earn a 7% average annual Return net after taxes. During the same 30-year period, you could have made additional contributions of $1,000 to prepay your mortgage. In other words you could save 4.76% by prepaying when you could have earned 7% by investing. That lost benefit is a cost that often remains hidden.

Thus, putting the money into your investment instead of using it to prepay a mortgage could boost your earnings by 2.24% (7% minus 4.76% = 2.24%). A 2.24% difference compounded over 30 years can make a big difference in the amount of wealth you accumulate.

Wealth Growing Inside or Outside		
Amount Invested:	**$1,000 monthly**	**$1,000 monthly**
Return:	4.76%*	7%*
Term:	30 years	30 years
Growth:	$850,650	$1,328,259
		**assumes an after tax rate of return*

Calculating EPR™

Calculating your EPR™ is very simple, and it's a necessity for managing present and future decisions about the location of your wealth. Here's how to do it:

- *Step 1: List all of your liabilities on the following chart by Liability Name first. Then insert the interest rate you are paying into the appropriate column, put interest rates for your mortgage, equity loans or other debt you know to be deductible in the Tax Deductible column. Insert the interest rates of other liabilities under the Not Tax Deductible column. These may include credit card debt, a car loan, equity line if you trigger AMT, mortgage loans if you don't itemize, and other consumer loans. Leave the EPR™* column blank for now.

EPR™ Worksheet			
Not Tax Deductible	**Liability Name**	**Tax Deductible**	**EPR™**
	First Mortgage	7.25	4.93%
8.00	Auto Loan		
Insert Your Liabilities Here			

Step 2. Use the following chart to estimate your marginal federal tax bracket based on your gross income. Then, add your state tax rate. The total is your state and federal marginal tax bracket. When you save money

from itemized deductions, it comes off your highest tax bracket. If you are married filing jointly and have combined income of $100,000, you would be in a 25% federal bracket. If your state tax rate is 7%, then add together for a total of 32% as your marginal rate.

2006 Federal Income Tax Brackets

Marginal Tax Rate	Single	Married Filing Jointly	Married Filing Separately	Head of Household
10%	$0-$7,550	$0-$15,100	$0-$7,550	$0-$10,750
15%	$7,551-30,650	$15,101-61,300	$7,551-30,650	$10,751-41,050
25%	$30,651-74,200	$61,301-123,700	$30,651-61,850	$41,051-106,000
28%	$74,201-154,800	$123,701-188,450	$61,851-94,225	$106,001-171,650
33%	$154,801-336,550	$188,451-336,550	$94,226-168,275	$171,651-336,550
35%	$336,551+	$336,551+	$168,276+	$336,551+

**or Qualified Widow(er)*

- *Step 3. Go back to your EPR™ chart. Apply all of your listings in the Tax Deductible column to the following EPR™ formula:*

1. Remove the percentage sign. If your mortgage interest rate is 7.25%, use 7.25.
2. Multiply this number by your state and federal marginal tax bracket. For example, if your marginal tax bracket is 32% this year and your interest rate is 7.25%, then multiply 7.25 X .32 = 2.32. The total is your tax savings. Your tax savings reduces your cost of borrowing.
3. Take the tax savings (2.32 in the example), and subtract from your step 1 total (7.25 in the sample). The total is your EPR™ (your estimated cost of borrowing). In this sample, 7.25 – 2.32 = 4.93, so 4.93% is your EPR™.
4. In the EPR™ column of the chart, write the EPR™ for each item in the left-hand column.

By listing your liabilities and calculating their EPR™, you can better understand Hidden Cost opportunities.

What if you realize that you are carrying a credit card balance at 12%, and prepaying your mortgage to save 4%? You could increase your Return by 8% by paying your credit card first.

What if your company matches your 401(k) contribution by 25%? Imagine that you are contributing $300 each month to the 401(k) and prepaying your mortgage by an extra $200 per month. You have one foot on the gas, and one foot on the brake. Prepaying your mortgage saves you 4.93%, but an investment in your 401(k) earns you 25% from your employer plus the investment Return on the account. You would be better off contributing the extra $200 per month to the 401(k) instead of prepaying the mortgage.

- *The EPR™ of money borrowed for a house is reduced by the tax deductible portion of the interest paid.*

- *The EPR™ of money borrowed for credit cards, auto loans, and personal loans is not reduced by the borrower's tax bracket. Interest on consumer loans is not tax-deductible.*

What if you have a house with no mortgage? The calculation is the same. You would use the current market interest rate for a mortgage. If you could gain use and control of wealth related to your house by borrowing at 7.25% and you are in a 32% tax bracket, then

Interest Savings With No Mortgage
7.25 X .32 = 2.32
7.25 - 2.32 = 4.93 EPR™

Having your house paid off saves you interest of 4.93% based on current market rates. You are saving interest of 4.93% that you would pay to a

lender if you had a mortgage. If your alternative is an investment with an after-tax Return of 8%, then your decision to locate wealth in the house has a Hidden Cost of 3.07%.

When to Invest House Wealth

Sometimes it makes sense to locate wealth outside the house for Safety and Liquidity reasons. If the primary reason to relocate wealth is for increased Return, you would have to identify investments that you expect would earn a higher Return than your cost of borrowing.

The Safety, Liquidity, and Return of different investments can vary considerably. If you are contemplating a relocation of wealth, consider working with a financial advisor to assess the suitability of investments that provide the right mix of Safety, Liquidity and Return. Also, when analyzing a relocation of wealth outside the house, consider the importance of Market Risk and Discipline Risk on your final decision.

Market Risk

Market Risk is the risk that your Return on money moved outside the house could earn less than your net cost of borrowing. If your net cost of borrowing is 4.76%, then principal located outside the house must earn at least 4.76% to maintain your relative net worth. Given that 4.76% inside the house is essentially a guaranteed Return, you should generally expect to earn a higher rate on investments outside the house to compensate for the higher Market Risk.

Wealth outside the house can be lost through market conditions, changing interest rates, or poor investment decisions. Any money invested outside the house will be exposed to some Market Risk in order to increase its potential Safety, Liquidity and Return.

- *Wealth outside the house must earn a Return to offset the cost of having that money outside the house.*

- *Wealth outside the house will have some Market Risk that is different from wealth left inside the house.*

Discipline Risk

Discipline Risk is the risk that the ease with which you may access your wealth could increase your chances of spending money that you might otherwise have not spent. With increased Liquidity comes increased use and control. If you lack financial self-discipline and spend money you had intended to save, you are undermining your choice to move principal outside the house to build greater wealth. The less self-discipline you have with your money, the more you need to consider Discipline Risk as a factor in your wealth-building strategy.

An advisor can be of great service in helping to minimize Discipline Risk. If you think you would be more likely to spend money if you move it outside the house, you should either leave the money inside the house or consider adopting an automated savings system or direct payroll savings deduction. Instead of a monthly savings, a lump sum could be made. Alternatively, you could establish an agreement with your financial advisor stipulating that he or she will "approve" any spending from an account that you've set up solely to pay off your house. The ability to save money that you don't need, and or want to spend is an important discipline for Retiring Rich.

- *If you spend the money that would otherwise be part of your future house wealth, you would have been better off leaving that money inside the house.*

Summary of Key Learnings

- There are two ways owning a house can influence your net worth: either appreciation/depreciation and the way you manage your mortgage. You have little control over the first but a great deal of control with the second.

- The Effective Percentage Rate (EPR) can be used to help solve many difficult decisions regarding mortgage choices.

- The EPR of money borrowed for a house is reduced by the borrower's tax bracket. It can be tax- favorable.

- The EPR for credit cards, auto loans, and personal loans is not reduced by the borrower's tax bracket. It is not tax-favorable.

- Wealth located in the house saves you interest at the current net after-tax cost of borrowing.

- If money outside the house is spent it will not generate future wealth.

- When you decide whether to locate money inside or outside the house, if the EPRs are the same then your decision should be based upon your preferences for Safety and Liquidity.

Co-Author Biography

Jim Kuhner is the owner of Wealth Education Strategies, LLC, a company dedicated to providing financial education. Jim is a faculty member with the prestigious National Institute of Financial Education (www.niofe.org). He teaches Borrow Smart workshops to consumers and continuing education courses for realtors, CPAs, CFPs and HR departments. Jim offers special training in the convergence of asset and liability management and provides a unique approach to building wealth. He is a leading provider of strategy, content, tools and education in eliminating unnecessary wealth transfers.

In 1981, he left a very successful advertising career to enter the insurance industry as a state manager for a specialty health insurance carrier. In addition to his teaching with the National Institute of Financial Education, he provides clients with solutions for retirement income, employee benefits, IRA distribution strategies and estate planning execution. Published in several industry publications, including Agent Sales Journal, he recently co-authored the book titled Stop Sitting on Your Assets. Jim is a graduate of the Borrow Smart University; Ed Slott's Advanced IRA Distribution Training, the Circle of Wealth Mentor Program, Certified College Planning Specialist, and is a Certified Liability Advisor.

Jim and his team at Wealth Education Strategies, LLC are waiting to help change your life. For a personal evaluation of your financial situation, please visit **www.jimkuhner.com**.