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Wealth Management

Retirement for Small Firms

Paying down your mortgage may not be the best planning strategy

By Dave Muti

You work in a solo practice or a small firm and as a result you don't have access to traditional 401(k)s or other qualified plans because they are too expensive to administer. Your retirement planning is left up to you, so your default strategy consists of having your house paid in full by the time you retire. Sound familiar? I know because that was my strategy when I was a partner in a small firm (in the last millennium) before changing careers. This approach sounds okay but the problem is the money you use to pay down your mortgage (a.k.a. Home Equity) earns a ZERO percent rate of return. You would not invest money in a mutual fund or with a money manager that advertises a zero percent rate of return, so why put it into the walls of your home? To make matters worse, this money you are using to pay down your mortgage is not earning money in other investments, so you are actually losing money. In addition, once you pay off

Muti, an attorney, is a Senior Mortgage Planner with Millenium Home Mortgage, LLC, and the President of Forgiven Equity, Inc.

your house it will not provide you with a retirement income; wasn't that the reason you were doing it in the first place?

Paying down your mortgage is not the best approach to creating wealth. In fact, that exact query was the cornerstone of a joint study published in August 2006 by the Federal Reserve Bank of Chicago, The University of Michigan at Ann Arbor and The University of Texas at Austin (www.chicagofed.org/publications/workingpapers/wp2006_05.pdf).

This study, titled "The Tradeoff between Mortgage Prepayments and Tax-Deferred Retirement Savings" (the Study), determined that at least 38 percent of all households are losing between 11 and 17 percent in "misallocated savings" by choosing to pay down their mortgage rather than directing the funds to a tax-deferred account. On page two of the study, the authors state "it is difficult to identify rational reasons for the inefficient behavior of people making this wrong choice." The authors place the rationale for this inefficient behavior as "risk aversion." They go on to state they believe people make this wrong choice because they simply have been misled and that they are not aware of these concepts. In

short, most Americans are stuck in traditional thinking towards creating wealth and retirement planning.

Those authors were not the first to write about this strategy but they are certainly some of the most prestigious. During the last decade, several authors began presenting strategies that focus on using your mortgage to make money and converting your home's equity into tax-free retirement income. These strategies have been used by the wealthy for decades and now give the average American the chance to duplicate how the rich get richer.

In 2000, one of these authors, Ric Edelman, wrote *Ordinary People, Extraordinary Wealth*. On page 12 of this book, Mr. Edelman writes "Carrying a mortgage doesn't cause you to lose money at all, just the opposite is true. Carrying a mortgage is actually quite profitable. It's eliminating the mortgage that forces you to give up profitable opportunities." These lost opportunities are what are known as opportunity costs. This means that for every dollar you direct towards reducing the principal of your mortgage, you have lost the opportunity to invest that dollar elsewhere.

While the authors of the Study and Mr. Edelman focus on the pitfalls of paying down your mortgage, what if you've already paid it down substantially or even paid it off? Now you are house rich and cash poor: the ailment

that many Americans suffer from. The good news is that there is an antidote: you can convert your home equity into wealth and instantly catch up or even get ahead with your retirement funds.

Two authors have dedicated entire books to this "catch up" strategy, *Missed Fortune*, published in 2002 by Douglas Andrew, is 535 pages and is full of all sorts of charts and graphs for the analytical type. If you prefer a lighter version, at 318 pages with some cartoons, I suggest you read *Stop Sitting On Your Assets*, by Marian Snow (March 2007). This latter one does a great job of comparing three different approaches to retirement planning in the epilogue. If you are really short on attention or time, just read the epilogue, as it is only 30 pages and it will send a chill down your spine.

These two authors focus their entire books on turning your home's equity into a retirement account that not only far outperforms any traditional planning methods but does so in a tax-free environment during the growth years as well as the withdrawal years. What if you could lump sum your retirement to catch up?

The accompanying charts are two possible scenarios if you were to repo-

sition \$100,000 or \$200,000 of your home equity versus saving \$6,000 or \$12,000 respectively per year in a tax-deferred account. I used the \$6,000 and \$12,000 figures for the annual contributions because that is roughly the cost to borrow the money from your home. All returns assume an 8 percent return over the life of the investment.

Using these examples, you can see why we call it "lump summing your retirement account and forgetting about it." By repositioning your equity once, you can secure your retirement and sleep well at night knowing you will have the money when you need it. You will not be relying on good intentions of monthly or yearly contributions, if you have money left over to make them. In addition, by lump summing it versus making annual contributions, you will earn 37 percent more over the 30 years for the same out-of-pocket expense. If you are able to earn a 10 percent return on your investments, then the difference over the 30 years increases to 60 percent. No matter how you look at it, lump summing your retirement takes the worry away and it performs better.

Do you have access to a retirement plan? If no, then may this be your solu-

tion? If yes, do you wish you could sock away more? Have you missed any retirement contributions? Did you start late and now are trying and hoping to catch up? Look at your current track record. If your retirement outlook is not where it needs to be, this may be the solution for you. I refer to this strategy as entering another horse in the race to retirement. It is a second horse because your house will still appreciate in step with the market but now you've taken your dead money from its walls and put it to work.

So now you're wondering: what should you do? Is it possible for you to actually catch up and even start dreaming about retiring again? It all depends upon your specific set of circumstances, but my suggestion is that you consider a nontraditional path since traditional methods do not work for most. At the very least go to Amazon.com, purchase one of the books I referenced and learn more about how to build a more secure retirement. This article focused on a nonconventional way of looking at and creating an instant retirement fund, even if you are starting late in the game. You can catch up. Remember, different is not always better, but better is always different. ■

\$100,000 lump sum vs \$6,000 per year			\$200,000 lump sum vs \$12,000 per year		
rate of return added at the end of the year			rate of return added at the end of the year		
Lump Sum	Year	Annual	Lump Sum	Year	Annual
\$108,000.00	1	\$6,480.00	\$216,000.00	1	\$12,960.00
\$146,932.81	5	\$38,015.57	\$293,865.62	5	\$76,031.15
\$215,892.50	10	\$93,872.92	\$431,785.00	10	\$187,745.85
\$317,216.91	15	\$175,945.70	\$634,433.82	15	\$351,891.40
\$466,095.71	20	\$296,537.53	\$932,191.43	20	\$593,075.06
\$684,847.52	25	\$473,726.49	\$1,369,695.04	25	\$947,452.98
\$1,006,265.69	30	\$734,075.21	\$2,012,531.38	30	\$1,468,150.42