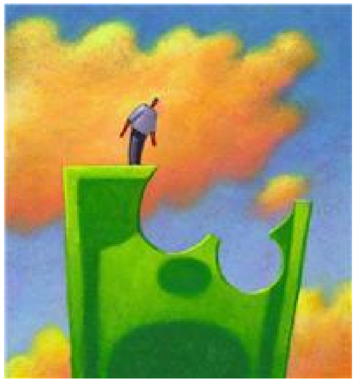
Avoid the 5 Most Common Mortgage Mistakes

If you own a home you may have already made an error that could cost you tens of thousands over the life of your financing. The good news is that once you become aware of the 5 Most Common Mortgage Mistakes that occur over and over you can adjust your personal planning to avoid similar mistakes happening to you.



The basis of this white paper is the fact that most people make financial decisions in isolation, often without regard to other important goals, like building reserves, planning properly for college expenses for our kids or understand what our retirement lifestyle will look like based on our current savings and investment patterns (or lack thereof).

It is often said that our largest asset is our home and largest debt is the mortgage on that asset-however it is clear that for many people the amount of time taken with analyzing this investment of money, time, energy and monthly cash flow is often less than we might take to plan our summer vacation, Thanksgiving dinner or our kids next birthday party!

This paper explores the larger concept of **Borrowing Smart™ and Repaying Smart™** – the decisions we make regarding how/when/why we borrow and how we choose to repay the debt has everything to do with how successful we will be in achieving our other financial needs and goals. The paper starts with Cash Flow, moves on to understanding Lifestyle and then how to develop a Borrow Smart – Repay Smart™ Strategic plan while understanding Savings, Borrowing and EPR™ (Effective Percentage Rate).

BUT – it starts with understanding the **5 Most Common Mortgage Mistakes** made by homeowners in all walks of life.

1) **The 30Yr versus 15Yr Mistake** – Intuitively we feel that debt is bad so we make a concerted effort to shorten the term of the money we borrow by opting for shorter term mortgages (15 yr. & 20 yr.) versus a 30 year term. The lower rate and shorter term and forced early repayment feels good and it seems we are making a smart financial decision. Since we are making larger payments there is even the feeling of personal sacrifice that makes our psyche hum and feel good. However, a shorter term mortgage has a few disadvantages that are often overlooked. First is cash flow (which will be explored in more detail later in this paper) along the potential loss of tax benefit and finally the opportunity cost associated with of both items over the entire term of the mortgage. A simple strategic Borrow Smart™ plan put in place at the beginning of a longer term mortgage that takes into account personal planning around EPR™ (another concept later in this paper). A commitment to cash flow discipline will often result in the ability to have the mortgage paid off earlier from other assets than paying the shorter term mortgage. In addition, a Borrow Smart™ plan could add tens of thousands of dollars of wealth to most financial portfolios using the same cash flow and provides opportunities over a lifetime for other important financial goals.

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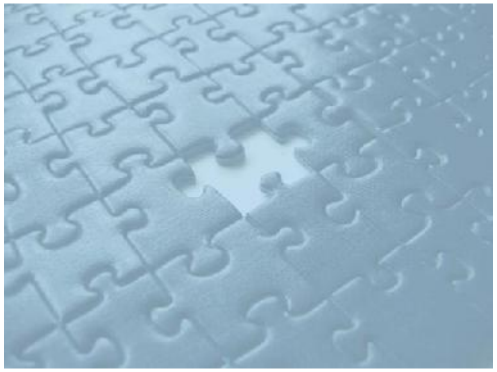
2) **Down or Debt Mistake** – A decision many home buyers make as they prepare to purchase a home is to save aggressively for a larger down payment with the belief that a larger down payment is good and will save lots of money over time. And certainly someone that borrows less money will pay less in interest for their borrowing over time – but at what cost? In an effort to save for a down payment, other debt does not get paid down or other financial goals are put to the side (like stopping pre-tax contributions to retirement plans). We have found that given the relatively low cost of mortgage borrowing for most borrowers a better financial choice would be to pay off all consumer debt with savings or even GIFT cash and go with a mortgage program that allows a lower down payment. This has the impact of reducing overall cash flow commitments freeing up funds to prepay any remaining higher interest debt, build additional reserves and create an overall Borrow Smart™– Repay Smart™ plan to reduce the cost of all borrowing and reach a personal Freedom Point sooner.

3) **Accelerated Prepayment Method** – there are plenty of folks advising homeowners on various methods of mortgage prepayment: Bi-Weekly, 13 payments a year, rounding up your payment. And in many cases, third party firms are collecting fees to provide these accelerated prepayment programs, partially negating the benefit of the additional prepayment. First, if you choose to prepay a mortgage there is no benefit at all to pay a third party firm to collect payments twice a month and send them to your loan servicer – you can do the same thing yourself! Some people like the idea of matching paychecks every two weeks with a mortgage payment every two weeks – making half your mortgage payment every two weeks results in 26 half-payments per year or 13 full payments – you can achieve the same accelerated amortization by dividing your monthly payment by 12 and adding that amount to each monthly payment. As far as matching payments to paychecks set up an auto draft to a savings account from each paycheck and then a single monthly auto-pay to your loan servicer – if you don't add the 1/12th of a payment to your monthly mortgage payment your savings account will have exactly one month's payment in it (plus interest earned). THEN Using EPR to help make a Repay Smart decision on the best use of cash and cash flow will determine if you should accelerate your mortgage payment!

4) **Borrowing Amount** – Mortgage lenders work in the world of eligibility and offer programs and approvals designed to match what a borrower says they want to borrow. Financial advisers work in the world of suitability – one in which risk tolerance and other goals are explored. A decision on how much mortgage to borrow should cross through both these areas. Many borrowers tend to max out their borrowing capacity, hurting them in the long run as they work to build wealth in other areas. On the other side of the spectrum there are borrowers who actually do not borrow enough, which affects the pace with which they can reach a Freedom point through an effective Borrow Smart™ – Repay Smart™ plan. Access to the correct amount of leverage is key to deploying assets in a balanced and strategic way. The amount to borrow is clearly a deeply

personal decision and there is no right or wrong answer. The best answer is one in which the borrower has a complete understanding of their personal risk tolerance, short and long term financial goals and how to use leverage to achieve those goals. Finding a trusted Mortgage advisor that can assist in developing this personal understanding is critical to success in avoiding this common mortgage mistake.

5) **Protecting Wealth** – If we look at the balance sheet of many households we discover that their largest wealth line item is the equity in their home. More than 30% of homeowners have more wealth in their homes than all other locations combined – we find this to be especially true for those that bought homes 2-3 decades ago and are moving into the pre-retirement phase of their lives. However, unlike most other wealth there is not an effective way of protecting that wealth – its value is controlled almost entirely by factors beyond the homeowners control, things like market forces influenced by politics, local projects, worldwide catastrophes and the whims of Federal Reserve officials. Developing a strategy to protect this wealth from market downturns is relatively simple. Every homeowner should have a Home Equity Line of Credit in place for the maximum amount they can borrow based on their eligibility and market availability – and this should be adjusted periodically to account for changes in income and value. A recent nationwide downturn in values created financial havoc for those that were counting on the wealth inside their homes for other goals! Avoiding that mistake in the future will be easier.



6) **Bonus – Management/Wealth Team** – Finding a trusted advisor in any financial area is incredibly powerful, whether that is a CPA, attorney, financial advisor, Realtor or insurance professional. Knowing that there are folks that focus on a specific area of competency and are willing to share that knowledge and expertise can accelerate one towards achieving goals. We all understand the idea of mentoring and coaching and developing a team to help us achieve our goals would seem to be a natural given. That being said, only a small percentage of people ever reach out and develop 1-2 trusted relationships, let alone build a Wealth Team around them. Simple to understand but not easy to do – but we can all look around us and learn from the most successful people we know and know that they have a Team supporting them in their drive to achieve their personal goals – don't let not building a Wealth Team be one of your mistakes!

Manage Cash and Cash Flow

What is cash? Cash is a legal tender used to buy goods or services now. It is liquid money you can spend today. What is cash flow? Cash flow is the pattern of income you expect each month. Expenses are the pattern of cash that flows out on a regular basis. Pattern? The majority of your income and expenses flow in and out on a fairly predictable pattern, with an occasional financial surprise.

CONSIDERATION – Cash and cash flow management are crucial to financial independence. If you save your way to wealth, cash flow management determines how long it takes to reach your future wealth goals. If you inherit or marry wealth, cash flow management determines how long you'll retain that wealth.

Practically speaking, cash typically enters your life as income from your work, or from cash you've already saved. It often arrives as a direct deposit into your checking or savings account until needed. We rarely use large sums of paper cash in our daily lives – it's impractical physically, and unsafe. Major bills can be paid with online bill pay services, and daily spending can be managed through the convenience of credit cards. Bill pay and credit cards provide a record of spending that make your spending patterns visible, while providing liquidity in a convenient and safe format.

Cash Management

Simple awareness of your current cash and cash flow situation is the most powerful first step toward building wealth. If your monthly cash flow exceeds your monthly expenses; you'll either borrow or utilize current savings to make up the shortfall. If incoming cash flow exceeds expenses, you'll have the choice to repay current borrowing or increase current savings.

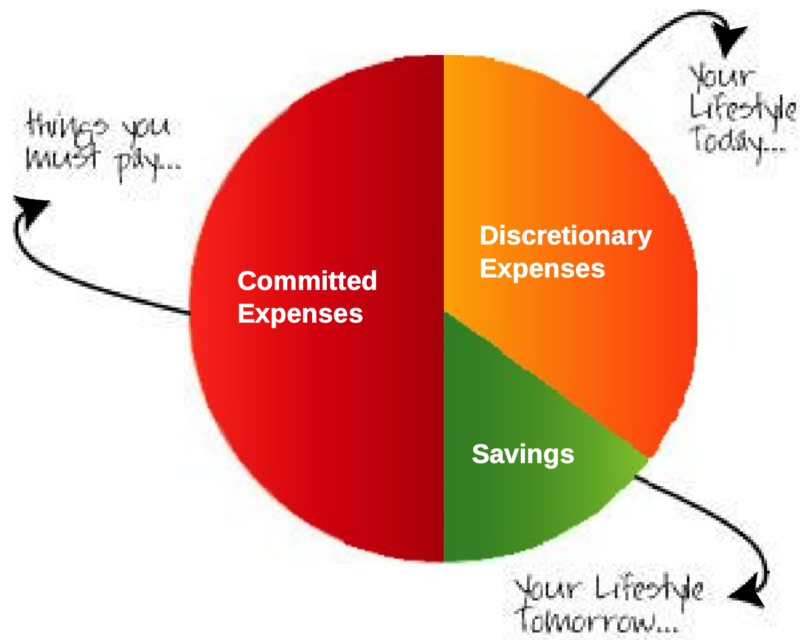
CONSIDERATION – Managing cash and cash flow gives you exclusive access to two of the most powerful wealth creation tools; borrowing and investing.

Using a single account for daily expenses with a credit card for each spouse makes this awareness a breeze.

Borrow Smart™ - Repay Smart™

Balancing Lifestyle Today with Lifestyle Tomorrow

Most Americans have about 50% of their income each month already committed to expenses such as taxes, insurance, housing, interest, withholding, etc. This leaves about 50% of our income as Discretionary income for our Lifestyle Today. We know if we spend all our Discretionary income on our Lifestyle Today, we'll never reach a dream of financial independence for our Lifestyle Tomorrow.



Financial independence is that point where passive income from savings exceeds your current expenses, the point at which work becomes truly optional. To build up savings over time a portion of your Discretionary cash flow today must be saved for your Lifestyle Tomorrow. Finding this balance in your cash and cash flow management is about finding a balance between your Lifestyle Today and your Lifestyle Tomorrow.

> **CONSIDERATION** – Our largest Committed expense is housing – and the first place to look for savings that can be used to increase our Lifestyle Today or our Lifestyle Tomorrow.

The Financial Surprise

On your financial journey, unexpected life events can dramatically impact your progress. Proper planning can diminish a catastrophic disruption to your Lifestyle Today and your Lifestyle Tomorrow if you build a reserve that can provide liquidity for a financial surprise. Three to six months current income is a typical liquidity buffer for most financial surprises. Saving for a catastrophic event like a house fire, a car wreck, a job disability, a job loss, a family illness, would often take too long. Consider using Discretionary current cash flow to buy insurance to protect from the larger losses that would negatively impact your future financial independence

Manage Cash and Cash Flow – Quick Summary of Key Concepts

Establish a cash and cash flow management system with a single checking account and credit card. As cash begins to accumulate, build cash reserves equal to three to six months of your current income and purchase insurance to protect yourself from catastrophic financial events. As you master these first steps, you'll be able to better use borrowing and saving to enhance your Lifestyle Today and your Lifestyle Tomorrow.

Manage Cash and Cash Flow – Quick Summary of Key Action Steps

- ☐ Set up a single account for direct deposit and all primary spending.
- ☐ Set up a second money market account to use for the six month savings.
- ☐ Utilize bill pay to automate major recurring expenses and protect your credit scores.
- ☐ Utilize credit card(s) for day to day expenses to provide better tracking.
- ☐ Review your insurance to make sure you have adequate coverage of life, health, auto, home, disability.
- ☐ Set up a personal account at www.mint.com and begin your cash flow awareness.

Borrow Smart™

Borrow or Pay Cash?

CONSIDERATION – Use a 12 month rule. If you can save for it in 12 months or less, purchase it with your credit card only when you can pay the balance in full. If it takes more than 12 months – consider a loan.

Most living expenses can be serviced with available monthly cash flow, but larger needs; such as a new television, couch, car or house put demands on immediate cash flow that requires some delayed gratification. Credit cards are a wonderful convenience tool for those who have money now, but using credit cards to finance a Lifestyle Today that you can't afford isn't smart borrowing.

When you borrow you pledge your future time and energy to use someone's cash today. You are essentially financing your Lifestyle Today with work you'll do tomorrow. The high interest rates of short term borrowing stunt your financial progress as time and compounding work against you. Consider borrowing only when you need longer term financing at lower interest rates - when saving cash to purchase something simply isn't practical.

Many Americans report their first major savings efforts were to buy a first car or house. Buying a car is often critical to mobility and income, and requires financing – yet the car asset depreciates quickly. A house is equally critical as shelter, and one of the few opportunities where borrowing at a low interest rate, with current tax benefits, and long term appreciation may increase your wealth as compared to renting. You would rarely save cash to buy your first house. Let's discuss how to Borrow Smart™.

Learning How to Borrow Smart™

Understanding when and how to borrow is the foundation of learning to Borrow Smart™. We've developed a 4-Step checklist based on: ***Product, Payment, Availability and Amount***. Let's review each step in more detail based on a $300,000 loan.

Product – The loan Product provides interest rate protection at the lowest possible cost. You expect to live in a house for 5 years. The fixed rate for 30 years is available at 5.5%, but a fixed rate for 5 years is available at 5%. Example: You'll have the same interest rate protection over the first 5 years with either product, but you'll pay $93 per month less for the Product fixed for 5 years.

Payment – The loan Payment determines how you repay the loan in the most efficient way possible. Choose an amortizing loan and you'll pay principal and interest each month. Choose an interest only loan and you'll pay only the interest each month. Example: You choose a 5 year fixed Product to save interest and an interest only Payment to give yourself control of your principal - your payment drops by $453 per month.

Availability – The loan Availability is determined first by what you could access today based on your current house value, income, credit and lending guidelines. Availability changes constantly. When it's time to purchase or refinance a house consider Availability now for current and future needs. Example: Your house is worth $400,000, you have good credit, income and based on 80% lending guidelines you can borrow up to $320,000 – that's your current Availability.

Amount – The loan Amount is how much you choose to borrow based on your Availability. This is true whether you purchase or refinance. If you know your availability is $320,000, and you currently have a balance of $220,000, then you'll decide on a loan amount between $220,000 and $320,000. Example: You have a child starting college in 2 years, and choose to borrow $320,000 to provide cash out of $100,000 for college funding. Because you chose the 5 year interest only loan Product, your Payment still goes down by $36 a month after borrowing an additional $100,000 from your Availability for college funding.

Working through these 4-Steps will create opportunities for you to better manage your liabilities, and reduce your overall cost of borrowing. Your advisor may help you with additional steps to further decrease your cost.

The House –vs- Home Obstacle

Home is the emotional experience you have living in a house. The house is the actual physical shelter. Its real estate; and it will have a positive or negative impact on your wealth based on how you choose to manage it. Don't let the emotional aspects of home get in the way of the practical considerations of owning a house. Consider that your balance sheet is really 3-sided. You have assets, liabilities, and real estate (both an asset and a liability). Build a solid team to support your goals - utilize a licensed and trained Financial Advisor, Loan Officer and Realtor to best manage your assets, liabilities, and real estate.

Borrow Smart™ – Quick Summary of Key Concepts

Knowing when to borrow and when to pay cash is a key step in building wealth. Once you decide to borrow, Borrow Smart™. Consider a fully integrated approach to managing all 3-sides of your balance sheet using the cash and liability management tools available through your advice team.

Borrow Smart™ – Quick Summary of Key Action Steps

- ◻ Save and pay cash for current Lifestyle Today needs.
- ◻ Use credit cards as a convenience; don't finance your lifestyle today with future earnings.
- ◻ Borrow for larger items that would be difficult to save for, like a car or house.
- ◻ When borrowing for a house, consider the Product, Payment, Availability and Amount.
- ◻ Don't let the emotional idea of home get in the way of practical aspects of managing your house.
- ◻ Review your current situation annually to see where new opportunities may exist.

Save Smart™

Repay or Invest?

The decision to repay prior borrowing, or save wisely for the future can be a challenging. Let's first consider the difference between rate and return. Rate and return are really the same thing from two different perspectives? When you borrow money you focus on the rate, the lower the better, because the rate is what you have to pay to a lender to use their money. The rate you pay is their return. When you invest, you lend your money to someone else for a return, the higher the better, because the return is the rate you are paid to lend your money. You'll be faced with monthly decisions about whether to repay or lend (save smart), and your decisions will compound over time just like interest.

The decision of whether to repay or save should be based on yours needs for safety, liquidity and return. Safety is about minimizing the risk of loss of your money, liquidity is about maximizing use and control of your money, and return is about maximizing the rate you earn lending your money. We can use rate and return to help determine whether you are better off repaying existing borrowing or saving for the future?

EPR™ (effective percentage rate)

When we compare repaying debt to saving we want to look at the after tax rate and return. Let's say you can borrow today at 5% for a new mortgage. You pay the lender a 5% rate each month and the IRS allows you to deduct the interest starting with your highest marginal tax bracket. If you are in a 30% marginal bracket, 30% X 5% equals 1.5%. You pay 5% now, you receive a 1.5% discount at year end, and your net interest rate is 3.5%. We call that EPR™, because it's your net cost of borrowing expressed as an interest rate.

It's the same when you save money. If you earn an 8% return and pay taxes of 20%, that 20% X 8% is 1.6%. You earn 8%, you pay 1.6%, and your net return is 5.4%.

Borrow Smart™ - Repay Smart™

Using EPR™

Sally and Joe Smith have a house, an equity line of credit, a car and some credit cards. They are faced with a monthly decision of whether to repay current borrowing or save securely for their future. Their advisor feels a 6% after tax return on their savings is a realistic goal based on the current market environment and time horizon.

Let's look at their situation in more detail to see how EPR™ may provide guidance on how to best proceed?

Sally and Joe Smith - Current Liabilities			***6% Target After Tax Return on Savings***	
Type	**Amount**	**PreTax Rate**	**After Tax Rate (EPR™) of Borrowing**	
Mortgage	$210,000	6.75%	4.725%	Repay • Save •
2nd Mortgage (HELOC)	$30,000	5.25%	3.675%	Repay • Save •
Auto	$29,874	6.25%	6.25%	Repay • Save •
Credit Cards	$8,500	10.00%	10.00%	Repay • Save •
				Assumes a 30% marginal tax bracket

In the above example, check the box that you think is most likely to benefit the Smiths financially.

If the expected net return on savings is 6%, then the client would ideally repay all debts that have an EPR™ of 6% or higher first. If the net cost of borrowing is under 6%, then additional consideration should be given to saving that money before repaying debts that are at a lower interest rate.

Create a plan to locate available cash to minimize interest rates and maximize your savings returns by paying off higher interest rates first and the saving as long as you can earn more than your net cost of borrowing.

Borrow Smart™ - Repay Smart™

Repay Smart™

To Repay Smart™ we want to make sure we pay down your highest interest rates first. In the above example, repay Credit Cards, then Auto, then Mortgage, and finally 2nd Mortgage liabilities to further decrease your cost of borrowing. Your advisor can provide realistic expectations about future returns, help you avoid missed savings opportunities, and finalize your plan to manage cash and liabilities so you can save securely for your future goals.

CONSIDERATION – If you borrow for an auto at 6%, it's not deductible, your EPR™ is 6% - the net cost of your borrowing.

Save Smart™ / Repay Smart™ – Quick Summary of Key Concepts

Knowing when to repay and when to save is crucial step in simplifying your day to day cash management. Additional wealth and peace of mind comes to those who properly manage cash and liabilities. Knowing your EPR™ for your current liabilities gives you a road map of how to use your discretionary cash each month. Develop a plan to manage cash and cash flow through proper liability management and accelerate your path to financial independence.

Save Smart™ / Repay Smart™ – Quick Summary of Action Steps

- ◻ List all your current liabilities and their current pretax rates.
- ◻ Calculate your EPR™ (after tax rates) for each of your liabilities.
- ◻ Speak with a financial advisor about expectations for future after tax returns.
- ◻ Repay your highest interest rates first to Repay Smart™ and consider at what point you'd begin to Save Smart™.
- ◻ Consolidate higher interest rates into lower rate home mortgages, and apply payment savings to accelerate debt repayment, or accelerate savings goals – use EPR™ and your advisors as a guide.

The Plan provided to you with this report has many of these considerations addressed for you. This report, and the underlying analysis are a simple guide, and should not be considered financial advice. Seek advice from licensed professionals who can help you tailor a plan to borrow, repay and save in the smartest way possible.

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