

## Excerpt from "Ordinary People, Extraordinary Wealth"

### **Secret #1: They Carry a Mortgage on Their Homes Even Though They Can Afford to Pay it Off.**

If you had enough money to pay off your mortgage right now, would you?

Many people would. In fact, "The American Dream" is to own your home—and to own it outright, with no mortgage. Imagine owning your home without having to send a check to a mortgage company or bank every month! Being so fortunate must evoke such a sense of security, satisfaction, and well-being that you could only dream of it! Imagine the feeling you'll enjoy when, after 30 long years—360 monthly payments—you finally make your last payment, and the house is yours forever!

If The American Dream is so wonderful, how can you explain the fact that thousands of financially successful people—people who have more than enough money to pay off their mortgage right now—refuse to do so?

Consider these facts derived from my survey research. Of the respondents:

1. The average home value is \$255,700; the average mortgage balance is \$142,000. Even though 100% have the ability to own their home without a mortgage, 83% carry a mortgage anyway.
2. 100% have the ability to send in extra money along with their monthly payments, to eliminate the mortgage ahead of schedule—but 90% choose not to. Instead, 85% of the respondents have a 30-year loan and no one in this group sends in extra principal payments or participates in bi-weekly mortgage plans.

Clearly, these successful Americans are not bothered by carrying a big, long mortgage. Compare yourself to them. If you have a mortgage and are struggling to pay it off, or if you're dreaming of the day when you make your final payment, you're trying to do something that financially successful people do not do.

What do they know that you don't?

It's vital that you understand what's happening here. And we begin with the fact that talking about mortgages is not a conversation about economics or finance. It's about emotions.

You "love" the idea of owning your own home. You "hate" your mortgage. If you're like many, you may even "fear" it. All of these are emotional words; none of them are financial. Yet, a mortgage is a financial tool—not an emotional state of mind.

Why, then, do you feel the way you do about your mortgage?  
Blame it on your parents.<sup>1</sup>

Just about everything you've learned about money, you've learned from your parents. Even though Mom and Dad never said a word to you about money, they had lots to say about mortgages—especially when you announced you were planning to buy your first house. "Make a big down payment," they told you, "and keep the mortgage payment low." "Pay it off early, child. You don't want that mortgage hanging over your head."

Indeed, your parents and grandparents made it very clear to you that mortgages are bad, something to minimize, or to avoid whenever possible. A necessary evil at best. But what they never told you was why they felt this way about mortgages. It's important you understand their perspective or you'll fail to understand why their advice is bad for you. So let's look at mortgages from your parents' and grandparents' point of view.

## Why People Fear Mortgages—and Why You Shouldn't

Our story begins in the 1920s. Back then, houses typically cost \$5,000. Sure doesn't sound like much, until you consider that the average annual income in the U.S. was \$1,434 in 1925. Consequently, few people could afford to pay cash for their homes—just like today. So, people borrowed the money from banks—again, just like today. But the loans were structured differently back then. A common clause in the loan agreement gave banks the right to demand full repayment of the loan at any time; if you failed to repay your loan when asked, the bank had the right to take your house from you and sell it to recoup its money.

So although the terms called for you to send \$24 to the bank every month<sup>2</sup> to pay off that \$4,500 balance over 30 years, you knew you suddenly might be required to repay the remaining balance in full at any time. You didn't worry about that clause, because you knew that having the bank ask you for \$4,500 in cash, well, they might as well ask for the moon.

Then came October 29, 1929.

When the stock market crashed, millions of investors lost huge sums of money. Problem was, it wasn't their money they had lost. You see, most investors back then had bought stocks with borrowed money—money lent to them by their stockbrokers, called a "margin account."<sup>3</sup> Under rules then in effect, you were allowed to buy \$100 worth of stock by giving your broker just ten bucks; your broker would loan you the other \$90. So when the Crash hit, knocking 30% off the value of everyone's stock portfolios, a typical brokerage account that previously was worth \$100 now contained stocks worth only \$70. But the investor had borrowed \$90 to buy them! This led to a "margin call," where the broker would tell the investor that because his account had exceeded the "margin limits," he had to come up with more cash. If the investor failed to do so, the broker would begin to sell some of the investor's stocks, and the broker would continue selling until enough cash was raised to meet the margin call.

Selling off the portfolio was the last thing the investor wanted his broker to do. The stocks were already down 30%—this was the worst time to sell. So, to avoid the margin call, the investor went to his bank and withdrew enough cash to meet his broker's margin call. The investor had to act quickly, because under stock exchange rules, margin calls must be fulfilled within 24 hours. Therefore, in the days following the Crash of '29, a lot of investors went to their banks and made withdrawals. It didn't take long for the banks to run out of cash.

When they did, word quickly spread. Bank depositors stampeded the banks, demanding their money. To get more, the banks started calling their loans due. They sent telegrams to their borrowers, demanding they pay off their loans immediately and in full. Because these homeowners didn't have the cash—you might as well ask for the moon—the banks foreclosed and put the houses up for sale in a desperate attempt to raise capital.

It didn't work.

With no one willing or able to buy the houses, banks found themselves owning virtually worthless real estate. Unable to satisfy depositors who were demanding their cash, the banks closed their doors, many of them never to reopen. With investors unable to get their cash from their banks, they were unable to meet their margin calls—so their brokers started selling out their holdings. But everyone was in this dilemma, so the brokers couldn't find buyers for the stocks. With no one willing to buy, the brokers had to continually drop the stocks' prices.

Ultimately, the Great Depression saw the stock market fall more than 75% from its 1929 highs. More than half of the nation's banks failed. Tens of millions of Americans lost their jobs as companies went bankrupt. And millions of homeowners, unable to raise the cash they needed to pay off their loans, lost their homes. The American Dream had become a national nightmare.

But not for those who owned their homes outright. These lucky few were immune to the banks' collapse. With no loans to repay, they got no telegram demanding full payment. As their neighbors went broke and lost their homes, with thousands committing suicide, those who owned their homes outright succeeded in keeping them. They

might not have found work, or had much to eat, but they kept a roof over their children's heads.

And thus was born America's mantra: Always own your home outright. Never carry a mortgage.

And yet, despite all this, a small group of Americans insist on carrying a mortgage even when they can afford not to. Why would they place themselves at such risk? Don't they know what they're doing?

Actually, they know exactly what they're doing. They are among America's elite: the wealthiest 1% of the population. Not only do they know what they're doing, they know why they're doing it. It's you who fails to understand.

What you and your parents have failed to realize is that our nation has learned from the harsh lessons of the 1930s. A '30s-like depression has not been repeated, and indeed cannot occur again, because of the safeguards that have long since been put into place.<sup>4</sup> Among them:

- 1) Banks are no longer able to cancel your mortgage. This means that if you have a mortgage, there is no risk that you suddenly might be required to pay off the loan. Instead, provided you make each month's payment on time, no bank can force you to pay off the entire remaining balance.
- 2) Customers are no longer permitted to buy stocks with only 10% down. The maximum margin limit is 50%; for some securities it's 20%—and zero for speculative investments (such as internet stocks). This dramatically reduces (or even eliminates) the risk that an investor will get a margin call, which in turn reduces the risk that investors will need to make simultaneous and massive withdrawal demands on their banks due to cash flow problems in the stock market.
- 3) By similar action, the Glass-Steagall Act of 1933 kicked banks out of the stock underwriting business. By building a "Chinese Wall" between Wall Street and the banking business, the government insured that brokerage failures wouldn't harm the banking business.
- 4) Congress created the Federal Deposit Insurance Corporation in 1933 to protect consumers from future bank failures. Before FDIC, consumers were unprotected in the event their bank went broke because of bad lending practices. Today, however, consumer accounts up to \$100,000 are protected, giving citizens a level of confidence in banks that didn't exist in the 1920s and early 1930s. Congress also created similar programs for savings & loans (FSLIC, now part of FDIC), credit unions (NCUSIF) and pension funds (Pension Benefits Guaranty Corporation). Though rare, bank failures still occur, but no depositor has ever lost his or her life savings as a result of one, thanks to these programs.<sup>5</sup>
- 5) The Federal Reserve, which controls the nation's money supply, now understands that the best way to prevent a "run on the bank" is to provide banks with all the cash they need, rather than withhold currency like the government did in 1929. Back then, the government feared that flooding the banks with cash would result in inflation. Instead, the government created the worst depression in history. But we've learned our lesson, as shown by two modern examples:
  - a) Within hours of the Crash of 1987 (the first 1929-like crash since, well, 1929), Fed Chairman Alan Greenspan announced that the Federal Reserve would supply as much cash to the nation's banks as they needed—reassuring all Americans (and the world) that there would be no repeat of 1929. Greenspan's comments are widely credited with calming much of the panic on that October 19th, and many argue that his actions, more than any other, helped America avoid another depression.
  - b) Responding to concerns that computer problems would lead to bank failures in the year 2000, the government said it would print and distribute \$200 billion in extra currency, so that banks would have more than enough cash on hand to meet any withdrawal request—even if the computers stopped working.
- 6) Competition in the mortgage industry has dramatically increased. If one lender won't provide you the loan you seek, odds are better than ever that another will. And new, innovative loan programs make mortgages more affordable than ever—reducing the likelihood that you'll default.

The point? Those who tell you to pay off your mortgage are basing their advice on their fear—fear that having a mortgage might cause you to lose your home. But as you now understand, your risks of losing your home are negligible compared to homeowners of the 1920s. And that means these fears are largely unfounded.

Largely, but not completely. Because there are still two aspects of mortgages that I haven't yet dispelled for you: the challenge of affording the monthly payment and the interest you'll save by not having to make that payment.

Let's start with the first one. Do you fear that you might not be able to make the payment every month? This is a problem, because, as I pointed out, the bank can foreclose on your home if you fail to make your monthly payment on time. Therefore, you fear, what if you suddenly lose your job? With no income, you won't be able to make the payments—and you'll lose your house.

Isn't this enough of a reason to eliminate your mortgage?

No.<sup>6</sup>

The truth is that the less money you have, and the more worried you are that you might lose your job, the more important it is that you keep a big mortgage. This might seem counterintuitive (as I warned you in the introduction), but it's the truth. And it's critical that you understand this point. Bill Gates can choose to have or not have a mortgage; it won't make much difference in his life either way. But if you have little money and even less job security, having a mortgage is the safest way to handle your home.

Why? Because there's more to life than having a home. Like putting food on the table.

Let me give you an example, adapted from my second book, *The New Rules of Money*<sup>7</sup>. Karen and Janet each earn \$35,000 a year. Both are in the 28% tax bracket. Both have \$12,000 in savings. Each buys a \$120,000 house.

Janet wants to minimize her mortgage, so she uses her \$12,000 in savings as a down payment, and opts for a 15-year loan at 6.5%. Her monthly payment is \$941, but only 57% of that payment is tax-deductible interest; the rest is principal. Therefore, Janet's net after-tax cost for her mortgage is \$790. And to pay off her mortgage even quicker, Janet sends in an extra \$50 with every payment. Of course, these payments are devoted entirely to principal, and therefore provide no tax deduction.

Karen, on the other hand, obtains a 30-year mortgage at 7%, putting down just \$6,000 and financing the rest. Even though her mortgage balance is bigger than Janet's (\$114,000 compared to \$108,000), her monthly payment is just \$758. That's not all: Because 81% of the payment is interest, Karen's after-tax cost is just \$586 a month—\$204 less than what Janet pays! Karen invests these savings each month for five years, earning 8% after taxes per year. And where Janet sends to her lender an extra \$50 each month, Karen adds \$50 to her savings. Result: Over five years, Karen accumulates a total of \$12,675.

Suddenly, both women find themselves out of work. Because Janet used all her money as a down payment, she has no savings to rely on. True, she's got \$43,285 worth of equity in her house (because she started with a big down payment and has been making monthly payments ever since), but that won't help her buy groceries. Being unemployed, she can't refinance, and news of her being out of work caused her bank to reject her application for a home equity line of credit. If she wants to get ahold of her equity, there's only one way for her to do it: She must sell her house. This would force her to lose her home—the one thing she wanted to avoid!

Indeed, Janet has discovered the biggest secret about homeownership: Your mortgage is a loan against your income; it is not a loan against the value of the house. With no income, you cannot borrow against your equity. Janet better get a job—and quick! Not only can't she afford to buy food, she's about to lose her house!

Karen, by contrast, has little to worry about. With \$12,675 in savings, she's easily able to make her payments

each month, even without a job. In fact, she's got enough money to make her monthly mortgage payment for nearly two years!

How ironic: Janet didn't want a big mortgage and did everything she could to pay it off quickly. Now, she's discovering that this strategy—rather than safeguarding her home—might cause her to lose it!

Clearly, then, you should not give the bank or builder a large down payment, nor should you be in a hurry to pay off your mortgage. And the less money you have, and the less stable your income, the more important the idea of carrying a big, long mortgage is for you.

But still, there must be something more to this notion of carrying a big, long mortgage. While it's true that fear might lead some people to avoid mortgages, lack of fear is not enough to explain why people carry mortgages. No, there must be some other motivator.

And there is. It's called a desire to accumulate wealth.

Here's an important lesson all wealth-wanna-bes must understand: No one ever got rich by saving money. Or, put another way, paying off debt is not the same as accumulating assets.

I stress this because many people think they will be better off financially if they eliminate their mortgage. But this is not true.

"Not true?!" you say. "Of course it is! If I don't have to make a monthly mortgage payment, I'm in far better shape than the guy who has a mortgage!"

I'm sorry, but despite the fact that millions of Americans believe this to be true, such thinking is misguided. You need to know why.

There are two kinds of people who hate mortgages: those who fear them and those who believe that mortgages cost you huge amounts of money in interest charges. We've already resolved the former issue—that fear thing—so let me dispel the myths surrounding the latter ...