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Tapping Into Home Equity?

Key reasons why your clients should not.

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A client of mine sits on the board of a not-for-profit charity and attended its quarterly meeting earlier this week.

During the meeting, the charity reported that it taps into an equity line it has on one of its buildings to finance its monthly operating expenses. The charity pays a bit north of nine percent on this money, so on an average monthly debt of $500,000, the charity shelled out over $45,000 in interest expense last year.

Why Did This Client Come to See Me?

My client was tasked by the board to investigate how to invest the $1 million the charity has in liquid assets. He was very impressed with the way his investments had grown over the past several years and he wanted to share the joy with this charity.

While I certainly appreciated the vote of confidence (not to mention the potential business) I told him that he and the board were nuts.

Why did I say that? Because the charity should take that cash and pay off the equity line before it worries about investing. With this strategy, it will effectively "earn" nine percent on its money because it forgoes the interest expense.

Certainly, alternative investment might return more, but alternative investments have risks. The higher the potential reward the higher the potential risk. By paying off the equity line, they earn nine percent with no risk. Not a bad return. So tapping into real estate equity to invest in the stock market is not something you should encourage your clients to do.

When Should Clients Tap Into Their Real Estate Equity?

In my opinion, as infrequently as possible.

From a financial standpoint, the only time it makes sense to borrow is when the cost of borrowing is less than the likely return on investment. Although many people have done this with real estate and they have been successful, I suggest that this is a risky strategy especially now.

Of course many real estate experts tell you that it's always a good time to invest in real estate. In fact, last year Donald Trump and others did a whirlwind tour of the United States giving investment seminars. They came to tell your clients (for a fee) that if they wanted to be wealthy, they should invest heavily in real estate. Some of the speakers encouraged your clients to take equity out of their homes by getting a second mortgage or equity line, and use that capital to buy more real estate.

Let me tell you about a couple I met last year who did just that and now face a real financial jihad.

Jim and Evelyn took equity out of their home three years ago when they heard how hot real estate was. They bought four rental home properties in Las Vegas and Arizona and as a result, they've gained over $100,000 in equity. Of course that's great — if they can hold on to the real estate. But I doubt they'll be able to do so.

You see, they put 20 percent in as down payments and financed the balance for each of the investments. But when they purchased the rentals, prices were higher than today. Also rents were low, so the mortgage payment for these properties exceeded the rent they received — even from the start. As a result they go deeper and deeper into their own pockets each month to finance the real estate. Now is where the story gets really scary.

You see, it costs them about $2,000 a month out-of-pocket, just to hold on to the real estate. Jim and Evelyn don't have that extra $2,000, so they took out more loans to finance the monthly deficit. They took out an equity line of credit and each month that loan grows larger and larger to finance this deficit.

By the time I met them, that loan had grown to over $50,000! So half of the equity growth they were so proud of was gone.

What will happen if one or two renters move out of the rentals? The income will drop and the negative cash flow will balloon to over $5,000 a month. Where will they get the money to pay back all those loans?

Ultimately, Jim and Evelyn run the real risk of building up a huge debt. To make matters worse, the real estate markets are weak now. If real estate prices continue dropping, they could lose everything they have — including their own residence.

Many experts have observed that the crazy real estate market of the prior several years pushed prices to wacky levels. Now, values are declining. If interest rates rise, many homeowners and real estate investors will be pushed beyond their financial breaking point. This could lead to a glut of real estate sellers and a (sharp) decline in prices. Every time interest rates go up, your clients should picture thousands of potential real estate buyers leaving the market.

Finally, your clients should ask themselves if they have the time and temperate to be a

landlord. I know that I don't want Jethro from the *Beverly Hill Billies* calling me up at 11 p.m. on a Sunday night because his garbage disposal won't work.

Conclusion

There is no denying that real estate has been a great investment — but it hasn't always been, nor can anyone promise that it always will be. With interest rates rising and prices declining it's a good time to be very cautious.

Certainly, if anyone, including Mr. Trump tells you to pull equity out of your home to buy real estate in this market, you should respond with two words: " YOU'RE FIRED."

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Neal Frankle, *CFP, is the author of* Why Smart People Lose a Fortune: 5 Steps to Restoring Your Wealth and Sanity*. He helps affluent clients establish and implement a safety-net strategy to protect their wealth. He also helps other professionals, such as CPAs, do the same for their clients.*

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