

July, 2004

STOP PAYING OFF THE MORTGAGE: YOU'LL BE BETTER OFF

By Fraser Smith

The traditional approach to paying off a house mortgage is a practice that is well past its due date, and one that is contributing to a disturbing trend of financial insecurity for many Canadians.

Sadly, the blind devotion that most people have to mortgage pay-down is paralysing their chances of ever becoming wealthy, or even more alarming, of becoming financially secure in retirement.

The house mortgage is the largest debt most Canadians will ever take on. In many cases, the cost of servicing it financially cripples homeowners, precluding them from building an investment portfolio. With no investment income to supplement their retirement income, too many Canadians retire "house rich and cash poor." Late in life, they are forced to go back into debt using a Reverse Mortgage.

The rising popularity of the Reverse Mortgage is a symptom of what's wrong with the way most Canadians deal with their mortgages. I have spent over two decades helping people fix their dysfunctional relationships with their mortgages so they can gain financial stability. How? By reversing the mortgage long before retirement, by turning the debt into the tax deductible kind.

Most Canadians are completely unfamiliar with the financial tools and tax rules that are utilized by the wealthy to turn their mortgages into a financial advantage, but that are rarely used by those who are not so wealthy. I have set out to change this with the publication of "*The Smith Manoeuvre*," along with a challenge to Canadians to discard everything their parents taught them about paying down the mortgage, and to approach their debt in a whole new way.

The tools and concepts *The Smith Manoeuvre* has developed and modified for ordinary not-wealthy Canadians are similar to the techniques that the rich use to get richer. So why not join them?

The not-wealthy and their mortgage.

Stats Can indicates that 10% of our population controls 53% of Canada's net worth. This 10% segment we will call wealthy, and the 90% remainder will be the not-wealthy. Let's compare how these two groups of Canadians deal with their house mortgages.

Most Canadians in the not-wealthy category bought their first home in their twenties, likely with the aid of a 90% high-ratio mortgage and some love money from family. During their thirties they moved once or twice, probably to bigger and better housing, so they likely still needed mortgages that amortized over 25 years to yield an affordable payment. The last 25 year mortgage is usually taken at age 40, because age 40 plus 25 equals 65 years, retirement day, and it would be nice to have the home free and clear of a mortgage when it's time to retire. For many Canadians in their working years, the total monthly income may be modest, but they are still obligated to pay out 50% in taxes of all kinds, 25% for housing and 25% for the rest of life's daily needs. They might own a bit of an RRSP, although only about 1 in 3 Canadians has managed to do so.

This is the scenario: on a certain day in your 65th year, you retire. You receive a gold service watch from your company. You get your picture in the local paper where you can be seen setting fire to your mortgage. It's the Canadian dream - retired and mortgage free on the same day!

The initial adrenalin rush does not last long. Within a year or two, it becomes apparent that because of inflation and a few financial surprises, retirement cash flow is a bit tight. It's that age old "people living on a fixed income" story. Thank goodness the house is free and clear - time to pull some equity out - the kids won't mind. But the banker is reluctant to lend - you are unemployed. You begin to think you will be forced to sell, or downsize in order to get at your equity. Then you see Gordon Pape's ad for a Reverse Mortgage. It's a bit complicated and it's a pretty stiff interest rate premium but it's there and you really need help, so you take it. Each month you get a cheque from the bank, and each month the bank owns a bit more of your house.

The interest expense compounds relentlessly, and the debt rises faster and faster. Soon the bank owns a huge chunk of your house - again.

You suffer a *deja vu* attack. At age 20, the bank owned 90% of the first house you bought, and now, at age 80, you are back to the same place. If you live a bit longer the bank will own the whole thing.

But should we blame the bank for wanting to make a profit? For being there for you when you needed that 90% high ratio mortgage? And is it fair to beat up the banks for being there for you with a Reverse Mortgage when cash flow was too tight to allow you to enjoy your retirement? The banks are not the problem - you are. As Pogo said "We have met the enemy...and he is us."

You did it wrong. You missed your cue. The clues have always been there, provided by the wealthy, that 10% group of Canadians who understand better than the not-wealthy how wealth is created. You think the secret is to pay off your mortgage while concurrently trying to build up some savings by buying "safe" Canada Savings Bonds and GIC's. Your parents did it that way, your neighbours, friends and co-workers do it that way, so it must be the way to do it.

The rate for cashable CSB's is about 1.75%. At the 40% tax bracket you will pay tax of 0.70% to the government when you file, leaving you with 1.05%. The inflation rate in Canada is about 2%. So your "safe" investment is safely losing you about 1% every year. Your need for a Reverse Mortgage is virtually guaranteed if you follow this course.

The wealthy and their mortgage.

The wealthy folks probably started out like you. They bought a house and took a mortgage too. But the wealthy know that the interest expense of a mortgage payment is not tax deductible in Canada. They call it "bad debt." But they also know that if the mortgage debt was related to the purchase of income-producing assets, it would be deductible - this is called "good debt." So they retain an advisor to *convert* the "bad debt" mortgage to a "good debt" investment loan. They don't pay their debt off - they convert it.

How important is that strategy?

If you are working and in the not-wealthy category, your future may look like this - unless you are prepared to make some changes:

You have a \$200,000 mortgage at 7% for 25 years, and you are at the 40% tax bracket. You run *The Smithman Calculator* on your computer. It tells you that you will have to earn \$700,402 in order to pay income tax of \$280,161. You will have \$420,241 left over to pay the bank the original \$200,000 loan plus \$220,241 in interest. You are a slave to your mortgage. This is why mortgages help make banks the largest and wealthiest companies in Canada. (But don't get mad at the banks. Instead, buy their shares.)

The wealthy person sees things quite differently. If the interest expense of \$220,241 was converted to the tax-deductible variety, then at the 40% tax bracket, he would receive refund cheques each year from the CRA totalling \$88,096. These cheques would be free gifts. These refunds would not even be taxable. This found money is used to reduce the mortgage faster. The wealthy then borrow back this new equity as fast as it is generated and use the borrowed money to buy more investments, be they real estate, stocks, bonds, mutual funds or investment in their own business. The house provides the security for the loans and the interest expense generates free tax refunds. Most importantly, the investments are free and clear, so the house is not at risk. On average, the investments will grow over time, starting immediately. The wealthy moderate their risk by diversifying the investments they purchase. Yes the markets have been down, but real estate is up. No matter, the wealthy are in it for the long haul. With time on their side, the wealthy know that their assets will grow. They always have. They make their equity work and they generate free money from tax refunds, by ensuring their debt is tax-deductible. They do *not* spend their working life attempting to pay off their house mortgage. To the contrary, the wealthy will likely die still paying interest (deductible) on that loan.

While the not-wealthy engage in a life-long struggle to make their house free and clear, the wealthy are using the equity in their house to get free tax refunds and to finance their ever increasing investment portfolio. Because the house is the security for the investment loans, the

borrowing rates for investments are the lowest possible, usually below prime. So interest rates for the wealthy are both low *and* tax deductible. The growth of the investment portfolio is the main wealth builder. Because the house is the loan security the investment portfolio remains free and clear. That means there are no margin calls. In the event of an emergency such as job loss, free and clear investments can be sold, raising cash by reversing the process. An emergency does not put the house at risk.

A powerful new twist on an old idea.

The world has always had the wealthy and the not-wealthy. Lots of commentators have tried to convince the not-wealthy that there is a better way, and with some success. Our premier contemporary guru in Canada is Garth Turner who is bright, wealthy, and Canada's former Minister of Revenue. He has written many books that you should read if you want to move to a higher rung on the wealth pyramid. Visit Garth's website at www.garth.ca.

Garth and I think alike regarding the need to work the equity in your home to your investment advantage. Where we differ is that Garth has counselled that first you pay your mortgage off, and then you borrow back your equity to fund investments to make your interest deductible. For most average Canadians working diligently to overpay their mortgages, Garth's method could mean a delay of 15 or 20 years while the mortgage gets paid off before the investment program can begin. To me, this is far too late to set most people on the road to financial security.

Instead, *The Smith Manoeuvre* teaches you how to start converting your house equity to investment starting *now*, so that you start getting tax refund cheques *now* while simultaneously building up an investment portfolio that starts compounding for you *now*. I am hopeful that Garth will agree that *The Smith Manoeuvre* is a strategic improvement on the excellent concepts he has championed over the years.

To be fair, in more recent years, Garth has been recommending you take out some equity for investment purposes using Home Equity Lines of Credit (HELOC's). While this is an improvement over waiting several years until the mortgage is completely paid off, HELOC's are a poor substitute for the 75% solution espoused here and in my book, "*The Smith Manoeuvre*". You will learn how to utilize 75% Readvanceable Mortgages as provided by the nimble credit unions, or the 75% Consumer Collateral mortgage loan or the excellent 75% Australian Mortgage, represented in Canada by Manulife Financial as ManulifeOne. These 75% debt conversion tools are put in place once only for most Canadians and will serve you well for dozens of years.

Another rising star in the Borrowing to Invest wars is Talbot Stevens. Every Canadian should read his book "Dispelling the Myths of Borrowing to Invest". Order it at www.talbotstevens.com.

Correct your mortgage situation, now.

Most not-wealthy home owners are in the not-wealthy condition because of several factors, including ignorance about mortgages, taxation and investment. Ignorance fuels fear-to-act in the face of mountains of evidence that action is required. If 100% of your home-owning friends, neighbours, co-workers and relatives are likewise paralyzed, then the not-wealthy end up like sheep headed down the road to a Reverse Mortgage, where they will continue to be mortgage slaves until they die. Don't let it happen to you. Act. Act now.

The Smith Manoeuvre eliminates this debilitating scenario by combining several processes:

1. Existing bad debt mortgages are converted to good debt investment loans starting now. Debt does not have to be increased. It will stay constant.
2. Simultaneously, an investment portfolio will be built with money borrowed at low rates, which will generate free tax refund cheques, starting now, because the loan interest will be converted to deductible interest. One dollar for investment borrowing will become available for every dollar paid down on the first mortgage. As the bad-debt mortgage goes down, the good-debt investment loan goes up.
3. The CRA offers free tax deductions to all Canadians who borrow to invest, whether wealthy or not-wealthy.

4. The banks will co-operate because they receive the same amount of interest on your loans whether they are deductible or non-deductible. They will be happier to provide loans to you against the equity of your house today as opposed to a Reverse Mortgage when you are retired. This is because sooner is better for banks, just as it is for you.
5. Your investment portfolio will be free and clear, so there is no risk of losing your home

Make time your friend instead of your enemy.

Procrastination is your biggest risk. Don't delay. I encourage you to read *The Smith Manoeuvre* and get the CD software at www.smithman.net. But don't do this alone. Contact a financial planner in your area and ask if he/she is an implementer of *The Smith Manoeuvre*. (Planners are listed by city at www.smithman.net) The benefits that have been outlined for you - which are substantial, and in most cases, life-changing - are entirely legal. This is not about clipping a few coupons. There are thousands and thousands of dollars at stake, which can be put to work for the benefit of your family's net worth. I am thrilled to offer you the tools to ensure you get every one of them. It's your turn - your opportunity to ensure you avoid the Reverse Mortgage by implementing *The Smith Manoeuvre*.

-30-

Fraser Smith is a retired financial strategist in Saanichton, B.C. on Vancouver Island. He is the author of "The Smith Manoeuvre" and the developer of financial software "The Smithman Calculator". For more information visit www.smithman.net. Contact 250-652-0825.