Put debt to work earning money, these experts say

Strategy requires savings, sacrifice, lots of patience

Heather Boerner, Special to The Chronicle
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Jessica Lanning has a radical idea: Don't pay off your mortgage. Don't pay a down payment if you can avoid it. Carry as much debt as you can comfortably pay, even if you could get a smaller mortgage, and put that debt -- that extra money -- to work for you in the stock market, in savings or in high-yield investments that can earn you more over the long run than simply buying and paying off your home.

Lanning, a San Francisco certified mortgage consultant and financial strategist, has spread this new debt gospel to more than 1,000 Bay Area residents, mortgage brokers, certified financial planners and real estate agents over the past 10 years, and she expects to share it with 1,000 more before the end of June.

"There's a revolution going on in this industry," she said. "More and more of us are starting to talk like this. It's a new mind-bend and philosophy."

Fellow mortgage planner Steven Hook said this kind of equity management became popular three years ago, after the publication of "Missed Fortune." Another book, "Stop Sitting on Your Assets," also trumpets the approach. Lanning, a self-described geek who loves to crunch numbers, is on the vanguard of this trend in the Bay Area, said financial planner David O'Brien, who calls her "one of the five smartest people I've ever met."

Investing home equity is nothing new -- financial planners like O'Brien have been helping their clients do it for years, and San Franciscans love to invest their equity in rental properties. But O'Brien said Lanning "does it smarter," finding ways people with more modest incomes can pursue the strategy. While most first-time home buyers probably aren't candidates for equity investing and some question whether it's broadly suitable for those without the extravagant cash flow of the wealthy, Lanning says homeowners with a good head for money and an ability to resist life's little luxuries can profit from this approach.

"If you are between ages 45 and 65, you're sitting on a ton of home equity and you don't have a lot of cash or retirement funds, this could be a tremendous opportunity," Lanning said. "That doesn't mean someone in their 20s or 30s can't do this. Once people realize that they can put their money into other investments, it's a small step for them to take $500 or $200 a month that they were spending on their mortgage and spend that on investments instead."

The fundamentals

It can work several ways, but here are two examples:

Suzy Colvin refinanced her home 10 years ago from a mortgage where she was paying principal to a mortgage where she pays only interest. With the equity she pulled out of her home, she invested in real estate. (Others invest in mutual funds, insurance products and even high-interest savings accounts.)

Over time, the homeowner could build up both equity and investments and create wealth that can be used to pay for anything from job loss or medical expenses to retirement and children's education.

Colvin said buying new properties was second nature to her as an agent with Paragon Real Estate. However, she admits the first time she took cash out of her house, it was scary. "We don't continue to do it, though," she said. "We don't want to fund these things out-of-pocket."

Or, consider another option: If you have a significant down payment saved ($100,000 or more), Lanning and others would recommend you put a small amount down and finance the rest. Take that extra down-payment money and invest it, making interest-only loan payments for several years.

Interest-only is important, she said, because most home mortgage interest is tax deductible.

"This is not a get-rich-quick scheme," she said. "It's a pretty boring, get-rich-over-a-long-period-of-time scheme."

Managing risk

But at a time when some homeowners are smarting from mortgages they couldn't afford -- adjustable-rate mortgages in the subprime market -- some are questioning the wisdom of taking on more debt.

"The question I would ask people considering this method is, 'How much can you afford to lose?' " said Peter Ogilvie, a Santa Cruz mortgage broker and president-elect of the California Association of Mortgage Brokers. "I'm sure a lot people in the late 1990s were putting their equity in the high-tech market and it seemed like a smart investment at the time. Then what happened? The high-tech market crashed, fortunes disappeared and equity disappeared. Be aware of that. If you have a 6.5 percent mortgage and can put that money into a bond that's earning 8 percent somewhere, you can make money over time. But be prudent."

It's that prudence that's key to this approach -- and everyone agrees that people who can't stick to a budget or are vague about how much debt they can afford might siphon equity out of their homes and be left with a bad debt.

"The advantage is that you can make a lot of money over time," said San Francisco mortgage broker Glenn Rodriguez of Inter-Bay Financial Services, who helps his clients invest equity. "The disadvantage is the higher monthly payment and being able to sustain that over a long period of time. For people with bad credit or who don't manage money well, they can get in over their heads. You want to have solid backing and a plan for the worst-case scenario."

That plan, said mortgage planner Hook, should include significant savings -- about six months of income.

And while Lanning says this strategy is good for most homeowners who are equity-rich but investment-poor, it might not work for most people in the Bay Area.

The California Association of Realtors reports that only 26 percent of Bay Area residents can afford the median-priced home, and in San Francisco that number drops to 19 percent. The association found that in order to afford a median-priced, $713,700 home, the average person would have to pay $4,820 a month and earn about $144,000 a year. Meanwhile, the Association of Bay Area Governments reports that the median household income in 2005, the most recent date for which statistics were available, was $66,657.

Earning power required

"This is not meant for entry-level people earning $50,000 a year," said Rodriguez. "Most of the time, a first-time buyer will get a condo or home for $600,000 and put $60,000 down. They would have to have an annual income of more than $100,000 to carry that mortgage. Most people are not going to have money to dump another $100,000 into an investment, whether it's real estate or something else."

Those who do "have the earning power to support it," said Colvin. That's how it works for her and her husband.

"It's a change in mind-set," she said. "Income-wise, we do well, but this strategy is so we don't have to interfere with that. I just imagine myself standing on a pile of money; I can stand on less. The biggest mind-set you have to get over is that you're not spending money, you're investing it."

Lanning knows this first-hand. She admits that she wouldn't ask her clients to do something she wouldn't do herself. So she has "practically no equity" left in her house and knows the pinch of those larger mortgage payments.

"That takes some adjustment," she said. "I'm writing these checks and thinking, 'Why am I writing these big checks?' When you're in QuickBooks, all you can see is your checking account. But then I switch over to my investment account, and every time I see that, I relax. I think, 'This is what's going to send my two kids to college. This is what's going to pay for my retirement.' "

Is it right for you?

Think you're ready to invest your home equity? Be forewarned -- it's not for the faint of heart.

"People who aren't disciplined with their money shouldn't try this," financial strategist Jessica Lanning said. "I have clients come in and they say, 'Look, we don't go out, we don't travel much, we love to save money, and we don't care if 50 percent of our income goes to our home and investments.' Those are the people who are ideal for this. Then I have clients who come in and say, 'If I don't make it to Macy's twice a week, I'll die.' Those second folks, the ones who spend frivolously, they have to take a 30-year fixed-rate mortgage. I can't in good conscience encourage them to do this."

To know if you're ready, consider mortgage planner Steven Hook's prerequisites:

-- Have six months of income in savings and available immediately. "The common problem is that someone will strip all the equity out of their house and put it into life insurance or other financial products, and then something bad happens and they can't access it," he said. "If you don't have short-term liquidity, you don't have any right to invest."

-- Pay off consumer debts. Someone with substantial credit card or other debts should pay those off before considering investing equity. "If you don't get a tax deduction from it, you should focus on paying it off sooner rather than later," he said. That way, debt isn't siphoning off money you could be investing in your future. It's also a sign of someone who can't manage their money.

"There's a lot of suitability and common sense that needs to be in place," he said.

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