Utilizing the Trapped Equity in Your Home

If you are an average Canadian homeowner, then 70% of all the wealth you have on this planet is sitting in one asset, in one location, on one street - in your house. Is this smart?

A few points (a) you have to live somewhere, so (b) you can pay rent, and support someone else, or pay a mortgage, and build equity, and (c) the sooner you pay off the mortgage the more interest you will save and (d) once you pay off the home, then invest in other, income-producing, properties.

This is exactly what millions of Canadian families do, which is why that 70% of all personal wealth is now sitting in residential real estate. We view housing as a riskless investment that is inflation-proof and timeless, and we just can't get enough of it - especially when prices are rising, as they have been for the past seven years.

However, there are some problems with this philosophy, at least when it comes to prudent financial planning. First, real estate may be a great, eternal long-term investment, but it's subject to short-term fluctuations that can be extreme and costly. If you happen to buy at the peak or sell at the trough of a market, then you will lose money. Guaranteed.

Are we at, near to, or just past a peak in this market? As interest rates seem to slide you guess is still as good as mine.

But apart from that, how smart is it to keep hundreds of thousands of dollars sitting in the equity in your home? It pays no interest there, no dividends or capital gains to give you cash flow, and offers no tax relief. Sure, you can live in a paid-for home without making mortgage payments, but it is still an asset that needs to be insured, heated, repaired and have taxes paid on it. So, the only way a mortgage-free home can actually make you wealthier is it the value of it goes up each year more than all the cash you spend looking after it, plus the lost earning potential of all the money you have locked within it.

We may be at or near the point where the big gains for real estate values are behind us. Going forward, every owner of a paid-for home would be smart to sit down and do the math - establishing what the true costs are.

Or, you could use your home as a tool. For example, every bank around these days will give you a home equity loan at the prime rate. That means on a $500,000 house you could borrow $450,000 easily at just 4.75%. Better still, all of the interest on that loan can be deducted from your taxable income if you use it for the right reason - to make more money. That's $21,375 a year in interest that you can write off the income tax check you send to Ottawa each year - the equivalent of making a honking big RRSP contribution.

Now, imagine you took that $450,000 and used it as a down payment on a small apartment building worth $1 million, which housed 20 tenants, all paying $1,000 a month for the privilege of living there. That would yield you $20,000 a month, or $240,000 a year in income, while your financing costs on the $700,000 mortgage were less than $40,000 a year. Even factoring in maintenance charges, taxes, utilities and a property manager's wages, you would be substantially ahead. In fact, instead of owning just a $500,000 house with no mortgage and no income, you'd now own $1.5 million worth of real estate, and a cash flow approaching $100,000 a year. And, yes, you would be writing all off the interest - on both the home equity loan and the mortgage.