EP 40: Is Home Equity Really Your Financial Savior?

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We help the tiny house community use their lower housing costs to build financial independence.

With Laura Lynch

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Laura Lynch

EP 40: Is Home Equity Really Your Financial Savior?

It takes a brave and independent mindset to go tiny. If you are trying to figure out your tiny pivot, this podcast is here to inspire and connect you with the other unconventional, gritty, inspirational people within this community.

I'm Laura Lynch, your tiny house friend and host. On this show, we are always going to come back to money because, as a financial planner, this is the question I hear the most: How do I make this work for me financially?

Well, that's my jam. So jump in, let's go. New episodes drop every Thursday.

Laura Lynch: Hey everybody, Laura here. It is just me this week, and I thought we would take an exciting and nerdy deep dive into a topic that may have been on your mind, or maybe on your mind, and that is home equity.

So for those of you who are listening on the podcast in audio only, I just want to let you know that I am going to be showing a whiteboard, which I'll be talking through the numbers. So if you're just listening, that's totally fine. But if you are sort of a visual learner and you want to get a little bit deeper into the numbers, I will be using a whiteboard and showing that content on the YouTube channel. So perhaps you want to pause and switch gears over to YouTube. This is episode 40 on YouTube. The channel is @lesshousemoremoolapod, so pretty easy to find it there. So I have in my conversations with folks within the tiny living community continued to talk about home equity.

I've written about this some on LinkedIn, definitely a topic that I'm thinking a lot about right now. And so I thought we would kind of explore the concept and try to have a little balanced approach to whether home equity is something that should be or maybe isn't as important a priority for you. And the reason why I think it's important for us to talk about this is because this is one of those things that you kind of figure you're supposed to do is work on your home equity for decades and decades. And so that's why the first-time home purchase and then trading up throughout your life in order to build

home equity, and so home equity is something that we feel a lot of pressure around and something that is sort of a conventional wisdom and maybe friends or family will sometimes say to us like, “Oh, you're not going to be building as much home equity.”

So let us explore what that means exactly. So to get us started, I'm just going to literally read from Investopedia about the definition of home equity. So home equity is the value of a homeowner's financial interest in their home. In other words, it is the actual property's current market value, less any liens that are attached to the property.

The amount of equity in a house fluctuates over time as more payments are made on the mortgage and market forces impact the property's current value. So there's two things at play when we think about home equity. One is how much you own minus how much you owe. So when you first buy a property with a mortgage, you are buying for 80% of the value.

If you have a 20 percent down payment, if you're using another loan product and you only have to put down 3%, then you own 97%, and if the price you get the property at is fair market value at the time, you kind of are at your lowest home equity point immediately following the purchase. The other thing at play is what is going on in the housing market.

And so this is where people really are kind of talking about the home equity piece because people have this understanding that real estate values go up over time. And so, historically speaking, on average, residential real estate since 1968 has gone up at about 5.4%. This varies significantly depending on where you are.

Obviously, different areas of the country have seen their property values soar. Whereas other areas of the country may have seen values go down. Likewise, markets fluctuate based on supply and demand trends, based on what's going on with interest rates. And so real estate, just like any other

investment, has some risks associated with it when it comes to what the market is going to do.

So in the whole home equity part of the equation where it's really about how much you have paid off, so how much ownership you have, if your property is getting paid off in a 30-year mortgage, then the idea is at the end of 30 years, you will have full ownership of the property if you stay on the payment schedule.

Now, if you refinance the home, then your 30-year time frame will likely change in some regard. Very often what happens is that people refinance in order to lower their payment due to interest rates going down, or they refinance to take cash out of their equity, which we're going to talk about a little bit more in a bit, or they sell their property and buy another property if they are upgrading to a new property.

Sometimes they will take on yet again a 30-year mortgage and extend the time frame that they are going to be working off that debt in order to get into full ownership of the property. So a lot of things in life can kind of shift around when it comes to that sort of really basic path of building up the full equity within 30 years.

I think it's important to understand that there are times when you can do everything right and the property can have zero or less than zero equity. I bought my first home after reading Homebuyer for Dummies and being really diligent about understanding the home-buying process, and yet I bought it in 2007 right before the Great Recession. So I was buying a home in Las Vegas while still attached with the Air Force and so that property just plummeted in value as the great recession played out And ultimately was short-sold in order to kind of cash out of the property when it was in an upside down position, meaning more was owed on the property than what was owned on the property.

So that was a significant lesson for me in what can happen. And so ideas that just by purchasing sort of traditional home that you're in a secure position were definitely disrupted during that period. And there have been other periods in time where home values were not going up, they were in fact going down. Now at that time in my life, I was maybe not nearly as educated as I am today when it comes to financial topics. And by buying a home, I was in essence sort of constructing a saving strategy for myself. So I think this is where we sometimes think about home equity being sort of the first place we go when we're trying to create financial security for ourselves.

When you are locked in a mortgage, it is most likely going to be the bill that you're definitely going to pay. And so to some degree, if that real estate is going to increase in value over time, you're in a bit of a forced savings strategy. So home equity, which is often described as the traditional way that Americans have built wealth certainly has a construct around it of the mortgage that incentivizes us to make sure that we are putting that money into that asset over time.

So it often will create wealth for folks who otherwise wouldn't if they had that extra money in their bank account, perhaps they would not save it and they would spend it. And so I think that there are definitely times when home equity in its forced way through a mortgage is very much a saving grace for people.

With that said, as we'll look at in a little bit, home equity may not be the end-all-be-all when it comes to creating financial security for ourselves. There may be other mechanisms that can create that for us that aren't–don't come with some of the strings that home equity does. So we're going to talk about that a little bit more in a minute.

But at the same time, I do think that it's worth calling out that there are a lot of folks who end up in their later years of life and they're the money that they have invested in their home because they have paid it off in one way or another comes to be the nest egg that they use when they need, for example,

to move into an assisted living facility, when they want to leave some sort of inheritance, or when they need more money for living expenses than what perhaps social security or their savings is providing. There are products that can help them harvest that equity. And so we're going to talk about those as some examples in a little bit.

When we talk about traditional ways that Americans have built wealth, I think it's important to tease out that word a little bit and understand that for example, the 401k was not created until 1978 and that prior to the 401k being created a lot of the burden of financial security in later years fell on employers, other family members.

There were lots of other ways that we created financial security for our later years that did not involve actually creating wealth in an asset one way or another, and that families often took care of their elder relatives. And so this modern experience that we have of feeling the pressure to save enough money to make sure that we have all of our living expenses for three or four decades of no employment is kind of a new phenomenon and something that we should be thinking critically about and figuring out what our blended strategy of support and savings, et cetera, can do for us when it comes to making sure that over the long term that we're going to be okay.

So now we're going to take a look at some numbers. And once again, for those of you who are listening audio only, this recording is on YouTube @lesshousemoremoolapod. And there you can see these numbers in visual on the whiteboard, but I wanted for us to look at some important calculations in order to better understand this home equity equation that we are talking about in our lives. And so the first one is to understand the cost of ownership of an average home at current interest rates.

So I have used a very basic mortgage calculator from MortgageCalculator.org to show what $40,000, which is the US average home price in 2023, when you look at it over 30 years at 7 percent interest, which is about where we stand right now from an interest rate perspective.

So I did not include a down payment in this equation because I wanted to show total interest and total principal.

I also did not include any PMI. I didn't include any home insurance. I did not include any taxes. I did not include maintenance costs. So understanding that there are certainly more costs than this to buy in the average home is important. But just for the pure purposes of talking about the difference between what you own in a home minus what you owe in a home really comes down to this equation of principle and interest of a mortgage.

So 430,000 dollars at 30 years at 7 percent interest comes out with a monthly payment of 2,860. We're going to talk about this a little bit more in a minute. And then our total principal being 430,000 dollars that we would have paid over those 30 years. And that's 7 percent interest is calculated at 599,888 dollars. So in my case, I was able to use VA home loan, which allowed me to finance a hundred percent of the mortgage.

And so this would be an example of what a VA home loan would look like today if a hundred percent was financed. The total cost when you take the principle of 430,000 dollars, which is the purchase price of the average U.S. home in 2023, and you look at the 7 percent interest that's paid over 30 years on that's 599,888 dollars. The total dollars spent on that home over 30 years is 1,029,888 dollars. So 1,000,000 dollars needed to purchase a 430,000-dollar home over 30 years based on current interest rates. So when we think about home equity, right, we understand that over 30 years, we're going to pay off that 430,000 plus all the interest that goes along.

So we will have paid a million dollars. And then if we wanted to estimate what potentially on average that home might be worth at the end of that 30 years, we can look to the average growth rate of real estate since 1968, a 5.4%. Again, this is an average, this varies significantly, depending on where you are, as we kind of say sometimes nobody and nothing is average. So it's important to understand that this varies significantly and has a lot to do with different market areas.

Just for illustrative purposes and thinking through what the growth might look like if you take 430,000 dollars and you give it a 5.4 compounded annually interest rate over 30 years using this very simple calculator at investor.gov, you'll see that there is a potential value on this property of 2,082,988 dollars in 30 years. So definitely some compounded growth fair of that 430,000 over that timeframe. So then on the side here, I do a little calculation to remind ourselves that we actually didn't spend 430,000, we actually spent 1,029,888 dollars.

So when we take the 2,082,988 and we subtract out the 1,029,888 that we spent on principle and interest, we see that our actual net growth there is 1,053,099. Net growth, of course, is just reminding ourselves that we did have to spend more than the principal value in order to get our full ownership of the home because we did have to pay someone interest for 30 years to borrow their money.

That doesn't mean that the value of the property, the estimated 2 million dollars is not equity. It certainly is. But just understanding that difference between what we spent and what we have grown our valuation to is an understanding that home equity is not all growth for us because we did have to pay that interest over 30 years.

So moving on to the next concept, I wanted to kind of explore if we do have 2 million dollars in home equity at the end of 30 years, what exactly can we do with that? That's the crux of the matter. That's why everyone's saying, “Build home equity because It's a tool.” So what can we use home equity for? So home equity has a couple of different ways to get access to it.

I've listed a few things here. They are the home equity line of credit, which is basically, you take out a line of credit on the value of your home. You can do a home equity loan which is more of a lump sum loan against the value. You can do a cash-out refinance whereas you get cash in your pocket that isn't in a loan fashion although it really is, so we'll talk about that. Also, reverse mortgage is that option for folks who reach a later stage in life and realize

they don't have enough income to pay their regular bills and so they need to get access at their mortgage, but they certainly aren't going to be able to pay it back because they can't manage all the bills that they do have, so that's where reverse mortgage can come into play. And finally, there is the sell and the buy and we'll kind of talk about that a little separately.

When it comes to all of those other items, home equity line of credit, home equity loan, cash-out refinance, reverse mortgage, all of these things are another loan, so they may replace the existing loan. They may be a secondary loan. Each one has its own specific details, but all of them come with interest and so I have been getting a ton of solicitations by my mortgage servicer at the moment, really strongly urging me that I need to do a cash-out refinance because I have equity in my home.

And so when I was doing some more research on this because of course, we don't all deal with this every single day, I realized when reading about it, that a cash-out refinance means that they are going to give me some money in a check or direct deposit into a bank account. And what's going to happen with that value that I have removed from my loan will be that they will take my existing mortgage.

They will add the amount of money that I have cashed out back into the loan and then reassign a new interest rate at higher interest rates. And today's interest rates are double what my interest rate currently is. So essentially I would have a larger mortgage with a higher interest rate, so therefore much larger payment. So in a rising interest rate environment which we're in, interest rates have been going up since 2022, we have to be very critically thinking about some of these offers that we're getting and realize that we are not in the interest rate environment that we may have been in before if we were lucky enough to purchase before interest rates went up.

But the bottom line is that all of these options come with interest and fees. Why? Because our homes are a single asset all together in one package, and we don't have an ability to break off the third bedroom and sell it for

100,000 dollars free and clear and put that money in our bank account or buy a tiny home with it, right?

It is all one asset. So anytime we are getting some equity out of that asset if we are still owning the property, even if we own it free and clear because we already paid off the mortgage, we're going to be back in a loan situation paying someone interest and fees, having to go through a loan approval process, and being subject to interest rates where they are today. So even though home equity can sound like a really nice thing to have in your back pocket, when you pull it out of your back pocket, there are some strings attached.

And I think this is the part that we don't often recognize when we talk about home equity and all of its many benefits. We forget that we have those strings attached. Now, there are times when using our home equity may be the best solution we have. If we have significant debt at higher interest rates than what we would have on a home equity loan, for example, we might be able to sort of self-consolidate our debts, reduce our interest payment and be able to pay off our debt more quickly by sort of shifting that debt over to home equity loan rather than continuing to pay on high interest credit cards.

As I mentioned, the reverse mortgage is sometimes a last resort for folks because all of their money is tied up in their home. And this is exactly the point that I want to make is that home equity is something that we don't have easy access to. It's not super flexible. It does come with strings attached.

And so maybe by spending so much of our time and energy and focus building up home equity over all these many decades, we are not getting free and clear access to financial security. And so if we rethink what we purchase and maybe spend a little bit less on our home, build up a little bit less home equity, but then are smart and also save elsewhere, we may create more flexibility for ourselves and more security from the standpoint that we don't have to get a good credit approval in order to get access to our own money.

The last thing that I pointed out on this slide is the sell and buy. And of course, that has a lot to do with the circumstances of the sell and buy. If we sell our 430,000-dollar home and buy a 600,000-dollar home, we take that equity that we have in the first home, it gets moved over to the next home, and then we take the difference and that ends up in a new mortgage at new interest rates. This is why there are so few houses available right now is because most people who have a home at a lower interest rate from prior to 2022 have no interest in getting a higher interest rate and upgrading or downgrading their home right now because they understand the significance of the difference in interest rate.

The great thing about the tiny option is a little bit of a hack here where we can sell a regular house, take the equity, buy a tiny house, perhaps free and clear, and then be done with the mortgage altogether. So it really depends on what happens with the sell and the buy. Obviously, selling and buying comes with its own set of costs when it comes to the fees of processing a real estate deal, real estate agents, and all of that.

But in any case, a sell and a buy-down is one situation in which you can get out your equity without continuing to have to pay more interest to use it. So very interesting different ideas around how we actually use the home equity. So as a comparison, I am now showing a slide where we, instead of buying a 430,000-dollar home, we buy a 100,000-dollar tiny home as an example.

Purchasing tiny home on a loan right now is generally a much higher interest rate. So I have a 12 percent interest rate in here based on some conversations I've had recently about what's going on in the lending market. The great thing is if you borrow a hundred thousand dollars at 12 percent for four years, you still pay less on a monthly basis than you do on the 430,000-dollar home at 7 percent over 30 years.

So again, I have used MortgageCalculator.org here. I have put in a hundred thousand dollar principal loan with zero down payment, with an interest rate at 12 percent, paying it off in four years, and I have calculated the payment

and so the payment is $2,633.38. Back at that 430,000-dollar house that we talked about a few minutes ago, that was 2,800 dollars a month. So this is a little bit cheaper. Then we pay it off with total payments of 126,402. So we only pay interest of 26,402. So you can see that there's a very significant difference. Whereas when we bought the 430,000 home, we paid well over 430,000 in interest for 30 years.

And here, when you buy a 100,000-dollar home, you only pay about a quarter of that in interest, 26,000. So we get it paid off and we become debt-free in four years, and then we have spent a lot less on the home, less than a third of what the regular tiny home calculation was. So again, I have not included taxes and insurance here.

It's not an apples-for-apples comparison. Tiny homes are very different in this regard. I have not included maintenance in here either. Obviously, tiny homes, depending on where they're situated, may come with all kinds of interesting costs that we are not talking about here. For moving it, there's fuel costs and all of that, but in any case, I just wanted to do a very simple calculation to understand what we would have here if we were to do a mortgage on a 100,000 dollars over four years.

So what? We get the home paid off in four years. We become debt-free. We don't have the equity. I didn't do the equity calculation on a 100,000-dollar home over a 30-year period because we all need a roof over our head, and there isn't really a way to tap equity. There's no home equity line of credits on tiny houses really yet.

So can't really imagine at the moment how we would use our home equity on our tiny house at this exact moment. But the point is if we pay the tiny house off in four years, then we have all of that income that we would have been spending on a mortgage that we can now use to save elsewhere. And so I'm not going to get into all the details of sort of saving strategy on that point today. But instead, I just wanted to show you a quick calculation. If you were able to pay off a tiny home of four years, take the amount that you

would otherwise have spent on that bigger house mortgage for 26 years that you are not having to pay for that 430,000-dollar house, and you were able to grow that money at 7%, which is a pretty conservative number when it comes to growing money in a sort of well diversified and thoughtful way.

Then what happens is you end up with 2,356,000 dollars at the end of that 30 year period, where the first years you saved nothing because you were just paying off your house, and then the next 26 years, you're taking the money that you would otherwise have been spending on the larger mortgage.

And you save that somewhere whether that's building a business or whether that's saving it in retirement accounts or whether that's saving it some other way with some other investments or real estate investments or whatever your strategy is. Just having the option to save money somewhere outside of your home comes with a flexible use nest egg that doesn't have to pay interest to get access to it, that doesn't have refinancing fees associated with it, that doesn't require you to fill out loan paperwork in order to get access to your money.

So I did this calculation once again, a hundred thousand dollars. This is from investor.gov. A hundred thousand dollars that we pay off in four years so then that means that we take the 2,800 dollars a month, 2,860.80 to be exact, that we were not spending On our conventional mortgage, regular American dream house.

And we put that away somewhere or into some other investment strategy for 26 years, and at the end of the 30-year time span with a 7 percent growth rate, we're at $2,356,976.46. So do I think that everybody who buys a tiny house is then going to take 2,800 dollars a month after they pay it off and save it somewhere?

No, because that isn't the point maybe of tiny living. It's about creating more flexibility in our lives and maybe focusing on maximizing our life rather than

maximizing our net worth, but I think it's a useful comparison to understand what kind of home equity you grow over 30 years on a 430,000-dollar single asset versus what kind of equity you can grow outside of your home, with having a home that you paid for and then just taking the remainder of your income that you did not spend on your home and putting it away for your financial security.

So I want to also mention there's a ton of tax implications and all of this and there's all kinds of strategic, optimizing that you might want to talk with a financial advisor about, but in any case, I think there is an argument to be made that for those of us that can save, that don't need the forced saving strategy of a mortgage and would prefer to have choice and flexibility about how we build some financial security for ourselves, that maybe It is worth considering looking outside of home equity to build that for ourselves because we can build it in a way that actually grows at a higher rate and also is far more flexible because we can in fact cash out a portion of that in order to start a business or invest in our community or buy a Airbnb tiny house or whatever it is that we want to do without paying someone interest to get access to our own money.

So this is why I wanted to kind of break this down. Definitely, it is not about home equity being the end-all-be-all or the worst thing ever. It's really about aligning with what is important to you and what works for you.

And so I wanted to though pointed out because we feel a lot of pressure and there's a lot of things that we see on the screens that tell us we must do the home equity thing. And so I just wanted to have a critical thinking conversation about what home equity is, how it works, what it can help us achieve, what it can't help us achieve and help to think through also the risks of putting all of our eggs in the one basket of our home equity.

And so I hope that this has helped you sort of maybe unpack the onion that is home equity and think a little bit more thoroughly about what it means for you. Of course, I'm always here to answer your questions if something pops

up: laura@thetinyhouseadvisor.com. Thank you for hearing this episode and if this was valuable to you, would you please let me know. You can send me a note or make a comment. It would be greatly appreciated.

Hey, I'm honored that you listened to this episode of *Less House More Moolah.* I hope something in it will help you continue to move toward a life aligned with your values.

Every algorithm out there is trying to tell us what to prioritize, but we get to choose. If you haven't ever identified your key values, I have a free resource on my website to help you.

You just have to go to thetinyhouseadviser.com. It's the tiny house A-D-V-I-S-E-R dot com.

At the bottom of the page, you can grab the tiny life values worksheet. When we design a life around "what is our core truth?", we shortcut to deep fulfillment.

See you next Thursday.

Please see the show notes for an important disclosure regarding The Tiny House Adviser, LLC and this episode.