The Home Equity Playbook

**What is Home Equity?**

Home equity seems to be a very simple calculation — the total amount of mortgages owed subtracted from the current market value of a home. Here is a simple example:

Current Home Market Value $325,000

Existing Mortgage $225,000

Homeowner Equity $100,000

One side of the equation is well defined, and it is found on the monthly mortgage statement, the loan balance. The other side is less obvious — the current market value of the property.

As a homeowner, your down payment purchases your initial equity, and your monthly (or additional) principal payments increase your equity. In strong real estate markets and in-demand locations, equity can increase quite rapidly as the property value increases, but the inverse can also happen — too much available inventory and market down-cycles can lead to falling home values and a reduction in homeowner equity.

It can be difficult to put an accurate value on something that you have emotional and monetary vesting in. It is safe to say that most people think their home is worth more than then it is.

Homeowners can make savvy assessments about their home’s current market value by following the sales of similar properties in the neighborhood, but should stay away from websites such as Zillow and Trulia, which provide inaccurate and outdated estimates. The most accurate measurement requires a comparative market analysis from a real estate professional or having the home professionally appraised. But, the bottom line — your home is worth as much as someone is willing to pay for it.

**Creating Value is in Your Hands**

Maintaining the condition of a home is vitally important to retaining and increasing value. Homes are judged against their peers: how they compare to similar homes in the neighborhood. Another way to retain value is to not over upgrade, since it is rare to ever recoup the money spent if you exceed neighborhood value. Keep up the landscaping and do the little things to add curb appeal.

**Putting Home Equity to Work**

Home equity represents the largest single asset of millions of people, and because it represents so much of an individual’s net worth, it must be treated with respect. Home equity is not a liquid asset until a property is sold, or it is borrowed against.

There are two types of loans that tap into homeowner equity as collateral.

*Home Equity Loans*

Many home equity plans set a fixed period during which the person can borrow money, such as 10 years. At the end of this “draw period,” the person may be allowed to renew the credit line. If the plan does not allow renewals, the homeowner will not be able to borrow additional money once the period has ended. Some plans may call for payment in full of any outstanding balance at the end of the period. Others may allow repayment over a fixed period, for example, of 10 years.

A home equity loan, sometimes called a second mortgage, usually has a fixed rate and a set time to pay it back, generally with equal monthly payments.

*Home Equity Line of Credit*

A home equity line of credit is similar to a credit card. The lender sets a maximum amount you can borrow, and you can draw money as you need it, though many home equity lines of credit require an initial draw. The interest rate varies daily, and is usually prime plus a set number, but the required payment is usually interest only. Once the loan has been paid down, the payment is reduced, and it can be paid off and initiated as many times as a homeowner requires.

**How Much Equity can be Accessed?**

Since the financial institution is lending money and using a home as collateral, they will not lend 100% of the home’s equity. The bank does not want to take the risk that if the house price drops, they would be carrying a loan for more than its market value. Therefore, most banks will allow a qualified homeowner to borrow approximately 80% of their equity.

**It’s Important to Use Your Home Equity Wisely**

Because it is likely the biggest asset most people have, losing your home equity is hard to overcome. It must be used in prudent ways, and the payments against the loan must be affordable. Using equity money to make the loan payment is only acceptable for a short-term solution.

There are number of good reasons to use money from a home equity loan… and some really bad ones. First, let’s cover smart uses.

1. Invest in Your Home

The best way to use the money is create more equity in the home. Among the very best returns on your investment (ROI) include kitchen and bathroom remodels, adding square footage or an extra bath, enhancing curb appeal and repairing/keeping the existing structure sound. Making prudent investments in your home is a wonderful win-win: you enjoy the upgrades and the repairs can add value to the home.

2. Invest in your Children’s Education

Using your home equity to finance a child’s higher education may be the greatest payoff of all. Not only is the rate much lower than a student loan, it is an investment in the child’s future.

3. Supplement Retirement Needs

Older homeowners spent their working lives paying down their mortgage. At retirement, when monthly income is reduced, a home equity loan could pay for a dream vacation or an unexpected major expense.

4. Augment the Impending Sale of a Home

If you’re planning to sell soon, a home equity line of credit may be the best way to finance improvements, and you can pay it off entirely when you sell. Investing wisely on upgrades and repairs may even reap a profit on your investment.

Here are some examples of some not very wise choices.

Adding luxury amenities like a swimming pool, a hot spa, lavish landscaping, expensive appliances and exotic countertops and flooring rarely pay off.

Purchasing a car or boat or most any personal luxury items is a poor use of the funds, since these items quickly depreciate in value.

Also stay away from using money on risk-heavy investments. Financing stock purchases, start-up businesses and paying routine bills is not financially smart. If you cannot afford to purchase those items with available funds, using equity from your home means they should not be in your budget.

You should treat a home equity loan as an investment and not as extra cash when making financial decisions. If your intended use of the money doesn't pay you back in some way, it's not the best use of your valuable equity.

**We Are Happy to Assist You**

If you would like an assessment of the market value of your home and the current equity you can access, give us a call for a comparative market analysis.