Couple seeks affordable mortgage

Money Manager/by Karin Price Muelle – www.businesstoday.com

Sunday, February 3, 2002

After a lifetime of renting, Tom and Diane have finally purchased their dream home. But it wasn't easy. They had to accept a pricey mortgage deal to get into the house, and it's put them in a financial quandary.

``It was just getting desperate, where I'd say yes to anything as long as we'd get the house,'' said Diane, 50. ``That's how we got into trouble.''

The South Shore couple contacted the Herald for help in getting a more affordable mortgage deal, and to organize the rest of their money matters.

Tom, 53, an Army veteran, qualified for a Veterans Affairs, or VA, loan, which would have enabled them to finance 100 percent of the mortgage. But when the appraisal for the property came in below their expectations, Tom and Diane had to look for a home loan somewhere else.

They began working with a mortgage broker who found them a way to finance the entire cost of the home. The couple accepted two mortgages. The first was on $128,000, at a higher-than-average rate of 9.25 percent. The second, on $32,000, was at a whopping 12.75 percent interest. Both are 30 year, fixed loans.

Diane said the couple had mixed feelings when they finally moved in.

``It was a relief because we finally owned something, but at what cost?'' she said. ``It's our dream house, but did we sell our souls to get it? Did we damage our possible future to get it? We're not 20-year-olds.''

The couple spent most of their 30 years of marriage raising their kids and living paycheck-to-paycheck. Now that their kids are on their own, Tom and Diane thought they'd have more money to devote to retirement savings. But the house and the two mortgages are eating away at whatever discretionary funds they had.

Tom has a 401(k) plan worth $7,000, invested with the Putnam family of funds. He invests 5 percent of his $46,956 salary as a print manager, and his company adds another 5 percent. Tom used to contribute the maximum of 15 percent - until the couple felt cash poor as they started house-hunting.

Diane, an artist, is unemployed. Since the couple relocated to their new home in October 2001, she hasn't found another job - she last worked as an art teacher.

Diane didn't have an employer-sponsored retirement plan at her old position.

Together, the couple has two checking accounts, one with a $2,500 balance and the other with an $800 balance.

Tom and Diane also just experienced a cash windfall that wasn't available to them when they bought their home. Diane's father recently passed away and his estate was tied up in

probate court. She recently received an inheritance worth $37,000, which is in another checking account.

Perhaps the couple will use the money to play catch-up with their retirement savings, Diane said. She's nervous about how the couple will afford their golden years. The mortgage will still have to paid even after Tom's paychecks stop coming in, she says.

``It's not like our backs are young and we can apply ourselves for years into the future,'' she says. ``Getting this refinanced is definitely goal No. 1.''

SOLUTIO costs of home ownership.

With careful planning and discipline, the couple can do both, says Art Ford, a certified financial planner and certified public accountant with Sullivan Bille Group based in Tewksbury.

``They had a bump in the road with this interest rate,'' Ford says. ``But they have their spending under control and they've made it a priority to own a home. A lot of people would not have done this at their time of life.''

Ford, a member of the Financial Planning Association and the chairman of the board of directors for the Massachusetts chapter, says the couple can use Diane's inheritance as a down payment to refinance the house and get a better mortgage rate. That move will free up cash flow that can be diverted to retirement planning.

After speaking with the couple's mortgage broker, Ford says the couple can qualify for a new mortgage with a rate near 7 percent, if Tom and Diane use $20,000 of the inheritance for a down payment. That would reduce the couple's monthly mortgage payment to $899, from the current $1,400 - a savings of $6,000 a year.

Unfortunately, their current mortgage carries a pre-payment penalty of $6,000 and there will be other costs associated with refinancing.

Still, over the long term - the couple plans to remain in this house forever - there would be a big savings in interest. The reduced mortgage payment will allow Tom to maximize his 401(k) contributions to 15 percent of his salary, making a huge difference to their nest egg. If Tom continued to contribute at today's level, and the account earned 7 percent, it would be worth $63,000 upon retirement in 12 years. If he maxes out his plan, the account could be worth $157,000 at 7 percent, or $182,000 at 9 percent.

If the couple uses $20,000 of the inheritance for a down payment, they'll be left with about $20,000 in cash to invest. Ford says Tom and Diane really need to boost their savings. Based on their ages, he recommends they consider placing $2,000 each in a Roth individual retirement account for the year 2001, and also each invest $3,000 in a Roth IRA for 2002.

``This is an aggressive strategy from a liquidity standpoint, but because of the need to accumulate money for their retirement, this would help jump start that goal,'' Ford said.

Saving that $10,000 now and letting it grow over the next 12 years will provide $23,000 at 7 percent, or $29,000 at 9 percent. Since this is Roth money, it is valuable from a tax perspective, Ford says, because any withdrawals will be tax-free.

Once the mortgage is refinanced, the couple has to redirect their efforts to retirement savings. If they're disciplined, they can accumulate a healthy portfolio before they retire in 12 years.

To get there, Ford says the couple should continue to use Roth investments to add to their retirement savings. Under new tax legislation, Ford says they are able to make a Roth contribution of $3,000 this year because they are over 50, and contribution limits will increase over the next few years until it reaches $5,000 in 2008.

As for asset allocation, Ford says 70 percent of their savings should be in good quality equity mutual funds and the remainder should be in bond funds or Ginnie Mae funds.

About five years before retirement, he recommends that they change the allocation to a 60 percent/40 percent ratio.

Of the 70 percent in equities, Ford says they should consider putting 25 percent in large-cap growth, 25 percent in an index fund (such as the S&P 500), 15 percent to large-cap value, 15 percent to mid-cap value, 10 percent to a large-cap international fund and 10 percent to a small-cap growth fund.

``Literally they're starting out as if they were 25 years old so they need to be aggressive,'' Ford says. ``They realize they're going to have to work until they're in their 60s and save on a regular pattern.''

And if Diane gets a job this spring, as she hopes, the outlook for retirement improves significantly. If she's able to save some of her income for retirement, the pot just keeps growing. Diane says she could earn about $1,000 per month - money that Ford says should go straight to retirement savings.

If she does, not counting equity in their home, the couple could accumulate a total of $400,000 at a rate of return of 7 percent, or $470,000 if they earn 9 percent, by the time they retire. They'd also be eligible for Social Security. All told, they'd be able to fund a pretty comfortable retirement.

``Now they're turning the corner, and it looks like they can do it,'' Ford says. ``They have the wherewithal to do this and they're really focusing on it, as they have to.''