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Beware losing home to risky mortgage, stock deals

Eileen Ambrose -- Personal Finance

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FOR MANY people, their home has been their best investment.

But some may be jeopardizing that investment by trying high-risk mortgage strategies being promoted by brokerages, say industry regulators and consumer advocates.

The strategies in certain cases might be appropriate for high-income individuals with enough resources to handle the risks and protect their homes, said Mary L. Schapiro, vice chairman of the National Association of Securities Dealers.

"To the extent these products start to work down to lower-income people, that's where we are concerned," she said.

That concern has caused the NASD, which regulates its member brokerage firms, to recently sanction some brokers and to issue warnings to investors on how these mortgage strategies can backfire on them.

The first strategy attempts to take advantage of skyrocketing home values, incredibly low interest rates and rising stock prices.

Homeowners are encouraged to tap the equity in their home through a new mortgage, refinancing or a line of credit and invest the borrowed dollars in stocks. The theory is that investment returns will be more than enough to pay the mortgage, the NASD said.

For example, the NASD said, a retired couple who has paid off their house might be persuaded to take out a new \$250,000 loan at a 6 percent fixed rate and invest the money in a mutual fund with a track record of gaining an average of 12 percent annually. If the fund continues going up, the investment returns will be enough to cover the \$1,663 monthly mortgage payment.

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But the stock market is hardly that predictable.

If, on the other hand, the fund loses money month after month and the retirees don't have cash on hand to pay the mortgage, they may be forced to sell some shares at a loss, the NASD said. Or, they might end up selling the house, trying to recoup enough to pay off the mortgage and real estate commissions, the NASD said.

In either case, they end up losers.

In March, the NASD took enforcement actions against three brokers in Colorado and Idaho, accusing them of making unsuitable recommendations. The brokers had advised clients with no other source of funds to take money out of their house and put it in either mutual funds or variable annuities, the NASD said. In one case, the homeowner had trouble keeping up with the new, higher mortgage payments and lost the house, Schapiro said.

Brokers have a duty to make sure investments are appropriate for clients. Schapiro said brokers should presume 99 percent of the time that this strategy is inappropriate for clients, and likely to trigger enforcement action by the NASD.

Consumer advocates also warn against taking cash out of the home to buy stocks.

"The equity people build up in their home is the primary source of wealth for ... moderate-income families," said Barbara Roper, director of investor protection for the Consumer Federation of America. "To put that at risk is just an unacceptable risk for the vast majority of the population."

"I'm a big believer in investing in the stock market for long-term goals," but it shouldn't come at the expense of an individual's financial foundation - the home, Roper added.

The second strategy the NASD warns about involves so-called 100 percent mortgages, where investors borrow the full value of the house with no money down. Instead, borrowers pledge stocks, bonds or other securities in their brokerage account as collateral. Brokerages promote the mortgages, sold through a subsidiary or affiliate, as a way to buy a home without having to sell investments for a down payment, according to the NASD.

But borrowers may not understand the costs or risks, the NASD warned.

Because you're borrowing the full price of the house, you'll likely end up paying more in interest. Of course, gains on investments could more than compensate for this extra cost, but there's no guarantee, the NASD said.

The risk, too, is if the value of the securities pledged falls too low, the brokerage will require you to deposit more cash or securities in the account. If you don't have any more assets to put up, or the securities keep dropping in value, the brokerage might sell securities in your account.

Typically, borrowers are notified of the sale, although they don't have to be. They also don't get a say in which investments the brokerage sells.



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If borrowers default on the mortgage, the potential consequences are even more serious: the loss of the house and the securities.

Before taking out a 100 percent mortgage, investors need to consider the worst case scenario, particularly if they have an adjustable-rate mortgage, Schapiro said.

Many people have adjustable-rate loans and many more may choose this option now that Federal Reserve Chairman Alan Greenspan has come out in support of them, she said.

If interest rates rise, as is widely anticipated, monthly mortgage payments will go up under an adjustable-rate loan. Also, rising rates could cause investments to fall.

"You are kind of getting whacked on both sides," Schapiro said.

If you take out a 100 percent mortgage after understanding the risks, pledge a diversified portfolio of stocks, bonds and cash to lessen the chances that all your investments decline at the same time, the NASD advised.

Review your pledged securities daily. That way if your investments start falling, you can take action long before it ever gets to the point that the brokerage sells your securities, the NASD said.

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