2120 Washington Blvd., Suite 400
Arlington, VA 22204
(703) 920-3807 • (703) 920-3809 Fax
www.sfepd.org

SF&PD
SOCIETY FOR FINANCIAL EDUCATION AND PROFESSIONAL DEVELOPMENT
Enhancing financial and professional growth...

financial $UCCESS

WINTER 2011

Are Strategic Defaults a Financial or Ethical Issue?

The recent recession has been marked by reduced consumer spending and ballooning debt burdens, rising unemployment and falling home values, and considerable hardships for countless people. The pain is real for those who have lost their jobs (almost 8 million since the recession began) and their homes (1.2 million) (Source: MSNBC, 2010).

Most people who have lost their homes to foreclosure did so because they lost a job, suffered an unexpected illness, or had an adjustable-rate or interest-only mortgage note with monthly payments that skyrocketed. The dramatic decline in property values that we've seen since the peak of the real estate bubble (29% nationwide and much more in some areas) has made it difficult or impossible for people facing financial hardship to sell and move into a less expensive home or relocate for a job (Source: Standard & Poor's, 2010).

Yet, some people whose homes have lost considerable value have simply walked away...even though they can afford the mortgage payment. This trend — strategic defaulting — has been growing in popularity as homeowners decide to cut their losses and stop paying on a mortgage that is far larger than the current value of the home. Mortgages that meet this criterion are considered to be underwater, and recent statistics show 25% of mortgages meet that definition (Source: CNN, 2010). How popular are strategic defaults? Surprisingly popular — they accounted for 31% of foreclosures during the first quarter of 2010 (Source: Housing Watch, 2010).

As with any issue of this magnitude, there are strong opinions on both sides. On one side are those

Continued on page 2

Credit Issues as You Age

While obtaining credit can be just as important for older individuals as it is for younger ones, older individuals often have unique credit issues. To help ensure that you don't have credit problems as you age, consider these tips:

Apply for major loans while you are still working. If you are getting close to retirement and know you'll need a loan, perhaps for a new car, apply for credit a few years before retirement.

Make sure that credit cards are obtained as joint accounts. If you have an individual account with your spouse listed as an authorized user, the lender can close the account if you die. However, if the account is a joint one, the creditor cannot automatically close the account or change its terms.

Ensure that both you and your spouse have a good credit history. Review your credit reports, ensuring that all information is accurate and that you both have sufficient history.

If you are denied credit, find out why. It could have been an error, or you may convince the lender to consider other information. You may also be able to negotiate a compromise with the lender. ❍❍❍

FR2010-0824-0005

Strategic Defaults

Continued from page 1

who believe it is highly unethical for a borrower to walk away from a mortgage contract when he's still financially able to make payments. When borrowers enter into an agreement with a financial institution, a legal contract is signed and the borrowers become obligated to make the payments required under the contract. This line of argument holds that walking away from a home and dishonoring the mortgage contract is a breach of good faith between the lender and the borrower and is, therefore, unethical.

On the other side of the issue are those who argue that a mortgage contract is nothing more than a business deal. Like many agreements in the financial world, if the terms no longer benefit both parties, the deal can be broken — ethically and legally (in fact, contracts provide for default and repossession as a possible outcome). Thus, the fact that a home mortgage is just a business deal excludes any moral, emotional, or ethical underpinnings.

Either way, the decision to default — strategically or otherwise — is certainly not one to be taken lightly. First, the borrower's credit rating (based on a scale of 300 to 850) is likely to take a big hit, as much as 160 points (Source: CNN, 2010). Second, it could be difficult to obtain credit for a number of years; and if a future lender does agree to issue another loan, the interest rates may well be higher. Finally, in some states, lenders have a right to pursue a deficiency judgment in court — to pursue the borrowers for any difference between the price at which the foreclosed home sells and the value of the mortgage note.

This past summer, Fannie Mae announced future restrictions applicable to borrowers who strategically default, indicating that strategic defaulters will be disqualified for new Fannie Mae-backed loans for seven years after their foreclosures. Also, Fannie Mae says it will go to court where it can to try to recoup outstanding mortgage debt from borrowers who strategically default.

You need to consider your own financial situation when deciding if a strategic default makes sense for you. If you can afford your mortgage and aren't planning to move for at least 10 years, then it may not matter that your home is worth less than your mortgage today.

On the other hand, if you don't plan on staying in your home for very long, if you purchased your house solely as an investment vehicle, if it is significantly underwater, if you can stomach the effects your default will have on your neighborhood, and if you can save money renting, then walking may be the best financial option for you. Ethical? That's up to your best judgment. ❍❍❍

Selling Your Home at a Loss

With the current state of the real estate market, more and more taxpayers may find themselves in a situation where the sale of their home results in a tax loss or their net sales price is less than the amount of their outstanding mortgage.

When selling a home, the basic tax rule is you can exclude gains of up to $250,000 if you are a single taxpayer and up to $500,000 if you are married filing jointly, provided the home was your primary residence in at least two of the preceding five years. But what happens if you have a loss on the sale? Since your primary home is not considered investment property, you cannot deduct a loss on your income tax return.

Although not a short-term solution, one way around this is to convert your home to rental property. Then, when the property is sold, the loss can be deducted as a capital loss, as long as you can prove the home was permanently converted to income-producing property. Your basis for calculating the loss is the lesser of your actual cost or the property's fair market value when it was converted to rental property. For instance, if you bought a home for $250,000, converted it to rental property when it was worth $225,000, and sold it for $200,000, your loss would be $25,000, not $50,000.

When calculating your gain or loss on the sale of your home, don't confuse your mortgage balance with the basis in your home. Your basis is the amount you paid for the home plus any improvements. It is possible for your mortgage and equity loans to exceed the sales price. If you sell the home for less than your mortgage amount, then you will owe more than you received but it is still possible to have a gain for tax purposes. For instance, assume you purchased a home many years ago for $200,000, have a mortgage and equity loan totaling $300,000, and sell the home for $250,000. Although you have to pay $50,000 out of pocket for the mortgage and equity loan, you will have a $50,000 gain for tax purposes.

Due to the home sale gain exclusion, you can exclude up to $250,000 if you are a single taxpayer and up to $500,000 if you are married filing jointly, provided the home was your primary residence in at least two of the preceding five years. If you move out of the house and it takes longer than three years to sell your home, your gain could be taxable. Please call if you'd like to discuss this in more detail. ❍❍❍

Before Purchasing That Stock

Whether you're investing for the first time or buying new stocks to augment your current portfolio, there are five important questions to ask yourself:

What's your objective? Is your ideal stock one that pays a high dividend or one that has a high growth rate with no dividends? Is it a stock with relatively little price volatility but lower potential gains or one with a lot of potential risk and higher potential rewards?

How you answer those questions — and the stocks you choose — depends on your objectives. If capital preservation is your goal, for example, a lower-risk stock is probably preferred. On the other hand, if you're young and growth is your target, a higher potential return stock may make more sense.

Is your portfolio diversified? When considering which stock to purchase, determine whether you need to target your investment in certain areas to balance out your diversification. Make sure your portfolio isn't concentrated in just one industry, but spread out over at least four or five. And there are other dimensions to consider as well, such as cap weighting (large, mid, and small), style (growth or value), and geography (U.S.-based, developed foreign markets, and emerging markets).

What's your expected holding period? If you're looking to trade for quick gains, your expected holding period is short. In that case, you need to be sure you are timing your purchase so you're getting in near the beginning of an upswing, not the end of one. If you are buying for the long term, on the other hand, the price you pay is less critical.

What's the prevailing market trend? In the 1990s, the market was so strong that almost any stock you bought was likely to go up in value. But in a trendless or declining market, it's a lot harder to find a winner, at least in the short and intermediate terms. That's because the majority of stocks move in the same direction as the market, no matter how fundamentally strong a stock may be.

At the current price, would you be paying too much? To answer this question, you'll have to consider some basic fundamentals. First, look at the stock's price/earnings (P/E) ratio, which is its price per share divided by earnings per share. How does it compare to the stock's normal range, and how does it compare to its competitors?

In addition to the P/E ratio, you should examine the stock's past and future earnings growth rate. Then look at its price/earnings to growth ratio (PEG ratio). The PEG ratio compares the stock's P/E ratio to its five-year projected earnings growth rate. A PEG ratio of 1 to 1.5 is typically considered normal. A PEG of 2.0 or higher is often a sign that a stock is overpriced, while a PEG ratio below 1 may be an indication that the stock is a bargain.

Please call if you'd like help reviewing your stock investments. ❍❍❍

Do You Have a Budget?

A budget serves as a road map for your spending, helping you find ways to save more money for your financial goals. For a one-month period, keep track of every dollar you spend, whether by cash, check, or credit card. Break down those expenditures by category and total them for the month. Are you surprised by how much small expenditures add up over a month? To make sure you get the maximum benefit from the budgeting process, keep these points in mind:

- ✔ Use spending categories that make sense for your spending patterns. If there are areas with good potential for spending reductions, even if the amounts are relatively small, set them up in their own categories.
- ✔ Set up enough categories to give you a good feel for your spending patterns, but not so many that it becomes difficult and time-consuming to monitor your progress.
- ✔ Include nonrecurring items in your budget, such as gifts, tuition, insurance premiums, property taxes, etc.
- ✔ Periodically compare your actual expenditures to your budgeted expenditures to find out where you are having problems.
- ✔ While everyone in the family should have some cash that can be spent without accounting for it, don't make the amount so large that it detracts from your savings efforts.
- ✔ Include savings in your budget and make sure you actually save that amount every month.
- ✔ While at times a budget may not seem worth the effort, remember that it is a tool to help you accomplish your financial goals. Remain committed and stick with it. ❍❍❍

Five Common 401(k) Plan Mistakes

While it's true that participation is the first step, simply putting money into a 401(k) plan won't guarantee a comfortable retirement. Consider these five common 401(k) mistakes and how you can avoid them:

1. Believing that simply contributing to your 401(k) plan is sufficient. Your goal should be to contribute the maximum annual limit — $16,500 for people under 50 years of age and $22,000 for investors 50 years of age or older.

2. Using your 401(k) plan as a savings account. When you go through a major life event, it can be tempting to cash out your 401(k) plan to get you through that "rough patch." Withdrawing from your 401(k) plan today not only puts a dent in the balance that will compound over time, but if you're not yet at retirement age, the Internal Revenue Service may send you a hefty tax bill for withdrawing that retirement money early.

3. Fearing diversification. Diversification is a risk management technique that mixes a wide variety of investments within a portfolio. It's based on the idea that a mix of different investments may yield higher returns with lower risk than any individual investment.

A good rule of thumb is to invest more in equities the further you are from retirement and then gradually increase your bond allocation over time to help make that shift from a growth orientation toward an income orientation.

4. Not participating in the company match program. If your bank gave you $10 every time you deposited $10, would you accept that? That's what many companies offer through their 401(k) matching programs. Figure out how to budget your monthly take-home pay accordingly so that you can contribute at least as much as your employer will match (most match 50 cents or $1 for every $1 contribution, up to a certain percentage of pay).

5. Suffering analysis paralysis. Whatever your situation, it is better to be prepared for retirement than not. The mistake here is either failing to tap the benefits a 401(k) plan offers (like company matching) or setting up contributions and then failing to pay attention to how they are allocated and making necessary adjustments.

If you feel like you may be making some of these mistakes, please call. ❍❍❍

What's Your Debt-to-Income Ratio?

It's common knowledge that lenders use your credit score (a mathematical calculation based on information on your credit report) when making lending decisions. But lenders also like to review your debt-to-income ratio.

To calculate your debt-to-income ratio, add up all your monthly debt obligations, including your mortgage, home-equity loans, auto loans, student loans, minimum credit card payments, and other debts. Divide that number by your monthly gross income to find your debt-to-income ratio.

To be considered a good candidate for debt, that number should generally fall below 36%. Go much higher than that, and you are likely to have trouble getting additional debt or debt will carry higher interest rates or significant fees.

Lenders review both your credit score and your debt-to-income ratio, because your credit score is simply a reflection of your past payment history and does not indicate how much debt you carry in relation to your income. ❍❍❍

Financial Thoughts

The average age of retirement for men has changed only slightly in recent years, but more than 40% of men born during the early years of the baby boom were still working at age 65, compared with less than 25% of men born 10 years earlier (Source: Urban Institute, 2010).

Almost half of individuals age 65 or older said they pay more for insurance and health care expenses than they had anticipated when planning for retirement. Less than one-third of retirees had saved specifically for the cost of health care in retirement during their working years (Source: *Employee Benefit News*, 2010).

The overall value of employer financed retirement benefits, including retiree medical and life insurance plans, fell by 19% over the past decade (Source: Towers Watson, 2010).

In a recent survey, 55% of respondents indicated that they have been affected at work by the recession, from unemployment and pay reductions to involuntary cutbacks and part-time work. On a personal level, 62% said they have cut back on spending since the recession began, and 48% say they are in worse financial shape now than when the recession began (Source: Pew Research Center, 2010). ❍❍❍