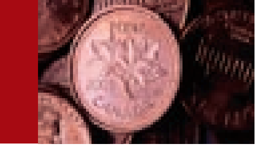
The $500 billion mortgage opportunity.

Fraser Smith
Author,
The Smith Manoeuvre
Sidney, B.C.
(recorded April 26, 2005)

Fraser Smith reveals the sea change underway in the Canadian financial planning industry, one that means new business for mortgage brokers.

Len and Clarence Bick are co-founders of venerable Bick Financial Security Corporation in beautiful Ancaster, Ontario. With 15 financial planners and half a billion in assets under administration, Len is what you would recognize as a savvy businessman. Last year he was quoted as saying, “The Smith Manoeuvre is like a small snowball just starting to roll down a hill covered in wet snow. This exciting new financial strategy will give every Canadian family with a mortgage the chance to make their debt tax deductible. Big things are going to start happening in the financial planning and investment industries.”

Len’s words have proven to be prescient: Nearly 200 financial planners across Canada have requested their names be listed at www.smithman.net as offering Smith Manoeuvre services to mortgage holders, with more signing up every week. The book entitled “The Smith Manoeuvre” has become a Canadian best seller. In every province, planners are pairing up with mortgage brokers to conduct public seminars for Canadians interested in making their mortgage tax deductible.



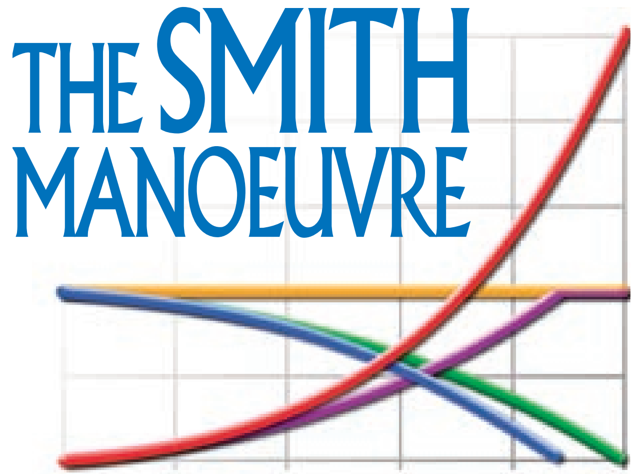
Opportunity for everyone

The size of the opportunity is breathtaking. The total financing for all of Canada's home mortgages is about $500 billion. There are approximately 3.5 million common house mortgages in Canada. Regardless of their size, their rate, their amortization or their owners, they do not generate tax deductible interest. More importantly, nearly every one of them can and should be converted to the tax deductible variety. This means that the $500 billion already spent on house mortgages can be spent again.

This can and will happen because The Smith Manoeuvre relies on the tax fact that if you borrow to buy your house, the interest expense is not tax deductible. If, however, you borrow to invest, the interest IS tax deductible.

Home owners who have mortgages have already assumed the biggest debt of their life. They want to buy investments for their retirement, but they are trained to pay off their mortgage first. Twenty years later they finally succeed, and with the mortgage gone, they start an investment program—too late in life. Their reward is apt to be the reverse mortgage which strips their house of equity at the back end of their life when they no longer work. Wealthy people start making their equity work for them as fast as it forms—while they are young. The other 90% of the population, the ones who need help the most, let their equity moulder.

The Smith Manoeuvre ensures that all mortgage holders, wealthy or not, can deduct the interest on their mortgage. Moreover, they will be building up a pool of investments that are free and clear because the house, not the investment pool, is the security for the readvanceable mortgage. This means there will be no margin calls, and the interest rate will be the lowest possible. If you were to lose your job, you could liquidate enough of your free and clear investments to make the mortgage payments until you were working again. While your primary objective is to build a personal pension plan for your retirement, it is a comfort that your portfolio is a private reserve in your middle years.



What makes it tick?

The logo illustrates the workings of The Smith Manoeuvre. The graph represents a $200,000 mortgage at 7% for 25 years. The green line is the standard amortization of this mortgage. The yellow line shows that the starting debt for these homeowners is $200,000, and that their debt will remain at that level at least until the loan is converted. This is because as fast as equity is generated via mortgage payments or tax refunds being applied (the blue line), the money is borrowed back to be invested, (the purple line). The red line shows the growth of the investments purchased via the purple line.

In this case the portfolio would be about $509,000 if the annual average rate of return matched the performance of the TSE over the past 54 years at 10%. There would probably be some tax to pay if this portfolio was sold, but it is unlikely that the owners would want to liquidate their position. It would be far wiser to let the portfolio produce retirement income. The portfolio represented by the red line is free and clear because the house is the security for both loans.

To be fair, the $509,000 portfolio value would have to be offset by the $200,000 loan still in place 25 years later. The net value of The Smith Manoeuvre for this family is therefore $309,000. On the other hand, the interest on the $200,000 loan is tax deductible every year into the future. Our advice to clients is that they should plan to die at age 130 still owing that $200,000 good-debt loan.

The dual functionality of paying down and reborrowing requires a modern instrument such as the innovative Matrix Mortgage offered by FirstLine Mortgages. In addition to the variable portion being readvanceable, this product automatically advances investment credit on the LOC portion as fast as the fixed portion is reduced.

Risk

The Smith Manoeuvre is not a leveraging strategy; it is a debt conversion strategy. Leverage occurs when debt is increased by borrowing money to invest. As you have seen, debt does not increase at all when the Manoeuvre is employed—it remains level. The leveraging occurred when the homeowners leveraged their tiny 10% down payment on their house into a 90% mortgage.

It can safely be argued that the risk is higher when carrying a non-deductible mortgage than it is if the debt can be made tax deductible. If there is any risk to be attributed to The Smith Manoeuvre, it is the usual investment risk that is unavoidable if we wish to build an investment portfolio.

Summary

Canadians are beginning to understand that they do not have to live with their bad-debt non-deductible mortgages. This debt hinders their ability to build a portfolio of investments to provide retirement income. If they implement The Smith Manoeuvre, they can pay off their mortgage sooner, generate perpetual and free tax refund cheques and build a free and clear portfolio of investments to build their personal pension plan. These three important benefits occur simultaneously.

The Smith Manoeuvre does not require that Canadians increase their debt, nor does it require new money from their family cash flow. The strategy has been alive for 20 years in B.C., and is legal anywhere in Canada. All of the advantages listed here can be effected to begin within days.

The financial planner is the likely customer interface for most of these mortgage conversions. It is a wise planner who teams with a mortgage broker so the task of shopping and arranging the best readvanceable product for each individual circumstance is handled by a specialist. The pairing will leave the planner with more time to meet more mortgage holders. It is also likely that the mortgage broker will refer his client base to the planner for the planner's expertise in putting the total package together for home owners. With 3.5 million mortgages needing to be converted, wise brokers should begin now to form as many liaisons with financial planners as they can manage.

When The Smith Manoeuvre is deployed, everybody wins. Especially home owners.