



BESTLIFE

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From the Editors of **Men'sHealth**

Work & Finance

Tax-Free Wealth

Surprising findings from a new study can save you big bucks

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Here's an arresting observation from a paper published by the Federal Reserve Bank of Chicago:

$$MAP = 1 + \tau X - X = 1 - \frac{1 - \tau}{1 - \tau - k\tau} \left(\frac{1 + (1 - \tau)r_B}{1 + r_L} \right)^T$$

On the chance you need help translating, here's what that means: **At least 4 million Americans are wasting money by accelerating their mortgage payments instead of investing in retirement accounts.** The paper itself—**"The Trade-off Between Mortgage Prepayments and Tax-Deferred Retirement Savings,"** by University of

Texas professors Jennifer Huang and Clemens Sialm and Federal Reserve banker Gene Amromin—takes more than 50 pages to back up that conclusion, which contradicts much popular financial advice. If you decide, as I did, to assume that people who work for the Fed probably know what they're talking about, you can skip the formulas and footnotes and claustrophobia-inducing prose, and go straight to our condensed version: **The money you use to pay off your mortgage has been taxed, which means, depending on your tax bracket and your state tax hit, you have only about 60 to 70 cents to show for every buck your employer paid you. Better to divert that dollar into your 401(k), because the full 100 cents goes into the account.**

Even if you are not among the millions of people accelerating their mortgage payments, the study is helpful because it shows just how powerful a tax shelter that lowly 401(k) can be. **The authors, incidentally, define a mortgage prepayer not only as someone who makes additional monthly payments but also as anyone with a mortgage that's original term was less than 30 years.**

Huang did a back-of-the-envelope calculation for *Best Life* to show the power of investing money before the taxman touches it. **Let's say you and your wife bring home \$200,000 a year in a high-tax state and you are just starting to pay off a 30-year \$400,000 mortgage at 6.5 percent. If you paid an extra \$300 each per month toward those mortgage payments, you could pay off your loan nearly 12 years early. Sounds great, until you see Huang's math. By diverting that \$600 a month into your 401(k), you'd come out \$44,000 ahead, she says. And that might even be lowballing it:** For the purposes of their study, the researchers assumed you'd invest the money in bonds. A couple investing in stocks may see an even bigger gain.

Why more people don't take advantage of this strategy is a mystery even to the authors, who write, "It is difficult to identify rational reasons for the inefficient behavior." (More than a third of eligible households with fixed-rate mortgages make no contributions to employer-sponsored retirement accounts.) The authors speculate that **these mortgage preppers are motivated by "debt aversion and risk aversion."** Most of us, the authors suggest, worry too little about bad debt (e.g., credit-card balances) and too much about the most benign (e.g., mortgages with tax-deductible interest). And this goes double for the surprisingly large number of people who don't take full advantage of their employers' 401(k) contribution-matching programs. Hey, it's free money!