



Don't rush to pay off that mortgage

You've got better things to do with your money, like saving for retirement, building an emergency cushion or even living it up a little.



By Liz Pulliam Weston

You normally don't think of people who prepay their mortgages as being wasteful or careless. But a recent study suggests these households blow more than \$1.5 billion a year, or \$400 per household, by accelerating their mortgage payments instead of contributing more to their retirement accounts.

The research found that at least 38% of those who were making extra payments on their mortgage were "making the wrong choice." Instead, these households would get back 11 to 17 cents more on the dollar by putting the money into a workplace retirement plan like a 401(k).

The study, titled "The Tradeoff Between Mortgage Prepayments and Tax-Deferred Retirement Savings," was conducted by Clemens Sialm of the University of Michigan's Ross School of Business, Gene Amromin of the Federal Reserve Bank of Chicago and Jennifer Huang of the University of Texas at Austin using Federal Reserve data.

If anything, I think the study underestimates how many people make a mistake by prepaying their mortgages. It didn't look at folks who were accelerating their mortgages while carrying higher-rate debt, or who failed to have an emergency fund, or who didn't have adequate life, health or disability insurance.

Most people, in short, have much better things to do with their money than to pay off a low-rate, tax-deductible loan.

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- regarding the acceleration of their mortgage payments

The urge to be free of debt

It's not that I don't understand the impulse to speed up the day that you own your home free and clear. There's something psychologically satisfying about knowing the bank can't take your castle.

Besides, the numbers can seem pretty impressive. Let's say you have a 30-year, \$250,000 mortgage at 6% interest. Your monthly payments are \$1,498.88. By paying an extra:

- \$100 a month, you could save nearly \$52,000 in future interest and pay the loan off 4½ years early.
- \$250 a month, you could save nearly \$100,000 in future interest and pay the loan off nine years early.
- \$500 a month, you could save nearly \$144,000 in future interest and pay the loan off almost 14 years early.

So who wouldn't go for that, right? Indeed, the study estimated that almost one in six U.S. households (16%) pay extra on mortgages each year.

But anyone who really understands money would realize that the savings aren't all they're cracked up to be.

For one thing, mortgages tend to be some of the cheapest money you can get, and, as mentioned earlier, the interest is often deductible. If you're in the 25% federal tax bracket, that 6% interest rate may be costing you as little as 4.5% if you itemize. (Your tax break depends on the amount of interest you pay and the total of your other itemized deductions.) Even if you don't get any tax break at all on your mortgage, though, the rate is still dirt cheap compared with that on most other loans.

Furthermore, those seemingly impressive interest savings are way in the future, where their value will be substantially eroded by inflation. For example, \$50,000 in 25 years would be worth less than \$24,000 in today's dollars, even at a moderate 3.1% inflation rate.

Contributions to a workplace retirement plan will get you a lot further ahead, for a variety of reasons:

- Most workplace plans have matches, typically 50% of every dollar you put in up to 6% of your pay. If you're not contributing enough to at least get the full company match, you're leaving free money on the table (and missing out on an immediate 50% return).
- You save taxes on the money going in. Federal tax brackets range from 15% to 35%; there are also federal tax credits when lower-income folks make retirement contributions. When the money comes out, you'll owe taxes, but most people's tax rates fall in retirement compared with when they're working.
- Your money can earn better returns in the market compared with paying off low-rate debt. Based on historical returns, a mix of 60% stocks, 30% bonds and 10% cash would earn an average of more than 8% a year in most 20- to 30-year periods, according to market researcher Ibbotson Associates.

The study didn't mention Roth IRAs, but they're another account you should take advantage of if you possibly can. You don't get a tax break up front, but the money comes out tax free in retirement.



OFG: The general public has been led to believe that they are in a safer position by having their home paid down; this is a myth-conception. They are in fact increasing their risk and making the lending institution safer. Every extra principle payment you make is money you will never see again unless you sell or refinance your home, while next months payment is still due. Unfortunately, if you need access to some of that built up equity due to the loss of a job, natural disaster or investment

opportunity, you need to qualify to access that money back on the banks terms. The equity that you are creating by paying down your principle is not liquid (you can't access it when you need it), not safe (it is not guaranteed or insured), and it is not earning you a rate of return.

By leveraging the idle equity trapped in your home, you not only increase the liquidity and safety of that equity, but by applying the principles of arbitrage in an account that has tax-advantaged accumulation, withdrawal and transfer, can pay off your mortgage in half the time.