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Laura Rowley Money & Happiness

The Cost of Peace of Mind

by Laura Rowley

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Jim Schenke, a 40-year-old writer/publicist for Purdue University in Indiana, is a conscientious saver.

Married with a toddler, Schenke has set aside a full year's salary in an emergency fund, because he and his wife decided she would stay home after their daughter was born 18 months ago. That cut their $50,000 income significantly.

Where the Money Goes

Their cars and student loans are paid off, and they studiously avoid credit card debt. Schenke also makes an extra payment each year toward his fixed-rate, 30-year mortgage, which has an interest rate of 6 percent. But he doesn't contribute to his employer's 403(b) plan; Purdue sets aside $5,000 annually for his retirement.

"The only company I owe money to is my mortgage lender, and I'm going to be beholden to them for as short a time as I can be," says Schenke, who follows the debt-free philosophy of the late Larry Burkett, founder of Crown Financial Ministries.

But a new study suggests Schenke might be better off putting that extra cash into the university's retirement plan. Researchers found that at least 4 in 10 homeowners would build more wealth by putting additional mortgage payments into a tax-deferred retirement plan, such as a 401(k) or 403(b).

The Best Possible Future

An estimated 23 million households face the mortgage prepayment versus retirement savings dilemma, the researchers found. Switching the money to retirement savings would save U.S. households up to $1.5 billion a year, they estimate.

"We're not telling people they should save more -- the study is about making optimal use of savings," says Gene Amromin, financial economist with the Federal Reserve Bank of Chicago, who conducted the research with Jennifer Huang of the University of Texas McCombs School of Business and Clemens Sialm of the

University of Michigan. "If you were to move a dollar from here to there without increasing risk, would you come out ahead?"

Using data from the Federal Reserve's Survey of Consumer Finances, the researchers examined individuals who had a fixed-rate mortgage with either a 15-year term or a 30-year term on which they made extra payments; were eligible to participate in a tax-deferred retirement account and weren't maxing out contributions; and took advantage of the mortgage interest deduction by itemizing tax returns.

"The tax code subsidizes both mortgage borrowing and 401(k)-type investing," says Amromin. Homeowners can deduct the interest paid on a mortgage, while workers who save in 401(k) plans reduce their taxable income by the amount they contribute, and the funds grow tax-free until they're withdrawn at retirement.

Do the Math

That makes it important to do the math before you make a savings decision. Consider a homeowner who takes out a 30-year fixed-rate mortgage at 6 percent, and is in the 25 percent tax bracket; he effectively pays 4.5 percent on the mortgage. "If you invest in Treasuries in your 401(k) plan that are earning 5 percent tax-free, that's a risk-free way of increasing your return," Amromin says.

Researchers examined household goals for prepaying a mortgage, and looked at what would happen if they invested the money in a retirement plan instead. For example, in the interest of making an apples-to-apples comparison, the researchers considered two investment scenarios:

Scenario A: The investor puts an extra amount toward his mortgage each year, paying off a 30-year fixed mortgage in 25 years.

Scenario B: The investor puts the extra cash in his 401(k) instead, investing it in Treasury bonds or mortgage-backed securities. After 25 years of paying the mortgage at a normal rate, the investor withdraws a lump sum from his 401(k) to pay off the house -- incurring income taxes (and a 10 percent penalty if the money is taken out before age 59-1/2).

Although mortgage rate, income tax brackets, and 401(k) contribution limits varied among households, in about 40 percent of the cases putting the money in a retirement fund beat paying the mortgage off early, the study found. "Basically, the investor met exactly the same goal of paying off the mortgage in 25 years by spending less money," Amromin says.

Conservative Estimates

How much less? Working backward, the researchers figured out the average difference on an annual basis: The investor who chose a retirement investment over a mortgage prepayment got to keep $400 a year in his pocket.

Amromin says the study probably underestimates the number of households that would benefit from switching a mortgage prepayment into a tax-deferred retirement account, because the researchers made a number of conservative assumptions:

- They assumed investors didn't get a 401(k) match from their employers. In reality, more than 90 percent of plans managed by Vanguard, one of the largest 401(k) administrators, offer a match.

- They presumed the investor would put the money into a low-risk investment -- Treasury bonds or highly rated mortgage-backed securities. Someone investing in equities would likely do better: Between 1926 and

2003, stocks returned an average of 10.5 percent a year on investment, while government bonds averaged 5.45 percent, according to Ibbotson Associates.

• They assumed individuals had a constant income tax rate over time. But retirees often slip in a lower tax bracket, making 401(k) contributions during peak earning years even more valuable. According to Federal Reserve data, 41 percent of households are in the top tax bracket before retirement, while only 18 percent are after retirement.

• The researchers excluded state tax obligations, which would also make the tax-advantaged features of the 401(k) more worthwhile during peak earning years. Currently, 43 states impose an income tax.

A Matter of Choice

For many homeowners, including Schenke, it's more of a psychological decision than a financial one. "If I own my house, I've got my stake," he says.

"Housing is the single biggest part of your costs, and if that's taken care of, I feel like I can get by on a modest income. Every dollar I put into a retirement account, I feel like it's gone for at least 20 years."

But if someone loses their job, no lender will offer a home equity loan, whereas money in a 401(k) could be withdrawn (albeit with a 10 percent penalty for someone younger than 59-1/2 as well as taxes). Meanwhile, the ability to sell a home in an emergency depends on market conditions.

An Outdated Approach

Why do so many people choose to put extra money into a mortgage when other options would likely increase their wealth? "This is really remnant of Depression mentality that has persisted from generation to generation," says Amromin. At the time, most mortgages had one- to five-year terms, with a lump sum payment due at the end.

"Any shock to income meant you couldn't afford your payment -- mortgages were much more susceptible to economic uncertainty," says Amromin, and roughly one-quarter of Americans were unemployed during the Great Depression. "It's fine to pay down your mortgage if it gives you peace of mind, but you should recognize what that peace of mind costs."

For more on the study, and a simple way to calculate the mortgage prepayment versus retirement savings choice, visit my blog.