Now May Not Be the Time to Pay Down the Mortgage

By John F. Wasik

May 21 (Bloomberg) -- When the housing market brakes, millions of homeowners who think they are going to stay in their home for a while start asking a common question: Is it time to pay down the mortgage?

After all, adding extra money to your monthly payment isn't only a way of paying the note off early, it will cut total interest expenses and give you peace of mind at a specific time.

Want to get rid of the mortgage before children enter college or before you retire? Simply want to build equity, so that if you need to get a second mortgage, you enhance your borrowing power?

All are good reasons for paydowns. Yet there are cases when early payoffs aren't the best economic strategy. You may be better off contributing to your retirement savings accounts.

Those who choose the paydown route over contributing to tax-deferred accounts may be losing about $1.5 billion a year, according to a recent study. That's because early payers could reap higher long-term gains by investing in fixed-income securities in their retirement account.

About 38 percent of U.S. households may be making the wrong choice by paying down their mortgages instead of funding their retirements.

That's the conclusion of a working paper by the National Bureau of Economic Research. It was written by Eugene Amromin of the Federal Reserve Bank of Chicago, Jennifer Huang of the University of Texas at Austin, and Clemens Sialm at the University of Michigan Business School.

Write-Off Benefit

The trio examined data from the U.S. Survey of Consumer Finances and isolated 10.5 million households that prepay their mortgages and contribute to a retirement plan.

Those who the researchers said weren't getting the best return on their mortgage paydown could be unaware of the extent of ``tax arbitrage profits,'' that is, the benefit of getting a write-off and tax deferral on retirement-plan contributions.

``For these households, reallocating their savings can yield a mean benefit of 11 to 17 cents per dollar, depending on the choice of assets in the tax-deferred account," the authors contend.

By redirecting savings from a mortgage into a retirement plan, the researchers are disputing the conventional wisdom of debt aversion. Isn't it better to be debt-free and then have that money to save for retirement or to boost cash flow?

One pitfall of mortgage paydowns is that they offer no immediate economic benefit. When you pay back principal, you get an imputed or assumed return of roughly the rate of your mortgage. Yet it doesn't necessarily compound tax deferred as it would in a retirement account.

House Prices

As an investment, your home offers you no cash dividends or diversification, especially if you have little in the way of stocks or bonds. Investing in a mutual fund that packages mortgage securities, real estate, U.S. Treasuries or Treasury inflation-protected securities reduces your dependence on the housing market, which is in decline in much of the U.S.

Housing prices fell 1.8 percent in the first quarter, the National Association of Realtors said May 15, as foreclosures continued to climb and lending standards became tighter. The Realtors group, a Chicago-based trade association, said it expected median prices to decline in the second and third quarters as well.

The retirement-funding strategy isn't without risks. Interest rates can rise, while inflation and defaults can depress bond prices. The only guaranteed investments are U.S. Treasury or inflation-protected securities that you hold to maturity. You need to compare returns to see which strategy works best.

Tax Liabilities

``A higher mortgage borrowing rate makes it less profitable to stop prepaying, while a higher investment return makes it more attractive to invest in a tax-deferred account," the researchers say.

Neither route gives you complete liquidity, though. If you need to tap retirement funds -- a bad idea because they are harder to replace the older you get -- a 401(k) loan is a possibility, though you will have to pay it back if you quit or change employers. Otherwise, you will pay full tax on the amount plus a penalty.

After age 59 1/2, you can withdraw retirement funds without a penalty, though you will owe income tax on withdrawals. Roth accounts let you take money out tax-free.

Unless you sell your home or refinance and withdraw equity, you can only extract money through a home-equity loan or reverse mortgage. One consolation is that home-equity loan interest is tax-deductible, and most gains on your home aren't taxed.

What to Avoid

Still swayed by the peace-of-mind school of economics? Here's the payoff: If you have a $300,000, 30-year mortgage at 6 percent and add $200 a month to principal, you will save more than $106,000 in total interest payments and knock almost eight years off the term of the loan.

Should you choose the mortgage paydown route, avoid gimmicky ``accelerator'' programs, which charge you unnecessary fees. You can pay down principal as often as you like and there's no additional charge. Just write on your mortgage check or statement the amount you want to ``add to principal.''

There's even a better deal that far too many avoid: Company-sponsored plans with an employer-matched contribution. Your return on their dollar-to-dollar match is as much as 100 percent.

Ultimately, the right answer of whether to contribute to retirement plans or your mortgage is ``both.'' You can save as much as $15,500 this year in a 401(k)-type plan and an additional $5,000 if you are older than 50.

Peace of mind is certainly important, but you can't ignore how you get there or how much it costs you.

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Last Updated: May 21, 2007 00:17 EDT