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FINANCING

To prepay or not: Usually not

Marilyn Kennedy Melia, Special to the Tribune

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Sooner or later, a homeowner who accumulates a little cash will wonder whether to put it in the house.

By contributing extra to their mortgage, homeowners essentially invest in their home by decreasing the share owned by their lender.

But given the array of investing options, is it smart to squirrel away savings in your home?

"That's one of the most common questions clients have," said Naperville financial planner Robert Gerstemeier.

A recent working paper published by the Federal Reserve Bank of Chicago examines the question exhaustively.

Though the paper focuses on whether it's more advantageous to use savings to prepay a mortgage or to put those dollars into a tax-advantaged retirement account such as a 401(k), the researchers glean insights into the overall merits of mortgage prepayment.

"Two of the most important financial decisions people make involve saving for retirement and purchasing and investing in a home," noted Gene Amromin, a Federal Reserve Bank of Chicago economist and one of the study's authors.

Most of the time, homeowners should contribute to their retirement plan to the max before even thinking about prepaying their mortgage, the study finds.

Very simply, that's true anytime a homeowner's after-tax mortgage interest rate is less than the before-tax return of a relatively safe investment in a retirement account, says Clemens Sialm, an assistant professor of finance at the University of Michigan and a study co-author.

Say your mortgage has a 6 percent fixed rate. And your employer offers to match every dollar you contribute to the company 401(k) up to 6 percent of your salary.

Furthermore, within the 401(k) there is an array of mutual funds to invest in, any of which are likely to yield at least a 5 percent annual return.

Because you can deduct the total you pay in mortgage interest each year from your taxable income, your

effective mortgage interest rate is reduced by your tax rate.

Assuming you pay about 25 percent of your income in federal income taxes, that means you're effectively paying one-quarter less in mortgage interest.

Because the after-tax mortgage rate is less than the return in the 401(k), which gets a big boost with the employer matching dollars, you'll be better off investing your dollar with your employer.

Sounds straightforward, but there are myriad wrinkles to consider, such as whether your retirement account income will be large enough to pay your mortgage, which will still be around when you retire if you don't prepay.

It also matters whether you have a fixed- or adjustable-rate mortgage [the researchers used a fixed-rate mortgage for their analysis]. And whether you plan to move or refinance soon.

But the study authors were able to determine how households were making the choice between prepaying a mortgage and investing in retirement by combing through data collected in the Federal Reserve Board's Survey of Consumer Finance.

"We found that about 3.4 million households don't contribute at all to their retirement but do prepay [their mortgage]," said Sialm. Those households are losing from 11 to 17 cents for each dollar they put into a faster mortgage payoff, the study estimates. The study considers households as prepaying if they make periodic extra payments to their lender or have a shorter-term loan, such as a 15-year mortgage.

Whenever they're considering prepaying, homeowners have to weigh the ultimate interest savings from a shorter mortgage against the projected growth of the same dollar invested elsewhere.

Given the variables to consider, it's a trade-off that will keep financial planners busy running calculations for clients.

Address questions to Financing, Chicago Tribune, Real Estate, 435 N. Michigan Ave., 4th Floor, Chicago, IL 60611. You may also e-mail realestate@tribune.com. Sorry, she cannot make personal replies. Answers will be supplied only through the newspaper.

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