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May 23, 2007

GETTING GOING
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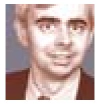

Why a Mortgage May Be Your Best (and Worst) Move

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If mortgage debt is good debt, why are so many borrowers having such a bad time?

Financial experts often tout the virtues of home loans, arguing mortgages are the cheapest money you will ever borrow. Yet many homeowners are ruing the day they took out a big loan, and some are falling behind on their payments and even losing their homes to foreclosure.

As these folks have discovered, mortgages are a double-edged sword. The leverage can magnify your gains -- but it can also leave you in a nasty bind.

• **Playing the spread.** If you need to borrow, you will be hard-pressed to do better than a home loan. Not only are interest rates typically low, but that interest is usually tax deductible. To get a mortgage, you need to own a home or agree to buy one. But once you have that debt, the effect is to leverage all your assets. That can be highly profitable.

Suppose you have $300,000 in stocks and you want to buy a $300,000 home. You could sell your stocks and pay cash for the house. But you will likely fare better by putting, say, $100,000 of your stock money toward the house and funding the rest with a $200,000 mortgage.

Result: You control $500,000 of stocks and real estate, 40% of which was bought with borrowed money. As long as your assets generate higher returns than your mortgage rate, the leverage is working in your favor.

• **Missing the boat.** Many homeowners, however, aren't taking full advantage of their mortgage's leverage. Consider a study slated to appear in the Journal of Public Economics.

Economists Gene Amromin, Jennifer Huang and Clemens Sialm found that, among households striving to pay down their mortgage quickly, at least 38% could be stashing more in their employer's 401(k) or 403(b) plan. That means these folks are missing out on their 401(k)'s initial tax deduction and tax-deferred investment growth. That combination should easily outpace the interest expense they save by paying down their mortgage.

Throw in a matching employer contribution, and the 401(k) would be even more compelling. Similarly, you could probably improve returns by taking money earmarked for extra mortgage payments and using it to fund an individual retirement account or to buy stocks in a taxable account.

Still, prepaying a mortgage can be attractive, especially if the alternative is to purchase bonds or money-market funds in a taxable account. The mortgage's after-tax interest cost is likely higher than the after-tax yield on these conservative investments.

• **Unraveling fast.** Like the idea of supercharging your returns with low-cost leverage? Before you take out a hefty home loan, make absolutely sure you can handle the monthly payments.

Indeed, that's why I get nervous when experts advocate getting the largest mortgage possible or recommend re-mortgaging a house to buy stocks or cash-value life insurance. If you end up with monthly payments you can't afford, things can unravel fast.

Consider the dilemma facing many recent home buyers. Their homes are falling in value, even as their mortgage payments are sometimes rising.

If you are in this predicament, it isn't a calamity, provided you can afford the monthly payments. What if you can't? This is one financial quagmire that's hard to escape.

If you have other savings, you could pay off a chunk of your mortgage. That should trim your monthly payment next time your mortgage rate resets -- assuming you have an adjustable-rate loan. "But unless you make a sizable repayment, it's not going to help a great deal," warns Keith Gumbinger, a vice president with mortgage-information provider HSH Associates.

Meanwhile, if you have a fixed-rate mortgage, paying down principal won't lower your required monthly payments. Instead, it will shorten the life of your loan, which won't help with your current cash crunch.

Mr. Gumbinger's advice: Try refinancing. By taking out a new 30-year mortgage, you could reduce your monthly payments, simply because you're re-extending your loan back over 30 years. If, at the same time, you can pay down a chunk of principal, that will help even more.

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