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Homeowners' Get-Out-of-Debt Instinct

By Martha M. Hamilton
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Free and clear.

I love the sound of it, and when I bought my house, I always figured that was how it would be eventually.

But here I am, 32 years and many refinancings later, still facing 25 years of payments unless I gear up and start forking over more money. But should I?

My gut instinct is . . . Are you kidding? Maybe it was all those television Westerns I watched as a kid. The slimy banker with the villainous mustache beating on the door, unpaid mortgage in hand, driving the virtuous ranch family from the homestead. Or maybe it was the frugality to which I was exposed as a child. (I didn't have a Big Mama, but I did have a Cheap Daddy who saw no reason to pull the plug after one child had a bath before the next one did. Luckily, my big sister was not a roll-around-in-the dirt kind of girl.) Paying the mortgage was the way to go, I felt strongly.

But I should know by now that my gut isn't a trusted financial adviser. It turns out that I was wrong.

Based on my situation, I'm probably better off *not* prepaying my mortgage. That's according to Clemens Sialm, a finance professor at the University of Michigan who looked at my finances. He recently co-wrote an analysis of retirement savings versus mortgage paydowns conducted for the National Bureau of Economic Research with Gene Amromin, an economist at the Federal Reserve Bank of Chicago, and Jennifer Huang, a finance professor at the University of Texas at Austin.

And I'm not the only homeowner who should resist that atavistic get-out-of-debt instinct, according to the authors. They looked at 22.8 million households that were in a position to choose between prepaying their mortgages or making additional payments to a tax-deferred retirement account. And what they concluded was that nearly 4 out of 10 would be better off directing the extra money into a retirement account.

But which choice works best for you? Sialm said there are three factors that can help you make that decision: whether you itemize deductions on your taxes; whether you're eligible for an employer match on contributions to your retirement savings plan; and whether you have alternative uses of the money, such as paying off higher-interest debt or earning more through investments. Holding off on prepayments generally benefits the more affluent, according to the study.

Itemization figures into the paydown decision because it can reduce the after-tax interest rate you pay on your mortgage. In my case, I have a 5.25 percent mortgage, a very low, very attractive mortgage rate.

Because I deduct my mortgage interest, my after-tax interest rate is about 3.5 percent. That argues against pre-payment in itself. Itemizing also helps me because I can deduct state income taxes, which reduces my combined state and federal marginal tax rate to 33 percent.

As to whether your choice is between pre-paying a mortgage and putting money into a retirement fund with an employer match, that's almost a no-brainer. Prepay the mortgage and turn down additional money from your company? Or contribute to the retirement fund and get the extra cash?

Okay, now for alternative uses of the money. In my case, I have about $250,000 worth of mortgage debt at about a 3.5 percent interest rate after taxes and about $56,000 on my home equity line at a pre-tax rate of 7.5 percent (5 percent after taxes). When I started piling up debt to do some needed repairs on the house, that rate was 4.5 percent. Not only is the interest on my home equity line of credit higher than on my mortgage debt, it also could keep rising. So paying off the home equity line should be my priority -- not my mortgage.

Even if that home equity debt were to disappear (and it will some day), I'm still probably better off not making additional payments on my mortgage. I'm not eligible for any employer matching contributions, but I could still add to my retirement accounts. If you assume, as Sialm did, that the bonds in my portfolio are earning about 5 percent tax free until I cash in, that's still a better return on investment than pre-paying the lower-interest debt.

As for whether investing in stocks is a better deal than paying off the mortgage, Amromin, Huang and Sialm didn't get into that. They did not want to pose a choice between a relatively safe investment (mortgage prepayments) and a riskier one. "That wouldn't be a fair experiment because then you would change the riskiness of your portfolio," Sialm said.

The figures they used to assess the benefits of prepayment versus an alternative investment were based on mortgage-backed securities or super-safe Treasury bonds.

The authors of the study know that weighing the balance between financing a home and financing retirement is one of the toughest issues families face, and they expect to do more work in this area. Right now they're looking at whether you should change your retirement investment portfolio's balance between safety and risk once you buy a house. I'll be interested in what they find.

In the meantime, I've got some other property out in Virginia I own free and clear. Just in case.

* * *

Correction: In a recent column I referred to the Graduate School, USDA as the USDA Graduate School. The institution is not part of the Department of Agriculture.

Any questions about retirement that you'd like to see explored in the column? Please e-mail me athamiltonm@washpost.com.

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