

Amid Market Shoals, Prepaid Mortgages Appear a Harbor

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In these troubling times for investors, there's no place like home.

That's the thinking of Adam Eisenson, a fourth-grade teacher who lives in Hillsborough, N.C. This summer, Mr. Eisenson stopped making contributions to the 403(b) retirement savings plan offered by his school. He's now applying the extra \$700 a month to pay down his 30-year mortgage, which carries a 7 1/8% interest rate.

"Even though I love the market and have an online trading account, I was getting really disappointed," says Mr. Eisenson, whose mortgage payment would normally total \$1,065 a month. Mr. Eisenson says he plans to continue making the extra payments "until after this whole war thing calms down and we start seeing a rebound."

With stock prices plummeting and the 10-year Treasury note (which calls the tune for mortgage rates) currently yielding just under 4.6%, some investors have decided that prepaying their mortgage is the way to go. The basic premise is simple: Prepaying a mortgage offers a return equivalent to the interest rate on your mortgage minus any tax benefit. Thus, spending \$10,000 to prepay an 8% mortgage will save you \$800 a year, the same guaranteed yield as an 8% Treasury bond.

Taxes are what make the calculation more complicated. If you're in the 27% tax bracket, losing the deduction on \$800 of interest will reduce your net savings to \$584 a year, or a 5.84% yield. But even that thrashes the current yields on bonds and bank accounts, most of which are taxable.

"You get a higher return paying off an 8% mortgage than investing in a 5% Treasury," says Robert Van Order, chief economist for Freddie Mac, the government-sponsored mortgage-finance company. Because of lower tax rates and limits on itemized deductions, the tax advantage of a mortgage "isn't what it used to be," he adds.


So far, any increase in prepayments hasn't shown up in mortgage statistics. The most recent data, from the second quarter, showed many people were doing exactly the opposite: opting for cash-out refinancings that increased their mortgage payments.

Indeed, many financial planners say that now isn't a good time to prepay mortgages, especially when stocks already have tumbled to more attractive valuations. They say investors over the long run will be better off plowing any extra money into the stock market, which historically has produced average annual

To Prepay or Not to Prepay

The table below compares paying off your mortgage with investing in the stock market. First, find your tax rate on the table below, then look for the interest rate that most closely corresponds to your mortgage. Where the two columns meet is your break-even point. For example, if you have an 8% mortgage and are in the 35% tax bracket, you'd be better off paying down your mortgage if you expect stocks to earn less than 6.5% a year.

MORTGAGE RATE	TAX RATE			
	27%	30%	35%	38.6%
3	2.74	2.63	2.44	1.87
4	3.65	3.50	3.25	2.49
5	4.56	4.38	4.06	3.12
6	5.48	5.25	4.88	3.74
7	6.39	6.13	5.69	4.37
8	7.30	7.00	6.50	4.99
9	8.21	7.88	7.31	5.61
10	9.13	8.75	8.13	6.24
11	10.14	9.63	8.94	6.86
12	10.95	10.50	9.75	7.48
13	11.86	11.38	10.56	8.11
14	12.78	12.25	11.38	8.73
15	13.69	13.13	12.19	9.35



Footnotes: Calculations assume income-tax rates as of July 1, 2001, that all returns on stocks are taxed at 20% long-term capital-gains rate and that they don't include the effect of state and local taxes.

Source: Grant Thornton LLP

suggest that clients pay down" 6.5% and 7.5% mortgages, says Linda Lubitz, a financial planner in Miami.

Ross Levin, a financial planner in Minneapolis, says he had been recommending that clients invest in their mortgages as a way to "reposition some assets." But Mr. Levin adds that he's more reticent to do it now because mortgage rates have become "so cheap."

But in a time of political and economic turmoil, many people want the sure thing. Last week, Mark and Nancy Xander of Albuquerque, N.M., paid down about \$135,000 of their \$265,000 mortgage and refinanced the balance to reduce the monthly payments. "It was a peace-of-mind thing," says Mr. Xander, 39 years old, a medical-equipment salesman who sold some stock to raise cash.

Falling share prices played a key role in the couple's thinking, says Mr. Xander. "We're not even breaking even if the market is losing money." By refinancing, the Xanders also sliced their monthly payments to \$1,200 from \$2,300 and reduced the interest rate on their loan by more than a percentage point. "If things get really bad, we've got a real manageable expense," Mr. Xander says.

To see how paying down a mortgage stacks up against a taxable fixed-income investment, you simply compare the interest rate on the mortgage with the yield on the investment. "It's a straight comparison because both are subject to the same tax," says Tom Ochsenschlager, a partner in the national tax office of Grant Thornton LLP.

Mr. Ochsenschlager is paying down about two thirds of the balance on his 6.25% adjustable-rate mortgage because he's earning just 3.85% on his money-market account. "I was trying to sit out the market even before the terror attack," he says.

The comparison is trickier if the alternative to prepaying your mortgage is buying stocks. That's because stocks held more than one year are subject to a lower capital-gains tax. The accompanying chart to this article on page C1 shows the break-even point for investors weighing a stock-market investment against paying off their mortgage. Someone who has an 8% mortgage and is in the 35% tax bracket, for instance, would be better off paying down their mortgage if they expect stocks to earn less than 6.5% a year. The calculations from Grant Thornton don't include state and local taxes and assume all stock-market earnings are taxed at the 20% capital-gains rate.

Prepayments shorten the time it takes to pay off a loan. A one-time, \$5,000 prepayment made in the 13th month of an 8%, 30-year mortgage can cut 56 months off the term of the loan and produce roughly \$36,000 in savings, according to HSH Associates, financial publishers in Butler, N.J.

Two big caveats-- If you have a 15-year or 30-year fixed-rate mortgage, prepaying your mortgage generally won't reduce your monthly payment, which is fixed at the time you take out your loan. Likewise, prepaying your mortgage won't allow you to skip payments when times are tough.

The exception is homeowners with adjustable-rate mortgages, who will see reductions in their monthly payments if they prepay. That's because the monthly payments on ARM's are typically adjusted once a year based on the outstanding balance and the current interest rate. If you have an ARM, it's best to prepay about two months before the loan readjusts, says Keith Gumbinger, vice

president of HSH. "Otherwise, the real savings on your monthly payment won't show up" until the next readjustment.

There are many ways of prepaying your mortgage beside a lump payment. You can replace a 30-year mortgage with a 15-year mortgage, adding a few hundred dollars to each monthly payment. Or you can simply include a few extra dollars when you send in the mortgage payment each month.

However, homeowners should be wary of so-called "biweekly" mortgage payments, says Nancy Castleman, a partner in goodadvicepress.com, a Web site that covers how to manage debt. Biweekly plans allow homeowners to make 26 biweekly payments, or the equivalent of one extra monthly payment a year. But they generally carry a one-time set-up fee and sometimes include a monthly charge. "It's a waste of money," says Ms. Castleman. "You end up paying for services you don't need."

Before prepaying your mortgage, make sure that you have enough spare cash to cover emergency expenses or the loss of a job. It's also best to pay down credit-card debt, car loans and other forms of consumer debt first because the interest on these loans isn't deductible and the rates are generally higher.

Keep in mind, too, that if you do need cash in the future, you're going to have to do some shuffling to get money back out of your house after prepaying. Donna Skeels Cygan, the Xanders' financial planner, says she advised the couple against paying off their entire mortgage because "I wouldn't want that money tied up where it's not accessible."

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