Don't Burn the Mortgage
Stephanie Fitch, Forbes Magazine, 06.11.01

Prepaying your home loan is not as smart as it sounds.

In the most critical moment of the final episode of CBS' 2001 series *Survivor*, contestant Tina Wesson was asked how she'd spend the $1 million grand prize. Her point-blank response: "Pay off my house and pay off my best friend's house." That sentiment won her a jury vote needed to win $1 million, leaving her runner-up, Colby Donaldson, with a paltry $100,000.

Everyone wants to burn the mortgage, right? Well, somebody should pull Tina Wesson aside and tell her the bad news: Prepaying your mortgage can be a lousy investment.

Behind the emotional appeal of paying off the mortgage is an economic fallacy that goes something like this: That mortgage has so much interest built into it that you wind up paying for the house two times over. The fallacy has to do with the time value of money. A dollar today is not at all the same as a dollar available 25 years from now. Adding up 2001 interest costs with 2026 interest costs is not just misleading. It is utter nonsense.

So, how do you evaluate your mortgage? Look at its after-tax cost. Compare that with the after-tax return you can get elsewhere.

A 7% mortgage has an after-tax cost in the neighborhood of 4% for a high-bracket investor. Can you invest at a better yield than that? Sure. The Vanguard Long-Term Tax Exempt Fund today is yielding 4.8%, or about 4.6% after state taxes (depending on where you live).

No, you can't take out a mortgage, invest the proceeds in a muni- fund and still deduct the mortgage interest. But if you already have the mortgage outstanding from when you bought the house, and then get a windfall from your aunt, you can invest the windfall in munis without disturbing your tax deduction.

"If you're [prepaying a bit of the mortgage] to whittle off the end of a loan so it matures in the same year you're planning to retire, that's fine," says Steven Schnall, president of the New York Mortgage Co. "But otherwise you're not getting much value."

And nothing says you have to buy low-risk munis with your windfall. Stocks might do better. The Vanguard 500 Index Fund's annual average return since 1976 has been 13% after taxes for an upper-bracket investor. Of course,

there's no telling if it will do as well in the future; indeed, the high prices of stocks these days make that outcome implausible (see "Charticle," p. 186). But beating 4% over the next 25 years should not be too hard.

Here's something else Tina perhaps didn't think about: the possibility of tax-sheltered investing with the windfall. A crucial factor is whether the sheltered investment would be not just tax-deferred but tax-deductible, like a 401(k). In the latter case it's fair to compare the *pretax* return on the investment account with the *after-tax* cost of the mortgage. Sticking only to investments of fairly low risk--say, Vanguard's Total Bond Market Index Fund, yielding 6.2% now--you can do much better than the 4% after-tax cost of a mortgage.

What if your tax-deductible retirement plans are maxed out? Then you may be looking at an assortment of savings plans whose contributions are not tax-deductible but whose earnings are tax-deferred. Section 529 college savings plans, deferred annuities and nondeductible IRAs are all examples. The calculation is more complicated. But if the deferral is for a long time and your deferred investment isn't burdened by high overhead costs (watch those expense ratios!), then you stand a good chance of doing better investing than prepaying a mortgage.

Two more things to ponder. One is that mortgages are a lot cheaper than almost any other form of borrowing. Don't prepay a mortgage if you have any credit card debt outstanding or are in the habit of leasing cars.

The other is liquidity. Don't prepay your mortgage until you have set aside a year's living expenses in a pot that you can get into without any penalty. A no-load intermediate-term bond fund is a good choice.