

MORTGAGE advisor™

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INVEST IN YOURSELF, NOT YOUR HOUSE

Consumer Reports Study Discourages Mortgage Mortality
“The longer you own your home, the less likely it is that mortgage prepayment will be the better choice.”

Home may be where the heart is, but it may not be the best place to house money. That was the conclusion of a March 2008 Consumer Reports story titled “Your Mortgage: It rarely Pays to Prepay.”

Consumer Reports editors posed the question of whether it is better for a person who has an extra \$100 a month to pay down a mortgage or play the stock market. To answer this age-old argument, researchers created a computer model to compare prepaying a mortgage with investing in a Standard & Poor’s 500 Index mutual fund in the following situation:

home 10, 15 or 20 years later at the prevailing U.S. average price. To make the exercise more realistic, the Consumer Reports statisticians figured that the borrower refinanced to a 15- or 30-year mortgage when rates went below a certain point.

These became the base numbers for a second and third set of numbers that figured the same scenarios, but with an additional \$100 either added to the monthly mortgage payment or put into no-load, low-expense Vanguard 500 Index funds.

The result? The investment almost always won – and in the case of long-term homeownership, some of the differences were dramatic. The 10-year scenarios averaged a \$10,058 gain for the monthly \$100 fund investment vs. a \$4,051 bonus for those who kicked an extra hundred a month to the mortgage bank. The investment advantage widened in the 15- and 20-year scenarios with savings of up to \$41,931.

“So, the longer you own your home, the less likely it is that mortgage prepayment will be the better choice,” the article declared.

One of the primary reasons for the earning gap was a discrepancy in average appreciations. The article acknowledged that while in recent years, home prices climbed as much as 17 percent in a single year, over the two decades studied, the average increase was 6.5 percent. The stock market, on the other hand, averaged 10 percent even taking into account some dramatic stock-specific swings.



A person buying an average-priced home with 20 percent down and a 30-year fixed-rate mortgage at 132 different points between January 1986 and December 1996 sells that

Reserve Judgment

This conclusion echoed a 2006 report by the Federal Reserve Bank of Chicago entitled “The Tradeoff between Mortgage Prepayments and Tax-Deferred Retirement Savings.” Researchers Gene Amromin, Jennifer Huang, and Clemens Sialm reported that “mis-allocated savings” in the form of additional mortgage payments were costing U.S. households as much as 1.5 billion dollars per year.

This number came from calculations using data from the Survey of Consumer Finances. They found that 38% of U.S. households accelerating their mortgage payments instead of saving in tax-deferred accounts could save as much as 17 cents per dollar by reallocating their savings to investments. “They are making the wrong choice,” the Reserve Bank researchers said. “A significant number of households can perform a tax arbitrage by cutting back on their additional mortgage payments and increasing their contributions to tax-deferred accounts.”

“Mis-allocated savings in the form of additional mortgage payments are costing U.S. households as much as 1.5 billion dollars per year.”

The Reserve Bank report pointed to the tax advantages of investing. “Mortgage interest payments are deductible from taxable income for households that itemize their deductions, while investment income in retirement accounts remains

effectively tax-exempt,” the researchers noted. Those tax benefits combined with the increased liquidity of investments over stranded equity were cited as powerful reasons to diversify savings outside the home.

In light of these results, why do so many Americans still mis-allocate their hard-earned money? The Consumer Reports study noted the psychological benefits of being mortgage free, including an emotional desire to own a home outright. The Reserve Bank writers also noted the illogical rationale for storing hard-earned cash in a low-yield, hard-to-access vehicle such as home equity. “Self-reported debt aversion and risk aversion variables explain to some extent the preference for paying off debt obligations early and hence the propensity to forgo our proposed tax arbitrage,” they ventured.

That emotional argument was often overcome, however, after the facts were laid out in black and white. “The bottom line, according to our Money Lab, is this: Although there are exceptions, chances are you’ll be better off putting extra money into a good mutual fund, not into prepaying your mortgage,” Consumer Reports concluded.

For further information, visit: <http://www.consumerreports.org>



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To arrange a mortgage planning consultation on strategies discussed in this article, please give me a call.