

Most Americans hate their mortgage, loathe the monthly payment, and strive to pay it off as soon as possible. They want to be done with it once and for all and freed from its pressures. If this describes your feelings for your mortgage, read on, as you may be surprised to find out that not only are these feelings detrimental, but downright absolutely wrong. You should love your mortgage.

Sure, it's the biggest payment of the month. It's oppressive, relentless, and scary. It looms over us and has to be dealt with every month. But, in fact, in the context of financial planning, a mortgage is an important financial tool. It just has to be used appropriately. Many top certified financial planners agree that paying off your mortgage is one of the worst financial decisions a homeowner can make.

The Federal Reserve Bank of Chicago recently released the results of an extensive study on the subject of paying off your mortgage versus investing the money elsewhere instead. Their results concluded that paying off or paying down your mortgage is the wrong choice for many Americans.

Most people compartmentalize their lives by looking at small parts of it rather than the big picture. The goal should be to create wealth. People want to retire, send kids to college, travel the world, support their parents. These goals require wealth creation. That is very different than debt elimination.

If you succeed at paying off a mortgage, you may end up being debt free and poor. Look at an older couple who has no mortgage, but is scraping by on Social Security. They live in a \$300,000 house they bought 40 years ago for \$30,000. They have no mortgage, but they have property taxes and medical expenses that have skyrocketed. Are they really better off? You have to recognize that you have a choice. You can have no mortgage and no money, or a mortgage and money.

When people say they fear their mortgage, they are lying. It's their inability to pay their bills that they fear. As long as they have the money to pay their bills, the mortgage becomes incidental.

Paying Down Mortgages are an Inefficient Use of Capital

From an economic perspective, it is an inefficient use of capital to pay off or pay down a mortgage. By investing in the mortgage, we give up the opportunity to invest elsewhere –stocks, bonds, other real estate, etc. The question is can we invest elsewhere and earn more than 6 percent? The answer is usually “yes.”

Mortgages are normally the least expensive way for homeowners to borrow money. This is for two reasons.

First, mortgage interest rates are typically lower than interest rates for any other type of borrowing (cars, credit cards, home equity loans, etc). Second, mortgage interest is tax deductible, thereby reducing the net cost of money even further.

However, even though mortgages offer individuals the least expensive method for borrowing money, Americans still insist on systematically paying down their mortgage each and every month (a portion of most mortgage payments goes towards paying down the outstanding principal balance).

Now consider this, the vast majority of these same Americans also have some level of credit card debt, car loans, college loans, or home equity loans. Why on earth would anyone want to pay down a loan with a low interest rate (their mortgage), when they also have debt outstanding with a higher interest rate?

For example, a typical 30 year fixed mortgage today carries an interest rate of about 6.25%.

Mortgage debt is tax deductible though, so the after tax effective rate we pay is less. A homeowner in the 28% federal income tax bracket would have an effective after tax mortgage rate of about 4.50%. This same homeowner is likely to be paying 8%-12% interest on their car loans and 10%-23% interest on their credit card debt.

An important side note is neither car loans nor credit card debt is tax deductible, so there is no net reduction to the interest rate. Many financial planners refer to debt that is not tax deductible as “non-preferred debt”. On the other hand, tax deductible debt (such as a mortgage) is referred to as “preferred debt” since Uncle Sam effectively pitches in to help us make part of the payment.

The Typical American Household

Let's look at the typical American household for a moment as an example. They have a mortgage at 6.25%, two car loans at 10% interest each, and credit card debt on which they pay 19% interest. We know the mortgage is "preferred debt" and the effective after tax rate is really closer to 4.50% (assuming a 28% federal tax bracket). The car loans and credit card debt are "non-preferred" debt, so no reduction or help on those interest rates.

Back to our question from earlier, why in the world would anyone pay down their mortgage (with an effective rate of 4.50%), when they have other debt where they are paying 10% and 19%? A rational person would certainly pay off the highest interest rate loan first and work their way down, paying off the lowest interest rate loan last. However, when we make our mortgage payment each month typically several hundred to maybe even over a thousand dollars is going towards paying down the principal balance of the mortgage, our lowest cost loan.

Given our typical American household scenario, we would be best served by paying off the credit cards first, the car loans second, and the mortgage dead last. The quickest way to pay off our debt, is to divert the portion of our monthly mortgage payment that is currently going towards paying down principal (on the 4.50% effective rate mortgage) and instead route it towards paying down the credit card balance (a 19% effective rate loan). Once the credit cards are completely paid off, we turn our attention to the car loans and pay those off too.

You will need an interest only or deferred interest mortgage to have the flexibility to divert your mortgage principal payments to paying off your credit card or car loans. The traditional fully amortizing mortgages require the homeowner to make a fixed payment that includes both principal and interest each month. The more flexible interest only and deferred interest mortgages allow the homeowner the opportunity to pay only the interest due each month. This gives the homeowner more choice and control and allows them to apply their cash each month to the best and most efficient use of the funds. For most Americans, the best use of funds is paying off non-preferred debt.

Once all non-preferred debt is paid off and the mortgage is the only remaining debt, the homeowner must make another decision. Is it best to go back to making principal payments and slowly pay down the mortgage balance each month? Or is there another better use of funds?

For those with financial self discipline, there is a better use of funds, and they should not go back to paying down the mortgage. Instead, they should save and invest the extra monthly cash flow, and build up their home equity in a side investment account, rather than inside the home itself. There are many advantages to keeping your cash outside the home. The three main advantages are greater liquidity, greater safety of principal, and greater rate of return on the money.

Consult with One of our Professional Mortgage Consultants Today!

Integrating your mortgage into your overall financial plan is one of the best ways to build wealth over the long term. A properly structured mortgage with regular annual reviews can be the difference between retiring early when you want or possibly not being able to retire at all.

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