In Defense of the Home Mortgage: Not all Debt Is Bad Debt

Michael J. Evans, Founder, The Cogent Advisor

I believe it's time to take a fresh look at a timeless question: Is it better to own your home outright or maintain a mortgage? Given all the factors involved, an experienced wealth manager can really earn his or her keep on this one.

When weighing the advantages and disadvantages of holding a mortgage, it's important to think through subjective considerations as well as the objective, number-crunching comparisons. With all due respect to William Shakespeare, who admonished, "Neither a borrower nor a lender be," there are often a number of valid reasons that homeowners may want to maintain a mortgage on their principal residence, even if they could afford to pay it off.

A Home "Investment" Can Cost You

While hopefully your home gives you comfort, joy and security, the money you put into this highly undiversified holding is often more like an expense than an investment. Think of it as the price you pay for all that comfort and joy, whether or not your home appreciates in financial value.

So, when you are considering the best use of your investable assets, your affordable home is usually best positioned toward the lower end of the places you want to lock up your equity. (By *affordable*, I mean a home that does not expose you to the risk of losing it should you fall on hard times. I've never seen anyone lose their home because their mortgage was too big; it's generally because they purchased a home that was too high-priced for their financial situation.)

A long-term mortgage can free up your financial assets for greater diversification in the global stock market, improved liquidity and more efficient pursuit of your most important wealth goals.

Now, let's apply some practical and empirical reasoning to this convention-defying premise.

Diversification, or Lack Thereof

When it comes to investing, decades of academic research on efficient portfolio management has demonstrated that global diversification helps investors succeed, with "success" defined as meeting your personal financial goals. A globally diversified portfolio is thus nearly every investor's friend, enabling you to maximize expected returns for a given level of essential market risk.

That's why I typically recommend that investors avoid making big bets on concentrated holdings. Sure, you may win big if it pays off … but you also could be left bereft if that single holding fails. That's no way to invest toward your desired future.

Owning your *affordable* residence outright and not having a long-term mortgage is often a big bet, exposing a substantial percentage of your wealth to concentrated risk. Your home may be your castle, but it's a decidedly undiversified fortress. It's classified as residential real estate, and it's located in one city, one neighborhood and on one block. In contrast, a Real Estate Investment Trust (REIT) investment can be broadly diversified geographically as well as by property type (such as residential and commercial).

Considering Liquidity

Personal residences are neither a liquid nor a flexible asset. Even when you're in a seller's market, with an abundance of "For Sale" signs being marked "Sold," the process of selling your residence is relatively expensive and usually time-consuming.

Best case, it can take days, if not weeks or months, of preparation and market time. And then you have to take the time and energy to move. When you factor in realty commissions, essential repairs, and staging, closing and moving costs, you can easily spend 8 percent or more of the selling price. (Zillow.com estimates 2-5 percent of home value for closing costs, plus I typically see agent commissions of around 6 percent.)

Contrast that to selling a stock or mutual fund, which typically occurs same-day, at a fraction of the cost, and with a single log-in or phone call.

Your Home as a Credit Card?

In lieu of, or in addition to, a mortgage, some may propose that a home equity line of credit (HELOC) is one way to tap into your home's equity when needed … maybe. As summarized in this Wall Street Journal article, there are limits to how much of a HELOC is deductible. And in an unpleasant twist of fate, this form of lending may be least favorable just when you are most likely to want to depend on it.

For example, during the financial crisis of 2008-2009, many banks reduced or cancelled existing HELOCs at precisely the same time many homeowners were experiencing job losses, stress-induced health challenges and other unexpected financial woes. They learned the hard way that their banks might refuse to issue desired lines of credit just when they needed them the most.

In contrast to a HELOC, a long-term mortgage offers three distinct benefits, plus potential tax advantages, which we'll cover next.

1. **A dependable line of credit.** A mortgage can ensure that you have full access to an appropriate amount of the equity in your home, essentially establishing a positive liquidity situation for you for up to 30 years. In exchange, you are required to make a monthly payment. As long as your payments are current, you can choose to pay off the loan when and if you please, but you never are required to do so. You – not the bank – control your pay-off date. This is one reason I often suggest that families go ahead and carry their mortgage into retirement.
2. **Favorable lending rates.** Mortgage interest rates are usually relatively cheap money. While mortgage loan amounts are based on your repayment ability as determined through

your employment earnings, they are collateralized by your home itself. This allows the lender to keep the rates very favorable. Historically, mortgage rates have remained relatively low while unsecured credit card interest rates have been going up. In short, a mortgage is typically among the cheapest money an individual can borrow.

3. **Continued equity-building potential.** If you're lucky, your home may appreciate over time. When this occurs, that value grows and builds regardless of whether you hold a mortgage. You can reap the dual benefits of building equity in your home while being able to diversify your investable wealth. And should you eventually decide to sell your home, having a mortgage balance should not affect its value in the eyes of potential buyers. They will not be concerned if your home has a reasonable mortgage on it at the time they make their offer.

Tax Rates, Interest Rates and Loan Bargains

There can also be significant tax advantages to having a mortgage. If you are able to itemize expenses on your Schedule A, your mortgage interest up to $1 million becomes tax-deductible, potentially for as much as 39 cents on the dollar. You will likely save on state income taxes, too. A 4 percent, fixed-rate mortgage may actually cost you as little as 2.6 percent. Here's the math to illustrate that:

Mortgage interest rate	4.0%
Tax savings (35% bracket)	-1.4%
Net cost	**2.6%**

When you factor in inflation (which has averaged 3.1 percent over the last 70 years) you may be able to take on a mortgage for 0 percent or less. Thus, while interest rates are low, your mortgage payment will become less significant compared to your income. And if you choose a fixed-rate mortgage, as I would recommend, your payments will never rise, but hopefully your home's value will.

Like a fine wine, your mortgage also can improve over time. If your payments remain fixed while your income increases over the course of your career, simple math shows us that your payments become cheaper relative to your income.

Of course you'll want to consult with a financial and tax-management professional to ensure that these numbers pencil out for your particular circumstances. If they do, a mortgage can help you shift the risk of rising interest rates and inflation onto the mortgage holder. That can be sound risk management, indeed.

15- or 30-Year Mortgage?

So far, I've suggested that a mortgage can help you more effectively build and sustain personal wealth by freeing up equity that you can then put to work in the markets. To make the most of this scenario, consider minimizing your required monthly payments and stretching out the life of the mortgage for as long as possible. The lower the mortgage payment, the more money you have for investing instead.Compared to a 15-year mortgage, a long-term, 30-year mortgage fits the bill insofar as that objective. Here's the math comparing a typical 15-year and 30-year mortgage for $300,000 at current interest rates and assuming a 33 percent tax bracket:

	15-Year	**30-Year**
Interest rate	2.78%	3.71%
Monthly payment	$2,040	$1,383
Interest portion	34%	67%
After-tax cost	$1,810	$1,076

Because the 30-year mortgage payment is less but contains a higher percentage of interest in each payment, you receive a lower cost of capital (assuming you are in a position to deduct the interest). It also allows you to save more than $44,000 in payments over five years and invest it in your portfolio, where it will hopefully add to your wealth-building efforts. The return on your portfolio over time should exceed the low cost of the mortgage, as illustrated above. (I am considering after-tax costs, including the estimated deduction cited above: $1,810 - $1,076 = $734 x 60 months = $44,040.)

This argument also holds for not making extra payments to your mortgage along the way, and for making at least a minimal down payment to begin with (enough to skip the private mortgage insurance that most lenders require if you put down less than 20 percent).

Making an oversized down payment or extra payments as you go won't affect the value of your home one way or the other. And it's money that could otherwise be applied to your investment portfolio, or to other life goals. Think paying for college, assisting aging parents, making career transitions or maintaining and improving your home (which *can* add to its value).

In short, ask yourself which you would rather do: Give the bank a small check every month for 30 years and keep the rest of your money for other purposes or make bigger payments (or one large payment at closing) and lose control of those dollars.

A Comprehensive View of Home Equity

One more time, repeat after me: Holding a mortgage – any mortgage – is always premised on making sure that your home is affordable and appropriate to your desired lifestyle and financial situation.

Food, clothing … shelter. Because there are few possessions more important to you than the home in which you live, you never want to take on a grander residence than you can comfortably afford if worse comes to worst.

Also, each of us is unique. Even if an investment makes good financial sense as a general rule of thumb, it may not make sense for you. For instance:

Do you have trouble saving? Do you or a family member have difficulty saving for a rainy day? Let's just say it: Are you a spendthrift? If so, you may need to incorporate that understanding into your financial plans by automating your saving habits and/or being especially conservative about the debts you do incur.

Do you have trouble sleeping? If holding a mortgage and a stock allocation exposes you to more risk than you can stomach in down markets or real estate declines, you may want to ignore my recommendation and pay more on the loan or put down the total cost anyway. You may sacrifice some returns, but in the end that might be better for your heart and your home than if you would otherwise stress out too much and/or panic-sell during a market bottom.

For any homeowner, here are some tips to guide the way:

- Always begin by buying a residence that you can easily afford and maintain based on a conservative view of your circumstances.

- Maintain a substantial reserve fund to make mortgage payments should your health or income sources take an unexpected hit.

- When buying your home, consider an affordable, long-term 30-year mortgage with a fixed rate.

- Make it a top priority to submit your monthly payments on time, perhaps by having them automatically deducted from your checking or cash-management account.

- Shift the value of your freed-up home equity into a globally diversified, cost-effective portfolio that seeks maximum expected returns for the minimum of risk required.

- Consider working with a professional who has the range of experience to ensure that your stocks, bonds, business interests, real estate and any other financial parts combine into a whole that reflects your personal goals and risk tolerances.

Last but not least, get on with living your life, safe at home.

About Michael Evans, Founder, The Cogent Advisor, Chicago, IL

Michael J. Evans is founder of The Cogent Advisor, an independent member of the BAM ALLIANCE.

Prior to founding The Cogent Advisor, Michael was a veteran commodities trader on the Chicago Mercantile Exchange for more than 20 years. He remains a proud member of the exchange.

Michael currently serves on the DePaul University College of Commerce Finance Advisory Board as well as the Lane Tech Alumni Association and The Irish Fellowship Club of Chicago. He holds a bachelor's degree from the DePaul University College of Commerce and completed the graduate certificate program in Financial Planning at DePaul.

Visit Michael's blog, The Cogent Advisor

Follow Michael on Twitter, @CogentAdvisor

The links above will redirect you from the BAM ALLIANCE site to other sites and content not related to the BAM ALLIANCE. The BAM ALLIANCE does not endorse or make any claims about the accuracy or content of the information contained therein. The security and privacy policies on these sites may differ from the BAM ALLIANCE.

The opinions expressed by featured authors are their own and may not accurately reflect those of the BAM ALLIANCE. This article is for general information only and is not intended to serve as specific financial, accounting or tax advice.