

# Turn Your Mortgage Into an Asset

Conventional wisdom says investors should focus on their assets and carry as little debt as possible. Many individuals are now learning that to build net worth, "Managing what you owe" is as important as "Managing what you own." Therefore, your home-financing strategy should be a key component of your financial plan to ultimately help you build your net worth.

Did you know that your mortgage is one of the largest financial transactions you will ever make? That's why it is important to select the mortgage program that not only meets your home-financing needs, but that also has a potentially positive impact on your financial plan. Traditional 15- and 30-year fixed-rate mortgages are not the only options available, and in many cases, are not the best choice in today's financial environment. The appropriate integration of home financing strategies into your financial plan can actually turn your mortgage into an asset. The right mortgage can help you reduce interest expense, maximize potential tax deductions and avoid disrupting a well-planned investment strategy to help your net worth.

## **When does Paying Off a Mortgage Early Make Sense?**

Paying off a mortgage early is often more of an emotional goal rather than a sound financial strategy. Paying down principal early may be financially correct for those who are heavily invested in short-term investments, such as certificates of deposit and money-market funds, if the mortgage interest rate is greater than the return on such investments. From 01/01/26 to 12/31/96, the S&P 500 index had an average annual return 10.7%. T-Bills have averaged a 3.7% return, U.S. Govt. Bonds a 5.1% return and Mortgages have averaged an 8.125% cost.

Compare your mortgage interest rate with the rate of return of an investment portfolio. Continue making standard monthly mortgage payments when your investment return rate is higher than your mortgage interest rate. Pay off your mortgage early when your investment return rate is lower than your mortgage interest rate. However, since mortgage financing is generally one of the least costly sources of funds available, mortgage prepayment may not be financially correct for long-term, active investors. Always compare investment earnings with the interest paid on borrowed funds, and keep in mind that earnings on most investments are taxable, while mortgage interest is generally tax-deductible.

There are now mortgages that allow you to pay only the interest portion for a period of time. A disciplined investor can take advantage of these programs to:

- Lower monthly payments.
- Maximize potential tax deductions.
- Invest or use the payment savings for other purposes.

### **How Can I Increase My Cash Flow?**

Increasing cash flow is a critical element of building net worth. A mortgage with interest only payments may help increase your cash flow by lowering your monthly payment. Funds that would have originally been used to pay down mortgage principal can be directed to meet other financial objectives.

#### Compare Payment Differences

Compare the difference between an amortization of a monthly principal and interest payment and an interest only payment for a \$300,000 mortgage at 8.125%.\*

<b>Payment Type</b>	<b>Monthly Payment Amount</b>
Amortization	\$2,227
Interest Only	\$2,031
<b>Difference</b>	<b>\$196</b>

\* Amortization payment is based on a 30 year amortization and assumes that the rate remains constant. Interest-only payment would only be in effect for a period of up to 10 years, depending on the mortgage selected. Monthly payments after that period would reflect both principal and interest.

#### Options for redirecting funds

- Pay off higher-cost, nondeductible consumer credit..
- Maximize contributions to 401(k) or other tax-deferred retirement accounts..
- Increase contributions to an investment portfolio..
- Meet day-to-day expenses (not often recommended unless you are at the beginning of your earnings potential).

#### How Should I Redirect Payment Savings?

The numbers are even more impressive if you can save more and get a higher return. For a married couple to save \$10,000 a year is not an easy task, but it is possible if they limit the French restaurants and European vacations. If they earn 10 percent annually, they will have \$1 million in 25 years.

Investing "redirected" funds may help you build your net worth. Compare the total amount of principal you would have paid on the amortization of your mortgage with the potential investment earnings from your redirected funds - the difference is the potential increase in your net worth:

The grid below compares the effect of making full principal and interest payments on the \$300,000 mortgage described above, and investing the \$196 difference between that payment and an interest only payment each month for 10 years.

<b>Scenario</b>	<b>Effect</b>
Full Principal and Interest Mortgage Payments	Mortgage Principal Pay Down \$36,153
Investing the Interest-only difference of \$196 in an S&P 500 index mutual fund	Mutual Fund Balance \$61,771
<b>Difference</b>	<b>\$25,618</b>

The big caveat to the above strategy is that in order for it to work, you must be a disciplined investor. You must commit to investing the money each month, and not spend it on something else. As we shall see in the next section, it is important to follow this regimen from the very outset of the loan.

### **Early Bird vs. Late Bird**

It's better to be early than to be smart in investing. That's the conclusion of a study by Neuberger & Berman Management, a mutual fund firm. Neuberger & Berman calculated the results that would have been achieved by two hypothetical investors in the stock market following two different strategies. One investor, Early Bird, invested \$20,000 via 10 annual \$2,000 purchases from 1967 to 1976. Early Bird's timing was terrible, since he invested his \$2,000 every year at the market's high. In other words, his market timing was the absolute worst it could be.

The other investor, Late Bird, put up \$40,000 in 20 annual increments of \$2,000 each from 1976 to 1995. Late Bird was a much better market timer. Indeed, her annual \$2,000 was invested at the market's low point ever year - a perfect 20-year timing record.

So which bird had the bigger nest egg at the end of 1995 (using the Standard & Poor's 500 as a yardstick)? Surprisingly, Early Bird's portfolio had a value of approximately \$320,000, compared with Late Bird's \$270,000.

**BOTTOM LINE:** It's hard to overstate the importance of time in an investment program. Even with investing twice as much and having perfect timing each year for 20 years, Late Bird came out in the short end because of a later start.