

Where to Put Your Extra Cash

Paying Mortgage Early? Study Sees Benefit in 401(k) Focus Instead

By JULIAN MINCER

PREPAYING a mortgage may seem like the best thing to do with your extra money. Yet investing the extra cash in a tax-deferred retirement account is often a smarter move, according to research.

Almost 40% of all households that are making extra payments on their mortgage—or taking on a mortgage that is shorter than 30 years—would likely be better off investing that extra money in a tax-advantaged savings account such as a 401(k) or 403(b) plan, according to the study, which is continuing. The financial benefit would be even greater if investors receive a company match as part of their retirement-savings contribution, the researchers say.

"We don't want to argue that it's bad" to prepay, says Clemens Sialm, an assistant professor of finance at the University of Michigan's Ross School of Business, who co-authored the study. "It's a good thing to save, but under certain circumstances, you're better off contributing to retirement [savings], especially if you get a match."

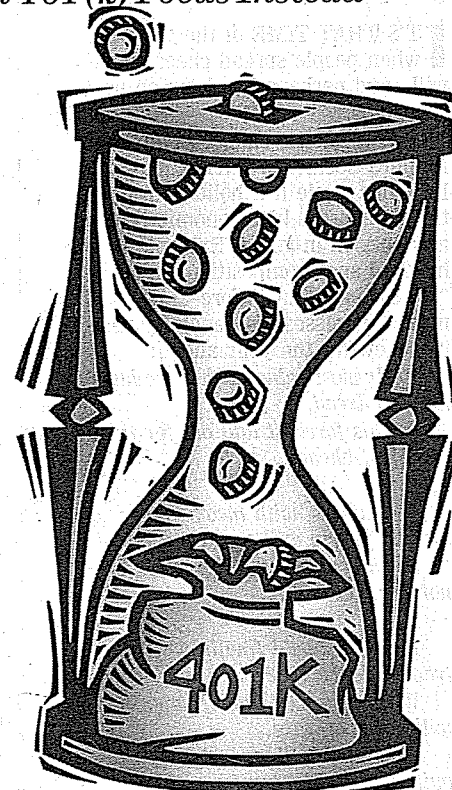
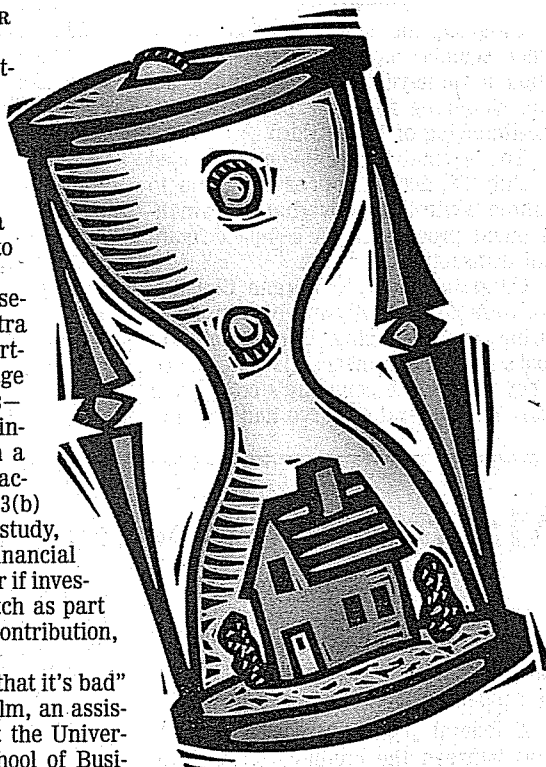
Using data from the Federal Reserve's Survey of Consumer Finances, which covered the period between 1995 and 2001, Mr. Sialm and his fellow researchers found that many people are so risk averse that they frequently opt for the lower returns of a prepaid mortgage rather than investing in a 401(k) plan.

Assuming an annual growth rate of 5% in a 401(k) plan, the researchers found that at least 38% of households would have earned 11 cents to 17 cents more on the dollar by investing in the plan instead of prepaying the mortgage. Those extra earnings would have resulted in additional annual savings of almost \$400 per household.

If the investors had received a company match for their 401(k) of 50% on the first 6% of their contribution—and contributed that amount—it would have added \$468 a year per household.

Jennifer Huang, an assistant professor at the University of Texas at Austin and one of the co-authors, said she was surprised by the "magnitude of the loss" when savings are put into mortgage prepayments rather than 401(k)s.

To eliminate potential risk, the research-



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ers assumed that the 401(k) investments would be in safe Treasury or mortgage-backed securities. The returns on the 401(k) investments potentially could well be higher if the investments were in equities.

The 401(k) option did even better if the person itemized tax returns and deducted the mortgage interest rate, says Mr. Sialm. For example, someone with a 6% mortgage would, depending on the tax bracket, see the effective interest rate drop by about a third—to 4%—after itemizing. In such a scenario, investments in the 401(k) would need to earn only more than 4% after tax for consumers to come out ahead with a retirement investment more than the extra mortgage payment.

Another factor to consider: Investments in 401(k)s benefit from tax deferral, and investors may have a lower tax rate in retirement.

The researchers also found that consumers with a college education and those working with a financial adviser were more likely to choose a 401(k) plan over the extra mortgage payments.

Of course, there are potential benefits to prepaying a mortgage, including peace of mind and more-tangible considerations. For example, adding just \$50 a month to your monthly payment on a 30-year \$100,000 mortgage could save you

\$24,546 over the life of the loan and shorten the term to fewer than 25 years.

"There's nothing wrong with having a house that's paid off," says Ralph Wileczek, a senior private-client adviser at Wilmington Trust Co., who points out that you are better off having less mortgage debt if you lose your job. "If you have more equity, it's easier to tap into," he says. But, he adds, "You should absolutely do the [401(k)] match. It's free money."

Another consideration: your age. A 30-year-old has a lot of time to pay off a mortgage, and lots of time to make a 401(k) account grow.

"If you're 58, the tables could be turned," says Greg McBride, a senior analyst for financial-information publisher Bankrate.com. At that point, you may be nearing the end of the mortgage and want to prepay it so it is gone by the time you retire.

Mike Fratantoni, a senior economist at the Mortgage Bankers Association, advises people when making this decision to think about their entire portfolio as well as the "opportunity cost" of using money in another investment. Investing in something other than the mortgage could provide more diversity and liquidity. That could make a difference if someone needs to relocate or loses a job.