THE NORTH BAY
Business Journal
NORTH SAN FRANCISCO BAY AREA: *SONOMA, NAPA AND MARIN COUNTIES*

427 MENDOCINO AVE., SANTA ROSA, CA · 707-521-5270 · WWW.NORTHBAYBUSINESSJOURNAL.COM · REPRINTED FROM AUGUST 18, 2014 · PAGE 23

EDITORIAL & OPINION

Is paying off the mortgage really the best thing to do?

Properly managed, a house loan is part of a balanced approach

WEALTH MANAGEMENT

BY MONTGOMERY TAYLOR

Most Americans have their financial net worth tied up in two large assets: their homes and their retirement accounts. We rely on this combination to provide us with a pot of money to survive on in our later years.

If you had enough money to pay off your mortgage right now, would you? Many people would. In fact, the 'American Dream' is to own your own home, and to own it outright, with no mortgage. If the American Dream is so wonderful, how can we explain the fact that thousands of financially successful people, who have more than enough money to pay off their mortgage, refuse to do so?

Now, really, is having a house free and clear of debt the best way to go?

No. And here's why.

Take a look at the features of the following investment, and tell me if, as a potential investor, you would be interested in putting a great deal of your savings into it:

• You can determine the amount of your monthly contribution and the length of time that contributions will continue.

• You can pay more than the minimum monthly contribution, but not less.

• If you try to pay less, the financial institution handling the investment keeps all of the previous contributions.

• The money invested is not liquid; it could take many months to put your hands on it in an emergency. The faster you need the money, the less you will get.

• The money invested is not safe from loss of principal.

• Each contribution made to the account results in less safety of the principal.

• The contributions that are deposited earn zero percent rate of return.

• Your income tax liability increases with each new contribution.

• When the investment is fully funded, there is no income paid to you.

The investment I just described deserves a thumbs-down from smart investors, and I doubt that you would choose to put serious cash into it. Yet many already do. The investment I just described is … a house with a traditional amortized mortgage!

Good debt–bad debt

A mortgage is a loan from the mortgage company to finance the purchase of your home. It's bad because of all the reasons my prior example pointed out. Plus, with any kind of loan, there is interest. No one likes to pay interest. Therefore, everyone thinks that the mortgage is their enemy because it is debt, and "debt" is an ugly word. Because we think mortgages are bad, many financial advisers advise their clients to invest in homes using the "payoff-the-mortgage-ASAP" program. The belief is that this program is the best investment for your retirement.

The reality is that the mortgage does more good than you know. Not only does it help you bankroll your home, but it helps finance your retirement.

The thing to realize here is that there are two kinds of debt: favored debt and non-favored debt. Favored debt is debt you should have because it gives you safety, liquidity, and rate of return. The tax advantage you get on the favored debt is just the icing on the cake, since favored debt is tax deductible.

Non-favored debt is the avoid-at-all-costs debt. It is debt owed to credit card companies and other institutions that charge a high amount of interest, as high as 10-20 percent. You can't deduct non-favored debt. It costs more to stay in non-favored debt than in favored debt. You are better off going into favored debt to pay off your credit card balance.

I put mortgages in the favored debt category. The first advantage of mortgages is tax deduction. You are in the 30 percent tax bracket, so after the tax deduction, your 4 percent mortgage is really only 2.8 percent after-tax. In other words, if you have a $2,600 monthly mortgage payment, you really pay $1,820 to the bank because of your 30 percent tax deduction. That is a really good deal.

"Arbitrage"–it's not a board game

Arbitrage is a method that gives you gain based on the difference between what you pay in interest and what you earn in interest. With arbitrage, you borrow at one rate and invest at another rate. Having a mortgage also allows you to take advantage of the arbitrage method.

Besides, if you try to pay off your mortgage as rapidly as possible, you put yourself at the mercy of the lender. Let me explain: Let's say you are thinking about paying extra each month on your mortgage. What if you pay $3,500 instead of the set $2,600 this month? You are basically saying to the lender, "here's an extra $900 that I don't need. You can take it, and don't bother to pay me interest for it. If I need this money back, I'll come to you, and borrow it on your terms by proving to you that I can afford to borrow my own money." Sound ridiculous? Well, that's exactly what that transaction entails.

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