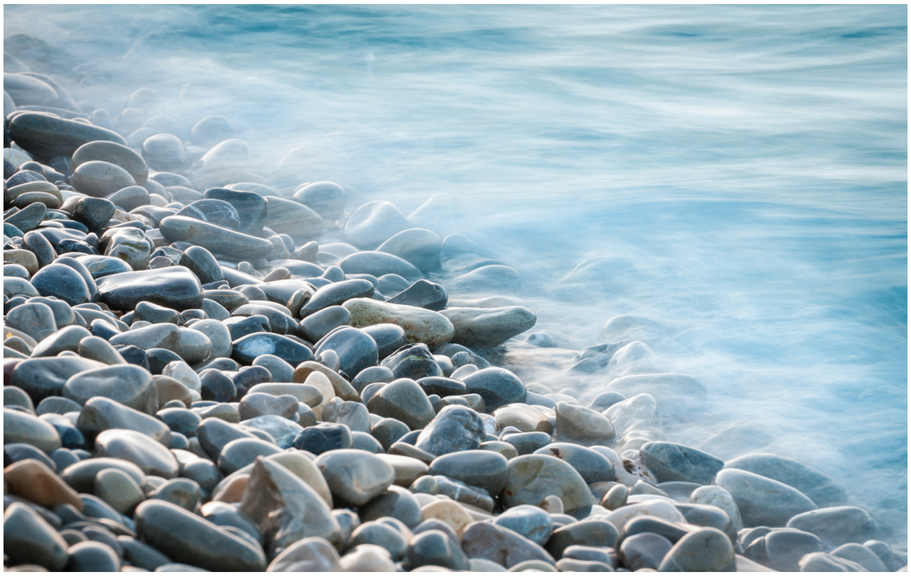
Financial Planning Update

Are extra principal payments on a home mortgage a good idea? It all depends.



CLIENTS OFTEN ASK whether they should make extra principal payments on their home mortgage when cash is available. While it is a goal of many clients to be debt free, paying down a home mortgage may adversely affect other goals, such as saving for retirement, if it results in an inefficient allocation of resources.

In general, we recommend that clients allocate their financial resources to the wealth strategy that produces the highest risk-adjusted after-tax rate of return over a given time period. A borrower who took out a 30-year home mortgage a few years ago might well have a rate in the 3% - 4% range. If invested in a balanced portfolio of equities and municipal bonds, the same borrower might expect to earn an average annual return of 6% over time. If the mortgage interest is fully tax-deductible, while the municipal bond interest, qualified dividends and long-term capital gains from the portfolio all receive preferential tax treatment, the borrower may conclude that investing available cash is a better wealth strategy than prepaying mortgage principal.

A borrower with a more recent mortgage might reach a different conclusion, however. Thirty-year mortgage rates are now averaging 4.70%. In addition, the 2017 tax reform legislation included provisions that could limit the tax savings from a mortgage. Many taxpayers will see their itemized deductions limited to three major sources: state and local taxes ("SALT"), with the deduction now capped at $10,000; charitable contributions; and home mortgage interest. The 2017 tax reform legislation also increased the standard deduction to $24,000 for married couples. As a result, if a couple's SALT deduction caps out at $10,000, the charitable contribution and home mortgage interest deductions offer no tax savings until they exceed $14,000 in total.

For a taxpayer in a 37% federal bracket, the 4.70% mortgage rate equates to 2.96% after tax if the interest is fully deductible. If the mortgage interest is only deductible to the extent it exceeds $14,000 (assuming no itemized deductions other than $10,000 of SALT deductions), the effective after-tax rate will be considerably higher and will vary over time. On a $750,000 mortgage, the effective interest rate over the 30-year life of the loan is about 3.88%. In the first year of the loan, the effective interest rate is about 3.65%, as the interest payments are well over $14,000. As the loan amortizes, the share of monthly mortgage payments allocated to interest declines and the effective after-tax rate increases. Once the principal balance reaches $297,000, the annual interest payments drop below $14,000 and the effective interest rate becomes 4.70%.

If the mortgage interest no longer provides a tax savings, the after-tax return on funds used to prepay principal will be 4.70% over the remaining life of the loan. The borrower may conclude that a certain 4.70% return on a mortgage prepayment compares favorably to the variable returns on the investment portfolio, even if the portfolio returns are expected to average a bit more than 4.70% over time. Before prepaying the mortgage, however, the borrower should consider the presence and timing of other itemized deductions, such as charitable contributions, that would enhance the tax benefit of the mortgage interest, and whether portfolio returns would increase should interest rates on bonds rise along with mortgage rates. Since funds used to prepay a mortgage cannot easily be recaptured, please consult your financial advisor before taking action.

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