

# Education

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## 11 Great Reasons to Carry a Big, Long Mortgage

From [The Truth About Money](#)

Many people misunderstand or misrepresent the benefits of mortgages, and they get the key points wrong. If you read this chapter from [The Truth About Money](#) with an open mind, then by the time you finish, you will agree that you should have as big a mortgage as you can get and never pay it off.

### Reason #1: *Your mortgage doesn't affect your home's value.*

You're buying your home because you think it will rise in value over time. (Admit it: If you were certain it would fall in value, you wouldn't buy it — you'd rent instead. In fact, your home's value will rise and fall many times during the next 30 years — you just won't get monthly statements showing you how it's doing.) Yet, the eventual rise (or fall) in value will occur whether you have a mortgage or not. So go ahead and get a mortgage: Your house's value will be unaffected.

That's why owning your home outright is like having money buried under a mattress. Since the house will grow (or fall) in value with or without a mortgage, any equity you currently have in the house is, essentially, earning no interest. You wouldn't stuff ten grand under your mattress, so why stash \$400,000 in the walls of the house? Having a long-term mortgage lets your equity grow while your home's value grows.

### Reason #2: *A mortgage won't stop you from building equity in the house.*

Everyone wants to build equity. It's the main financial reason for owning a house. You can use the equity to help pay for college, weddings, and even retirement. Mortgages are bad, many people say, because the bigger the mortgage, the lower your equity.

They're wrong, and here's why. Say you buy a house for \$300,000, and you get a \$250,000 30-year 7% mortgage. Your down payment (\$50,000 in this example) is your starting equity, and you want that equity to grow, grow, grow.

Figure 8-3 shows what happens: By making your payments each month, your loan's balance in 20 years will be just \$143,250. You've added \$106,750 in equity! This supports the contention that equity grows as you pay off the mortgage and that, therefore, the faster you pay off the mortgage, the faster your equity will grow.

But this thinking fails to acknowledge that this is not the only way you will build equity in your house. That's because your house is almost certain to grow in value over the next 20 years. If that house rises in value at the rate of 3% per year, it will be worth \$542,150 in 20 years! You'll have nearly a quarter million dollars in new equity even if your principal balance never declines!

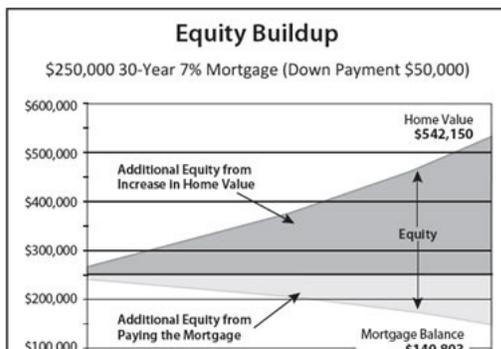




FIGURE 8-3

**Reason #3: A mortgage is cheap money.**

Mortgages, in fact, are the cheapest money you will ever be able to borrow. (Oh, sure, you can get a credit card that offers 0% interest for six months, but try to borrow a couple hundred thousand for 30 years that way.)

As Essential Mortgage Fact #1 showed you, you get the loan when you demonstrate you have the ability to repay it. But how much interest will you have to pay? The more confident the lender is that it will get its money back, the less interest it will charge you. By offering your house as collateral, you agree to let the bank have your house if you don't repay the loan. This dramatically reduces the bank's risk, resulting in a very low interest rate. (By contrast, credit cards have no collateral; Visa can't take the sweater you bought if you don't pay the bill. Credit card companies know that a certain portion of their cardholders will default, so they charge 18% to most cardholders. They figure that if a third of the cardholders default, they'll still end up with a 12% return on their money. Not a bad business.)

**Reasons #4 and #5: Your mortgage interest is tax-deductible. And mortgage interest is tax-favorable.**

These two points are related, and together they offer you important benefits to carrying a mortgage.

Interest you pay on loans to acquire your residence (up to \$1 million) is tax-deductible. The deduction is taken at your top tax bracket. Thus, if you're in the 35% tax bracket, every dollar you pay in mortgage interest saves you 35 cents in federal income taxes. You save on state income taxes too.

And here's the best part: When you earn profits from investments, those profits are taxed at 15% or less in 2010 — even if you are in the 35% tax bracket. Say you're in the 25% tax bracket and you get a 7% mortgage. That loan costs you 5.25% after taxes, as shown in Figure 8-4. Meanwhile, say you invest money and earn 7%. Your profits are taxed at only 15%, meaning your after-tax profit is 5.95%. Thus, even if your investments earn no more than what you pay for your loan, you're still making a profit!

Mortgage Interest Rate	7.00%	Investment Return	7.00%
Tax Savings (25% bracket)	-1.75%	Capital Gains Tax 15%	1.05%
After-Tax Mortgage Cost	5.25%	After-Tax Profit	5.95%

FIGURE 8-4

**Reason #6: Mortgage payments get easier over time.**

Carrying a mortgage actually gets to be fun. Yes, fun. My father used to love to talk about his mortgage — all \$98 per month of it. You see, he and my mom bought their home in 1959 for the whopping price of \$19,500! Yet, my dad used to tell how his father thought he was crazy. How in the world was my father going to be able to handle such a huge mortgage payment, Grandpop Max asked. After all, my father was earning less than \$3,000 a year back then. To spend \$1,200 a year on mortgage payments ... Grandpop Max thought my dad was nuts!

Of course, by the 1970s, Dad was laughing about it. Why? Because his monthly payment in 1974 was identical to what he was paying back in 1959. Yet, Dad's income had risen steadily. Thus, his mortgage payment had become insignificant when compared to his income — not to mention the fact that his house had grown substantially in value.

You probably remember struggling to make your mortgage payment when it was new. But over time, that payment becomes cheaper relative to your income — especially if yours is a fixed-rate loan: Payments on such loans will never rise but incomes usually do.

**Reason #7: Mortgages allow you to sell without selling.**

Have you noticed that your home is worth much more than it was 10 years ago?

You might be worried that your home's value will fall — after all, in many parts of the country, the real estate market is not as strong as it was earlier this decade.

If you're afraid that your home's value might fall, you should sell the house before that happens. But you don't want to do that! It's your home, after all. You have roots in the community. Uproot the kids? And where would you move? No, selling is not a practical idea.

Still, you fret that your home's equity is at risk. Can you protect it without having to sell? Yes! Simply get a new mortgage, and pull the equity out of the house. It's the same thing as selling, except that you don't have to sell!

Here's how the idea works: Say you bought a house for \$200,000 with no money down (meaning you owe the bank \$200,000). Further say that prices have skyrocketed, and houses in your neighborhood have been selling for \$500,000. You fear that prices will fall, dropping your home's value to \$400,000.

If you sell now for \$500,000, (Assuming that you can, and ignoring real estate commissions and other selling expenses, and pretending that you still owe the bank the full amount of the original \$200,000 loan. Work with me here people.) you'd pocket \$300,000. But you don't want to sell, so just refinance and get a new loan for \$500,000. You now have the \$300,000 in hand — just as if you had sold the house! Obviously, this is an extreme example simply to prove a point: (I'm not necessarily suggesting you actually get a new mortgage that's two-and-a-half times bigger than your old one - although I might, depending on the situation. And don't forget the tax limitations regarding the deductibility of the large new loan.) Borrow the money now, because you won't be able to do so after the house falls in value. (For example, if you plan to use the equity in your house to put the kids through college — not that I'm endorsing that idea — you should get the loan now so you don't have to worry that the house might fall in value later.)

I'm not suggesting that you'd want to owe more on the house than the house is worth. But that's certainly better than watching the equity evaporate before you have a chance to use it.

Get the equity out of the house now, while you can — a lesson many people wish they'd acted on back in the 2000s.

**Reasons #8 and #9: *Mortgages allow you to invest more money and to invest it more quickly. Mortgages allow you to create more wealth than you otherwise would.***

As I mentioned in Reason #6, people get big mortgages on their first home simply because they don't have a choice. You're excited about buying a house, and even though you don't have much money, you have a good income — two good incomes, if you're like many couples. Some years later, with a growing family, higher incomes, and newfound equity in the house, you're ready to move up to a bigger home.

Let's say you net \$300,000 from the sale of your old house, and you're ready to buy a new home for \$500,000.

Should you use all your cash and make a \$300,000 down payment? Or should you place only \$50,000 down, which is 10% of the purchase price?

If you make the bigger down payment, your monthly mortgage would be \$1,331, assuming a 7% 30-year mortgage. If you make the smaller down payment, your payment will be \$2,994 per month.

This explains why so many people prefer to make big down payments when they buy houses. A big down payment translates to a small monthly payment. In our example, that big down payment saves you \$1,663 per month.

But the people who are trying to ask you to choose between big monthly payments and small monthly payments are lying to you. Yep, they're tricking you by asking you the wrong question.

The correct question is not about the amount of money you want to pay monthly, but the amount you want to invest. Again, it's all about wealth creation, not debt elimination.

Here's the question you should be answering:

Would you rather invest:

\$250,000 right now, as a one-time-only deposit

or

\$1,663 a month, every month, for the next 30 years?

Obviously, you'd prefer the strategy that results in a higher profit. And Figure 8-5 reveals the answer. Regardless of the time period, investing a large amount now produces better results than investing small amounts over long periods.

Thus, while a low mortgage payment lowers your overall expenses, it also lowers your overall wealth.

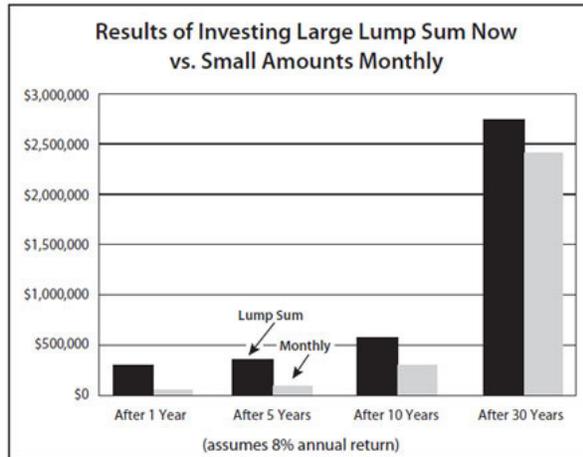


FIGURE 8-5

But you suspect there's a flaw here. In order to invest that \$250,000, you'd have to be willing to accept the higher monthly payment. Where will you get the money to do that each month?

You'll find the money from two places. First, increase your paycheck! Remember that the new loan payments are almost entirely tax-deductible interest. That means you don't need to have as much money withheld from your paycheck. So file a new IRS Form W-4 at work to increase your exemptions; this will reduce the amount of taxes that are withheld from your paycheck, boosting your net pay. Yes — you've just given yourself a raise! And you can use this increased paycheck to help you pay for your new mortgage payment.

Second, if your paycheck isn't enough, simply make periodic withdrawals from the investment account you've just created. Soon enough, as your income rises, you won't need this crutch; your income will become enough to handle the cost, as shown in Reason #6.

In fact, getting a big mortgage and using investment proceeds to help you make the payment is superior to getting a small mortgage and having no proceeds to invest. This is especially true when you discover the most important reason of all to carry a big, long mortgage...

#### **Reason #10: Mortgages give you greater liquidity and flexibility.**

To help you understand this, let me introduce you to Nervous Nick and Smart Sam.

Each earns \$75,000 a year; each has \$50,000 in savings; each wants to buy a \$250,000 house.

Smart Sam gets a \$237,500 30-year mortgage at 7%. He makes no extra payments. But Nervous Nick takes a different approach. Nick hates mortgages and wants to get rid of his mortgage as quickly as he can. He fears that if he has a mortgage, he might one day lose his house. He doesn't quite understand how that could actually happen, but his granddaddy told him that mortgages are bad, and Nick believes his granddaddy, so he goes with a small mortgage — as small as possible. That means he uses his entire \$50,000 in savings to make a down payment. His mortgage is therefore smaller than Smart Sam's — \$200,000. Nervous Nick also gets a 15-year loan instead of a 30-year loan, because he hates mortgages and he figures the 15-year loan will let him get rid of his loan in half the time. Nick also knows that this clever ploy garners him a lower interest rate, because lenders charge less for 15-year loans than they charge for 30-year loans. So while Sam is paying 7%, Nick is paying only 6.75%.

Nick, in fact, is so obsessed with getting rid of his mortgage that every month he sends an extra \$100 to his lender. He knows that the more he sends in, the faster his loan will be paid off. So, compared to Sam, Nick has a smaller mortgage, a shorter mortgage, a lower interest rate — and he's adding money to each payment.

Figure 8-6 shows where the two men stand. Smart Sam's (It's hard to believe that Sam is the smart one, right? Wait and see.) monthly payment is \$1,580. Thanks to amortization (which you learned about earlier in this chapter), almost all of Sam's payment — 88% of it — is comprised of interest. Thus, on an after-tax basis (assuming he's in the 25% federal income tax bracket), Smart Sam's payment costs him \$1,232 a month.

Meanwhile, Nervous Nick's payment is \$1,770 a month. But only 64% is interest. That's because Nick's loan is for 15 years: The shorter the term, the more principal you must pay each month, and principal payments are not tax-deductible (only the interest is deductible). So even though Nervous Nick is paying more per month than Smart Sam, he's deducting less. Nick's after-tax cost, therefore, is \$1,487.

	Smart Sam	Nervous Nick
Monthly payment (P&I)	\$1,580	\$1,770
Interest portion	88%	64%
Tax savings	\$348	\$283
After-tax payment	\$1,232	\$1,487

FIGURE 8-6

Thus, Smart Sam is paying \$255 less per month than Nervous Nick. But Nick doesn't mind. He doesn't mind the extra monthly cost because he knows he'll get rid of his mortgage quicker.

So for the next five years, Smart Sam makes his monthly mortgage payments. And instead of sending an extra \$100 every month to his lender like Nick does, Sam puts that \$100 into exchange-traded funds. Then both men lose their jobs. Or perhaps one develops a medical condition, or his wife has a baby and quits work. Whatever the cause, something happens in five years that causes their income to fall or expenses to rise — or both. Figure 8-7 shows Sam's status.

For Five Years, Sam Invested:	
\$37,500 he did not use as down payment	@ 8% \$55,100
Savings from the lower payment \$255/month	\$17,951
the extra \$100/month	\$ 7,039
<b>Total saved after 5 years</b>	<b>\$80,090</b>

FIGURE 8-7

Nick's been busy paying down his mortgage; the outstanding balance is only \$149,000. But does that matter? The guy just lost his job, but he still has to make his monthly mortgage payment. So it doesn't matter that his mortgage balance is \$149,000; what matters is that his mortgage payment of \$1,770 is due at the end of the month.

This is a real problem for Nick, because with no job, he has no income. He also has no money, because he's given every available dollar to the bank in the form of extra payments. Nervous Nick's nightmare is coming true! He's about to lose his house!

Sam, though, is in much better financial condition. Oh, sure, his mortgage balance is higher than Nick's — \$224,000 — but does that matter? Not at all. What matters is that he has to find some way to make his \$1,580 payment.

But Sam is not in the same predicament as Nick. That's because Sam has lots of savings, as shown in Figure 8-7. First, he gave the bank a smaller down payment, enabling him to invest \$37,500. Based on an average annual return of 8%, that money grew to \$55,100.

Smart Sam also took advantage of the fact that his monthly payment was \$255 less than Nick's; he invested that money too, which is now worth \$17,951. And instead of sending \$100 a month to his lender like Nick, Sam added \$100 to his investments; those investments are worth \$7,039. All told, Smart Sam has \$80,090. So even though he's out of work, he'll be able to make his mortgage payments for another four years!

How ironic that Nick, who wanted to get rid of his mortgage so he wouldn't lose his house, is about to suffer the fate he was so desperately trying to avoid. This fable shows you why it is so important that you minimize both your down payment and your monthly payment. By doing so, you retain more of your money.

By keeping control over access to your money, you maintain liquidity. But when you give your money to your lender, you lose control of it. After giving money to your lender, the only way to get your money back is to sell the house — and that's the one thing Nervous Nicks does not want to do.

This reveals the fatal flaw in the logic of those who lie to you about mortgages. Sure, owning a home mortgage-free is an appealing concept. But it is completely unrealistic! I mean, sure, paying off your mortgage is great — if that's the only thing you need to do with your money. But what about paying for college? Saving for retirement? Caring for elderly parents? Or even just paying for car repairs!?!?

Indeed, the fatal flaw of those who tell you to do everything you can to pay off your loan as quickly as you can is that they are completely ignoring everything else that's happening in your life! If you succeed in paying off the loan, you might fail in paying for college, or covering costs in the event of a job loss, medical problem, marital issue, or other family concern.

That's why you must stop listening to those who pretend that the only thing that matters is paying off a mortgage. Your life is more complicated than that, and by realizing this, you see that trying to pay off the mortgage like Nervous Nick is actually a risky thing to do. Instead, the smarter and safer approach is to carry a big, long mortgage and don't bother trying to pay it off!

***Reason #11: You'll never get rid of your monthly payment, no matter how hard you try.***

You want to eliminate your mortgage so that you don't have to make any payments in retirement. That's too bad, because even if you somehow eliminate your mortgage, you won't eliminate your payments.

Sure, paying off your mortgage means you no longer make any principal or interest payments. But mortgages are known as PITI, and we've only addressed the P and the I. Let's not forget about the T and the other I — or the M and the R.

I'm talking about taxes and insurance. Even if you manage to pay off the loan, you'll still have to pay property taxes and homeowner's insurance. Thus, your goal of "getting rid of the mortgage payment" is impossible! Even if you eliminate the mortgage, you'll still have tax and insurance payments.

And as long as you own your house, you'll have Maintenance and Repairs to contend with as well. So don't bother trying to make your mortgage go away. Instead, create wealth so that you can comfortably afford the cost of living in and owning your home.

**Now That You're Convinced**

Go ahead, admit it. You're convinced that carrying a big, long mortgage is the smart financial strategy. That means you might want to refinance.

The above examples are for illustrative purposes only and do not fully take into account expenses such as property taxes or homeowner's insurance. The examples used here assume that the rate of return on investments will be greater than the interest rate paid on a home mortgage. As there are risks with virtually any investment, there can be no assurance that you will achieve returns greater than the interest rate on your home mortgage. Changes in federal income tax laws could have adverse consequences for the mortgage interest deduction.

Taking equity out of your home involves risk, particularly in slow or declining markets. This could result in some homeowners owing more money than their home is worth. Even if your home sells for its appraised value, the net proceeds could be much lower than anticipated due to legal fees, realtor fees, and other closing costs. There is also the potential for a reduced tax deduction. Any amount that you borrow over 100% of equity is not tax deductible.

### What the Academics Say About Mortgages

"Thus, a homeowner with a long time horizon and a willingness to assume some risk will likely have a much higher net worth than someone who selects the less risky option of the 15-year mortgage."

**"The Effects of Income Tax Rates and Interest Rates in Choosing Between 15- and 30-Year Mortgages." *The CPA Journal* #65, 1995.**

"...home owners...may not be adequately considering the opportunity costs of the investment in their home. Individuals should not attempt to analyze the mortgage decision in isolation from their overall personal financial plan. Instead they should consider the mortgage decision along with their plans for long-term investing, insurance needs, tax planning and so forth. If the only way home buyers can afford the higher 15-year mortgage payment is by delaying long-term investments or by limiting the funds they commit to a long-term investment plan, they may be better off in the long run by taking the 30-year mortgage with the lower payment and investing the difference...."

"...the 30-year mortgage is clearly the best financial choice for many home buyers."

**"15-Year Versus 30-Year Mortgage: Which Is the Better Option?" *Journal of Financial Planning*, April 1998.**

"Planners must consider many factors when analyzing the 15-year versus 30-year mortgage option, but certain issues deserve mention. First, even if the mortgage is held to maturity, the argument that the 15-year option is optimal because fewer total dollars are spent to purchase the home is seriously flawed. The fact that a smaller total dollar expenditure is required for the 15-year loan is irrelevant to the maturity decision."

**"Including a Decreased Loan Life in the Mortgage Decision" *Journal of Financial Planning*, December 2003.**

"Advantages of the 30-year mortgage include lower monthly payments and accumulated wealth, in an investment account available to help alleviate hardships. Withdrawals from the investment account would be free of penalties for the non tax-deferred accounts, and free of penalties for the tax deferred....The data showed that a borrower...willing to invest with a risk level associated with the S&P 500 would benefit from a 30-year mortgage."

**"Effect on Net Worth of 15- and 30-Year Mortgage Term." *Journal, Association for Financial Counseling and Planning Education*, 2004.**

"When households have a substantial risk of unemployment -- or of a big fall in income -- a long-term fixed rate mortgage looks preferable."

"The long-term fixed-rate contract becomes more attractive as people start to borrow a lot."

"It is reasonable to expect that if consumers in the UK were helped to understand better the risk and cost profiles of different types of mortgages there would be more longer-term fixed-rate lending."

**"UK Mortgage Market: Taking a Longer-Term View. Final Report and Recommendations." *HM Treasury on behalf of the Controller of Her Majesty's Stationery Office*, March 2004.**

"The popular press, following conventional wisdom, frequently advises that eliminating mortgage debt is a desirable goal. We show that this advice is often wrong...mortgage debt is valuable to many individuals."

**"Mortgage Debt: The Good News." *Journal of Financial Planning*, September 2004.**

"Better financial results accrue to some borrowers when they select a 30-year mortgage coupled with a simultaneous investment plan rather than a 15-year mortgage term and a

subsequent investment plan...for the vast majority of borrowers, there remains a significant probability that the 30-year mortgage is the better mortgage product even in higher mortgage rate scenarios. Further, the financial benefit associated with a 30-year mortgage increases as the borrower's marginal tax rate and risk tolerance increase."

**"Is a 30-Year Mortgage Preferable to a 15-Year Mortgage?" *Journal, Association of Financial Counseling and Planning Education, 2006, Volume 17 Issue 1.***

"...U.S. households that are accelerating their mortgage payments instead of saving in tax-deferred accounts are making the wrong choice...in the aggregate, these mis-allocated savings are costing U.S. households as much as \$1.5 billion dollars per year."

**"The Tradeoff between Mortgage Prepayments and Tax-Deferred Retirement Savings." *Federal Reserve Bank of Chicago, August 2006.***

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