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Retirement and Your Mortgage

The retirement transition requires a lot of decision making. While the biggest decision is, obviously, the retirement date, there are a host of other decisions that must follow: when to take Social Security, whether to roll a 401(k), which type of pension to choose, and, for many of us, whether or not to pay off the mortgage. This topic has been in the news recently as the result of a study just published by the Center for Retirement Research at Boston College. The study's conclusion? Retired households are, in theory, better served paying off their mortgage than continuing to hold that debt in an attempt to maximize the size of their investment portfolio.

The author, economist Anthony Webb, starts by sharing some statistics: based on 2007 data, 41% of households aged 60-67 have a mortgage, and of these, 51% have the means to pay that mortgage off. This issue is clearly relevant for a lot of Americans.

Webb suggests that the correct question is: can a retiree expect to earn, after-taxes, a rate of return on his/her portfolio that exceeds the mortgage rate? He makes the point that the rate of return on a diversified portfolio is not the appropriate earnings rate to use for comparison -- only the earnings on low-risk assets such as cash, CDs, and Treasury debt -- as paying off the mortgage is a risk-free rate of return that cannot be compared to a rate of return that requires taking on uncertainty.

After looking at historical interest rates on US Treasuries and historical rates for newly-originated 30-year mortgages, Webb found that the latter has most often exceeded the former, so concludes that most retirees are better off retiring their mortgage, unless they itemize deductions on their tax returns <u>and</u> are in a high marginal tax bracket <u>and</u> can't pay off the mortgage with dollars in a taxable account (but rather must take IRA or 401(k) distributions). That's a lot of ands, but it's personal circumstances like these where our long term projection software is really useful, helping to provide understanding when rules of thumbs don't suffice.

Among those circumstances: when a retiree's Social Security benefits are not fully taxable (Social Security benefits are taxable anywhere from 0% to 85%, depending on your other income). If a retiree has to take excess portfolio distributions every year for mortgage payments, boosting the amount of Social Security income that is taxed each year, it can be advantageous to pay it off, even if the funds to do so are in a tax-deferred account, and temporarily bump you into a higher tax bracket.

Of course the most common reason we see clients wanting to pay off their mortgage prior to retirement is a non-financial reason -- it gives them an enormous sense of comfort to be mortgage-free. One of my brothers just wrote his last mortgage check; he can't stop marveling at the fact, and celebrating it! My husband and I are also making extra monthly payments in order to have our mortgage paid off by the time we retire. These extra payments don't represent the bulk of our annual savings, but they're a piece of the puzzle, and one that has an emotionally satisfying component for both of us.

We do expect that we'll see increasing numbers of clients entering retirement with both a mortgage and a sizeable nest egg. We also expect tax law to change over time, so the appropriate strategy is likely to change -- keeping things interesting for all of us!

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