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The Home Financing Decision

Overview: Some investors may have the means to purchase a home with little or no mortgage needed. But is it a good idea? The following provides some items to consider regarding the home financing decision.

Many investors have questions related to financing a home (be it the primary residence or a vacation home). One such question is whether to use investment assets in purchasing the property or to borrow the maximum. As with many questions related to investing, there is no single right answer. There are, however, important points to consider.

Holding a Mortgage to Invest in Equities

Investors may choose to invest assets in the equity market rather than spend them on their home. The main reasons for taking this approach would be a high need to take equity risk (and its associated expected return) or a significant expected difference between a low mortgage rate and a high equity premium. In other words, the relatively low after-tax cost of the mortgage compared with the possibility of large relative returns from tax-efficient equity investing can make the mortgage an attractive alternative.

For example, assume a mortgage rate of 8 percent. The after-tax cost for a high-bracket individual would probably be less than 5 percent. Let's assume for illustration purposes that a well-diversified equity portfolio might be expected to return 8–10 percent in a highly tax-efficient manner (assuming the use of tax-managed funds). If such a differential were to exist, it would be tempting to remain invested in equities rather than pay off a mortgage.

However, it also means accepting the risks inherent to equity investing, which should not be underestimated. Also, since the equity risk premium is not constant, there are times when it may be more or less attractive to borrow and invest in equities.

Holding a Mortgage to Invest in Fixed Income

Holding a mortgage to invest in fixed income is another option, although not generally as attractive as holding a mortgage to invest in equities. For fixed income assets held in taxable accounts, reducing or eliminating a mortgage is a risk-free alternative that typically offers a better rate of return. Even tax-free municipal bonds are not likely to earn much (if any) higher returns, especially considering two risks in municipal bond investing not present in paying off the mortgage — credit risk and the risk that Congress may someday eliminate the tax exemption on municipal bonds.

A mortgage should be treated as negative exposure to fixed income assets in the asset allocation picture. If an investor is holding a $200,000 mortgage with $200,000 in fixed income assets, the exposure to fixed income is zero, not $200,000.

Fixed-rate mortgages are effectively short (negative) bond positions and should be considered as such in the overall portfolio. A fixed rate on a mortgage does provide inflation protection. In addition, it has a “put” feature. If interest rates decline, the “put” (putting the mortgage back to the lender by paying it off) allows the borrower to refinance the mortgage at the current rate. This provides protection against falling interest rates (for those on fixed incomes) and deflation. Of course, the interest rate paid reflects the cost of the prepayment option feature.

Adjustable Rate Mortgages
For homes financed with adjustable rate mortgages, the risk picture is considerably different, as the rate on the mortgage would move up or down as interest rates changed.

Individual Tolerance for Debt
Beyond investment considerations, there also are behavioral characteristics that may play a role in the decision. Having no or little mortgage may provide a high comfort level. Some investors may sleep better with less debt, while still being able to accept the economic cycle risk inherent in equity investing. Thus, they may be more likely to stay disciplined during bear markets.

With little or no debt, investors also may feel more comfortable taking the greater risk inherent in value and small-cap stocks. This allows for higher expected returns within the equity allocation. Alternatively, the greater expected returns can be used to lower the equity allocation needed to achieve the same expected rate of return on the portfolio.

Summary
There is no one right answer to the home financing question. It ultimately comes down to each investor’s marginal utility of wealth, which is a measure of the value to the investor of the incremental expected greater return relative to the incremental risk accepted. The greater the marginal utility of wealth, the more equity one should hold (thus having as big a mortgage as possible), and vice versa. Before drawing any conclusions, investors should work with their advisors to accurately run the math.

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