

RETIREMENT PLANNING: PAYING OFF YOUR MORTGAGE

Many soon-to-be retirees rightly desire to begin retirement with as little debt as possible. With the steady stream of income from their paycheck eliminated, the wish to reduce expenses to a minimum is one of the keys to successfully managing retirement finances. But is eliminating the mortgage expense, quite often the largest monthly outlay, really the right thing to do?

The simple, fiscal answer to this question says that you should pay off the mortgage loan if, over the term of the loan, the rate you will earn on the money (if invested) is less than the rate on the mortgage note. For example if you have a 6% rate on your home mortgage, you would need to earn more than 6% on the money if you were to invest it rather than pay off the loan. 6% should be easy over time, right? The simple answer is yes from a historical perspective, but is your portfolio up to the task? Are you taking on the appropriate amount of risk to even allow for success (you probably aren't going to get there with a fixed income only portfolio) or are you setting yourself up to be decimated during the next stock market downturn? Are you willing to ride out the inevitable volatility that is a part of a balanced portfolio? These concerns are why most retirees defer to paying off their loans.

The table below analyzes the two choices in question (#1 - pays off the loan and #2- keeps the loan and invests the money) based upon the following scenario.

A couple is ready to retire with a nest egg of \$1M and holds a 30-year, 6% home loan with an outstanding balance of \$300,000. It is assumed the couple takes a moderate approach to investing and their portfolio will be able to return an average of 7.5% over the term of the loan. Only the return on the portfolio will be used to fund their expenses (no principle will be used). The analysis stops in 30 years with the payoff of the loan. As you can see, from the start of their retirement the couple is not burdened by a mortgage payment under choice #1 but their investable retirement nest egg starts off \$300,000 lighter than with choice #2 where the couple keeps the loan and puts the entire \$1M to work for them in a well diversified investment portfolio.

	Choice #1	Choice #2
Beginning retirement assets	1,000,000	1,000,000
Home loan amount	0	300,000
Investible assets	700,000	1,000,000
Annual Earnings (@7.5%)	52,500	75,000
Mortgage Payment (6%)	0	-21600
Tax benefit (1)		2,700
Money available for annual living expenses (2)	52,500	56,100
Assets transferable at Death to heirs (3)	700,000	1,000,000

Notes:

1. Assume one half of payment is deductible throughout the life of the loan and the couple has a 25% combined (federal and state) tax bracket.
2. Depending upon term of loan and date of death the mortgage payment would be eliminated and the \$21600 would be available for additional life income.
3. The couple dies on the day their mortgage is paid off.

In this example it clearly demonstrates the advantages of retaining the loan and investing the entire nest egg. Not only does the couple have more money available for living expenses but also a 42% swelling in the assets available for transfer to their heirs at death.

In both options in the example it is assumed the couple dies after the 30-year term of the home loan has ended. If the couple should live longer the picture gets even better if they don't pay off the loan as the monthly home mortgage expense, \$1800, becomes available for other living expenses or, if not spent, to help compound the amount available to transfer to their heirs.


The above analysis relies on the assumption that both the rate of return and withdrawal rate are linear in nature. While assuming a linear return is not at all realistic, especially when considering it will be over the 30-year term of a loan, the likelihood of averaging a 7.5% return annually over the long-term is a reasonable assumption (depending, of course, on the couple's asset allocation). For this reason and others, the greater the difference between the reasonably assumed rate of return on the investable assets and the home loan rate the more compelling the reason to NOT pay off the loan.

Another major advantage of keeping the loan is that it allows the couple to be more prepared with a larger lump sum of money available in case of a fiscal emergency. Additionally, if at a later date things have changed and it makes sense to eliminate the debt, you can easily do it. The reverse may not necessarily be true.

Going into retirement with the least amount of debt is an outstanding and desirable goal. The less debt you have the more that is available towards other living expenses and the less burdened you feel. While debt is frequently looked at as an evil, there are times that it makes (fiscal) sense to have it. Carefully weigh your options with your financial advisor and see if when the emotional reaction of carrying debt is removed whether it makes fiscal sense to do so in your unique situation.

Financial Perspectives was founded in 2000 by Charles "Chuck" Gibson—a CERTIFIED FINANCIAL PLANNER™ certificant, Accredited Asset Management Specialist, and Chartered Retirement Plans Specialist—who has worked in the financial advisory industry since 1994. With more than \$50 million in assets currently under management*, Chuck and his staff have advised hundreds of individuals, businesses, and other organizations, helping them establish sound investment strategies by providing informed, objective financial planning and asset management advice.

*As of 04/16/2007. Dollar value of assets under management at any given time can and does fluctuate according to current market values, economic conditions, etc.

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