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Investment Insights from the Economics Podium

Mortgage Madness

When I think of low mortgage interest rates, I'm reminded of Arnold Schwarzenegger's memorable line as the Terminator – "I'll be back." Indeed, low rates do come and go (actually, they haven't really risen much from the historical lows of recent years), and with each reappearance we see another mortgage refinancing spree. Homeowners throughout the nation jump at the opportunity for lower interest mortgages, sometimes shortening the term of their loans as well.

As interest rates fall, news columns devoted to the topic of refinancing swell, with one expert after another offering sage money-saving advice to the consumer. During one refinancing boom of the last decade, a national magazine claimed that on a $100,000 mortgage, a shorter term (15 years instead of 30) would save the homeowner $83,000 in interest over the life of the loan. That is, by borrowing for a shorter period, the consumer would reduce the total interest paid to the lender, thus saving money. I do not dispute the mathematics behind this interest-saving calculation, but consider the following.

If consumers can save $83,000 by opting for a 15-year instead of a 30-year mortgage, then could they save even more if they bought the house with cash and held no loan at all? Certainly it would appear so. Using the figures provided in the example, the magazine could claim that readers would save over $183,000 in reduced interest expense. With a claim like this perhaps the magazine could sell many more copies to naïve readers searching for a free lunch.

Isn't there something missing here? Absolutely! The analysis is missing half of the equation. Since every choice has a cost – that is, the value of the best foregone alternative – every choice should involve a comparison of benefits weighed against costs.[1] This and many other press stories during periods of refinancing frenzy accurately identify the ***benefit*** – but fail to explore the ***cost*** – of paying off a loan.

In purely economic terms, the opportunity cost of a shorter term loan is the expected rate of return that could be earned with these funds in the next best investment of similar risk. Of course, some people may not have even invested these funds, but instead used the money to travel around the world or to buy a new car. However, the economic principles remain unchanged, only the form of the opportunity cost is changed – from the foregone expected investment return to the sacrificed pleasure. Both represent opportunities lost.

Another way to think about this is to consider that since interest accrues with the passage of time, unless you can stop time, you can't stop the accrual of interest. If you borrow, you pay interest to the lender; if you pay cash, you incur an implicit cost in the form of interest ***not*** received from one's investments or pleasure lost from a vacation passed up. Either way you pay – explicitly (interest paid) or implicitly (interest not received).

Interest saved by paying off a loan could well exceed the rate of return given up from an alternative investment. On this simplified basis, a rational person might decide to pay off a loan. However, a more complete analysis would incorporate costs such as the loss of the interest tax deduction which may lower the effective interest paid.

Here's a more recent example from a website devoted to investment advice titled, "Interest – The Eighth Wonder of the World?" When discussing mortgages, the author writes:

> *Let's say you have a $125,000 mortgage at 7.5% interest over 30 years, and you decide to pay an extra $30 on top of the monthly payment.* ***The savings are stunning****. For the extra $30 a month,* ***you save yourself*** *$25,087.27 in interest . . . a $100 prepayment would save you $61,000 in interest . . .* (emphasis added)

Wow! These are indeed "stunning" savings, but could this advice be misleading? If a homeowner goes along with the above advice <u>solely</u> on the basis of the interest payment reduction, then perhaps the decision is being made with only a half deck of knowledge. To be more complete, those advising homeowners should state that

[1] See Economics Podium column *The Road Not Taken*.

one “reduces interest payments *to the lender* by a stunning $61,000.” To argue that one will ***save*** this amount is simply misleading. Actual savings depend on both the interest paid to the lender *and* the returns, monetary or otherwise, sacrificed by not using the funds elsewhere. Since the returns sacrificed are most likely greater than zero, net savings from prepayment and shorter term loans will most certainly be less than advertised in the examples cited above and could, for some people, be negative.[2] Because each homeowner confronts a unique situation, it is not a “one-size-fits-all” conclusion. Rather, each household must conduct its own cost-benefit analysis, applying sound economic principles.

I am ***not*** suggesting that one should (a) opt for longer term loans whenever possible, or (b) always borrow to buy. I am merely pointing out that informed investment decisions should consider both the ***benefits*** and the ***costs*** of every choice. As we discuss in other Economics Podium columns, the cost of an investment is the surrendered return from the next best alternative, and astute investors always take that cost into account.

John R. Brock
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[2] Given the low rate of personal saving in this country, it is clear that some consumers find it difficult to save and will likely find the opportunity lost from paying a loan off to be the missed enjoyment from a vacation, a new car, etc. For some non-savers, paying off the loan may create some spending discipline, and is thus another factor to consider.