Mortgages: Beyond the Math

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The first time I bought a mortgage, I went into the process with confidence. I study financial decision-making, so I figured I'd be able to easily determine the best option for my family, sign the paperwork and go about my day.

Alas, that confidence should have been labeled "misplaced": I quickly realized I was in over my head and had a difficult time deciding among the many options presented to my wife and me.

As Part 2 of our *Behavioral Divide* "Beyond the Math" podcast mini-series, I dug into the psychology of mortgage decision-making alongside Columbia Professor Eric Johnson, author of *The Elements of Choice*, who has studied mortgage decisions extensively, and Debbie Grose, CFP, senior vice president at Wealth Enhancement. Suffice it to say, I wish my past self had had this conversation with them.

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His research asks, "How can we help move people from who they are now to who they'll be in the future in a way that maximizes well-being?"

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1. Mortgages are among the most complex financial products we buy – and we almost never buy them.

A mortgage is one of the largest financial decisions most people will ever make, yet it's one we make only a handful of times in our lives, if at all. Prof. Johnson pointed out that you never get to learn from experience the way you do with something like shopping for milk, where you see the price move week over week and develop a feel for it.

They're also not "fun" to buy – it's just something you have to purchase if you don't have enough money to buy a house outright. As Grose noted, the complexity often leads clients to approach the process with trepidation, either avoiding the decision for a time or rushing through it.

There's a deeper point here: Economists often assume people weigh the pros and cons like a spreadsheet – quantifying every cost, discounting future dollars at the going rate and acting on the number. That type of thinking rarely holds in real-world settings.

Take the immediate aftermath of the 2008-2009 financial crisis. Prof. Johnson noted that many economists expected people whose mortgages were underwater (that is, the value of their houses was less than the amount they owed on their mortgages) to simply walk away and leave the keys in the mailbox. But they didn't, in part because the "spreadsheet approach" left out enormous costs that never appear as line items: the pain of moving, finding a new neighborhood, making new friends, changing school districts and so on. When you take those costs into account, it becomes easier to see why people wouldn't just leave and why they wouldn't act in a purely "rational" way.

What to do: If mortgages are unpleasant, rarely considered and complex, anything an advisor can do to simplify the decision for a client is likely a win. Prof. Johnson's perspective was that offering people one clean option instead of two, and making it the simplest, yields far higher uptake. The job, then, isn't to show everything; it's to narrow the field to a small number of clear choices and guide them through it (a point that resonates far beyond mortgage decisions, of course).

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2. Mortgages tap directly into discounting behavior.

As I'm fond of studying and writing about, we tend to overweight what's right in front of us and underweight what's down the road. We value up-front gains and downplay losses that may occur in the future. This tendency to discount future outcomes is at the heart of why certain mortgages get us into trouble.

Adjustable-rate mortgages (ARMs) are attractive precisely because the up-front cost is lower – the payment today feels manageable. The catch is that the increase comes later, and "later" gets less attention and less weight. That's a big part of what fueled the 2008 crash: People loved ARMs more than they should have because the pain was deferred.

The same instinct often shows up today, according to Grose: If a variable rate means a lower payment now, that immediate affordability carries outsized weight in the decision, and the future risk gets waved off with some version of "I'll deal with that when it comes," or "I'll be making more by then."

The same tendency cuts the other way, too. When a client could genuinely save money over time by refinancing, they may still fail to do so because the up-front costs of going through the process, including paying for the refinancing, get overweighted relative to the gains that accrue over the years.

Prof. Johnson pointed to exactly this situation with the Home Affordable Refinancing Program (HARP), which, starting in 2009, allowed eligible homeowners to refinance at no cost. But only about a quarter of eligible consumers took advantage of it, and those who didn't left real money on the table (on the order of several thousand dollars each). One reason for the failure to do so could be discounting; another, as Prof. Johnson found, is a lack of trust in financial institutions.

What to do: Practically speaking, it may help to bring future costs into the present. For instance, consider the decision as if the costs were occurring now, not years from now.

On the ARM side, that means having the client consider the decision as if the higher payments were hitting now, not years out. On the refinancing side, flip it around and pull the gains forward: If refinancing would save someone $4,000 over time, ask whether they'd really say no to $4,000 handed to them today. Almost nobody would. The gist is to turn deferred numbers into present-day ones, so they get the weight they deserve.

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3. Mortgages have a correct mathematical answer, and an answer that has to do with feelings.

Like the other topics in our “Beyond the Math” series, mortgages come with a correct mathematical answer and an answer that has to do with feelings. Grose mentioned that this tension often shows up when her clients start thinking more seriously about retirement. There’s an almost overwhelming sense among many of them that “I want to go into retirement debt-free – I want this mortgage paid off.” As a result, they want to make extra payments and pay the mortgage down early. But does it actually make sense to do so?

Grose’s framing is that a client with extra dollars has three choices: put them toward extra mortgage payments, invest them to build a portfolio or spend them to increase their lifestyle. Even though, from an “I want no debt” standpoint, paying off the mortgage is the right choice, it’s also possible that there are better uses for those dollars.

The point? An advisor shouldn’t just look at the dollars and cents but should also surface how the client feels about the mortgage and then push on that feeling to figure out what actually makes sense.

What to do: One way to address these complicated feelings is to clarify the concept of “cost of capital”. The core idea is simple: A mortgage requires a payment, so the real question is always, where does that payment come from? Every dollar used to service or pay down a mortgage has a source, and that source carries a cost that varies widely depending on a situation.

Here’s an example: During working years, if they are paying a mortgage with earned income, they’re paying with after-tax dollars, meaning they had to earn more than a dollar to make each dollar of payment.

In retirement, the picture gets more nuanced. Clearly, a dollar withdrawn from a brokerage (after-tax) account carries a different cost than a dollar withdrawn from qualified retirement funds, and that difference depends on the tax bracket. So, the question of “should I pay down the mortgage early?” can’t be answered by looking at the mortgage rate alone.

You have to weigh it against what those same dollars would cost to deploy and what they could earn if invested instead. The “cost of capital” concept seems invisible to many and making it understandable and discussable could lead to better, or at least more clearly thought-out, decisions.