Pay Off the Mortgage or Invest?

Individuals with additional, disposable income can find themselves facing a question. Should I *invest* the extra money? Or, should I use the funds to *pre-pay my mortgage*? The "right" answer to this question is often a highly personal one and frequently involves weighing the pros and cons of a number of different issues. Some of these issues are objective, involving a number-crunching approach, while others are more subjective, reflecting an individual's personality, values, and stage in life.

The Highest Investment Return

From a purely mathematical standpoint, the answer to the question would be: *put the money where you achieve the highest investment return*. In this approach, a comparison is made of the return that could be achieved by paying down the mortgage versus the result of, say, investing in the stock market. In the business world, this is referred to as "Return on Investment," or ROI.

The problem, of course, is that many of the variables used in these calculations are guesses about the future. Although the historical record can provide a rough guide as to how well or how poorly certain investments have done in the past, there's no guarantee that the past will repeat itself. Investing does involve risk, including the possible loss of principal.

Reasons to Pay Off the Mortgage

Even if the mathematical analysis points toward investing, there may be other, more personal reasons why a homeowner would want to pay off the mortgage:

- **You keep the interest:** The interest paid over the life of a loan can amount to a very large sum. Paying a mortgage off early keeps this interest in your pocket and not in someone else's. The investment "return" is equal to the interest rate charged on the mortgage.

- **A sense of security:** A homeowner may rest easier knowing that the home is paid for, in case of unemployment, health problems, or other financial setback.

- **A smaller monthly budget:** For many, the home mortgage is the biggest single expense in the monthly budget. Paying off the mortgage significantly reduces the monthly cost of living. This may be particularly important to those who are near, or already in, retirement.

- **A more stable return:** Financial markets can fluctuate, sometimes wildly. The rental value of a place to live, combined with the savings achieved by not paying interest over a long period of time, can provide a more stable return than that found in other markets.

Reasons Not to Pay Off the Mortgage

There are also a number of very good reasons why someone would not want to pay off the mortgage:

- **Lost income tax deduction:** If an individual itemizes deductions on his or her federal income tax return,[1] home mortgage interest generally reduces taxable income. Paying off a mortgage early eliminates this deduction.
- **Other investments may provide a higher return:** Despite the uncertainties involved (investing does involve risk, including the possible loss of principal), investing the extra money elsewhere may ultimately provide a higher investment return.
- **Loss of diversification:** Paying off a mortgage concentrates a higher proportion of an individual's net worth in one asset, the home. Should something happen to that asset, it could represent a major financial blow. A key tool in fighting investment risk is diversification, spreading your funds over different types of assets.
- **Repay loan with cheaper dollars:** If inflation continues to be a part of our economic lives, then not paying off a mortgage allows an individual to pay for an asset over time with what are effectively "cheaper" dollars.

What Else Could the Money Be Used For?

The additional funds could also be used to meet a number of other personal planning needs, such as:

- **Qualified retirement plans – "free money":** If you're not adequately funding an employer-sponsored, qualified retirement plan, such as a 401(k), you may be walking away from "free money" provided through an employer-matching program.

[1] The discussion here concerns federal income tax law. State or local law may vary.

- **IRAs – maximize tax deferral:** Both traditional and Roth IRAs allow an individual to "shelter" savings from income tax. Fully funding an IRA each year maximizes the available tax deferral.
- **Pay off high-interest debt:** The extra funds could be devoted to paying off high-interest debt such as credit cards. As with paying off the mortgage, the investment return equals the interest rate charged on the debt.
- **Build an emergency reserve:** Having extra cash quickly available in case of an emergency is a key part of every individual's financial safety net.
- **Insurance needs:** Do you have enough life insurance? Is your health insurance coverage adequate? Are your home and auto adequately protected?
- **Education needs:** Is there adequate provision for educating your children or grandchildren?

Seek Professional Guidance

The decision to either pay off a mortgage or invest is a personal one. Factors that are important to one individual may not be as important to someone else. The guidance of trained, experienced financial professionals in sorting through the various issues involved is strongly recommended.