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Should You Pay Off Your Mortgage or Invest?

Is it smarter to pay off your mortgage or invest your extra cash?

Owning a home outright is a dream that many Americans share. Having a mortgage can be a huge burden, and paying it off may be the first item on your financial to-do list. But competing with the desire to own your home free and clear is your need to invest for retirement, your child's college education, or some other goal. Putting extra cash toward one of these goals may mean sacrificing another. So how do you choose?

Evaluating the opportunity cost

Deciding between prepaying your mortgage and investing your extra cash isn't easy, because each option has advantages and disadvantages. But you can start by weighing what you'll gain financially by choosing one option against what you'll give up. In economic terms, this is known as evaluating the opportunity cost.

Here's an example. Let's assume that you have a $300,000 balance and 20 years remaining on your 30-year mortgage, and you're paying 6.25% interest. If you were to put an extra $400 toward your mortgage each month, you would save approximately $62,000 in interest, and pay off your loan almost 6 years early.

By making extra payments and saving all of that interest, you'll clearly be gaining a lot of financial ground. But before you opt to prepay your mortgage, you still have to consider what you might be giving up by doing so--the opportunity to potentially profit even more from investing.

To determine if you would come out ahead if you invested your extra cash, start by looking at the after-tax rate of return you can expect from prepaying your mortgage. This is generally less than the interest rate you're paying on your mortgage, once you take into account any tax deduction you receive for mortgage interest. Once you've calculated that figure, compare it to the after-tax return you could receive by investing your extra cash.

For example, the after-tax cost of a 6.25% mortgage would be approximately 4.5% if you were in the 28% tax bracket and were able to deduct mortgage interest on your federal income tax return (the after-tax cost might be even lower if you were also able to deduct mortgage interest on your state income tax return). Could you receive a higher after-tax rate of return if you invested your money instead of prepaying your mortgage?

Keep in mind that the rate of return you'll receive is directly related to the investments you choose. Investments with the potential for higher returns may expose you to more risk, so take this into account when making your decision.

Other points to consider

While evaluating the opportunity cost is important, you'll also need to weigh many other factors. The following list of questions may help you decide which option is best for you.

- What's your mortgage interest rate? The lower the rate on your mortgage, the greater the potential to receive a better return through investing.
- Does your mortgage have a prepayment penalty? Most mortgages don't, but check before making extra payments.
- How long do you plan to stay in your home? The main benefit of prepaying your mortgage is the amount of interest you save over the long term; if you plan to move soon, there's less value in putting more money toward your mortgage.
- Will you have the discipline to invest your extra cash rather than spend it? If not, you might be better off making extra mortgage payments.
- Do you have an emergency account to cover unexpected expenses? It doesn't make sense to make extra mortgage payments now if you'll be forced to borrow money at a higher interest rate later. And keep in mind that if your financial circumstances change--if you lose your job or suffer a disability, for example--you may have more trouble borrowing against your home equity.

- How comfortable are you with debt? If you worry endlessly about it, give the emotional benefits of paying off your mortgage extra consideration.
- Are you saddled with high balances on credit cards or personal loans? If so, it's often better to pay off those debts first. The interest rate on consumer debt isn't tax deductible, and is often far higher than either your mortgage interest rate or the rate of return you're likely to receive on your investments.
- Are you currently paying mortgage insurance? If you are, putting extra toward your mortgage until you've gained at least 20% equity in your home may make sense.
- How will prepaying your mortgage affect your overall tax situation? For example, prepaying your mortgage (thus reducing your mortgage interest) could affect your ability to itemize deductions (this is especially true in the early years of your mortgage, when you're likely to be paying more in interest).
- Have you saved enough for retirement? If you haven't, consider contributing the maximum allowable each year to tax-advantaged retirement accounts before prepaying your mortgage. This is especially important if you are receiving a generous employer match. For example, if you save 6% of your income, an employer match of 50% of what you contribute (i.e., 3% of your income) could potentially add thousands of extra dollars to your retirement account each year. Prepaying your mortgage may not be the savviest financial move if it means forgoing that match or shortchanging your retirement fund.
- How much time do you have before you reach retirement or until your children go off to college? The longer your timeframe, the more time you have to potentially grow your money by investing. Alternatively, if paying off your mortgage before reaching a financial goal will make you feel much more secure, factor that into your decision.

The middle ground

If you need to invest for an important goal, but you also want the satisfaction of paying down your mortgage, there's no reason you can't do both. It's as simple as allocating part of your available cash toward one goal, and putting the rest toward the other. Even small adjustments can make a difference. For example, you could potentially shave years off your mortgage by consistently making biweekly, instead of monthly, mortgage payments, or by putting any year-end bonuses or tax refunds toward your mortgage principal.

And remember, no matter what you decide now, you can always reprioritize your goals later to keep up with changes to your circumstances, market conditions, and interest rates.