



Does It Pay to Pay Off Your Mortgage?

Reducing debt is a good thing, we are told. But paying off your mortgage as you grow older may not be in your best interest.

Callout:

Given today's historically low mortgage rates, you might want to consider refinancing rather than paying down the principal, especially if you currently have a mortgage with an APR of 6% or higher.

Social Media Message:

Reducing debt can be a good thing. But is paying off your mortgage in your best interest?

Most financial experts agree that reducing debt whenever and wherever possible is a good thing. But paying off your mortgage as you grow older may not always be in your best interest.

The idea of no monthly mortgage payment and outright ownership of your home is indeed an appealing prospect, especially if you're depending on Social Security or a fixed pension for income. But does it make financial sense?

Factors to Consider

To answer this question, you need to consider two factors: opportunity cost and flexibility. The opportunity cost is what else you could be doing with the money you use to pay off your mortgage. If, for example, you're looking to pay off a \$100,000 mortgage, you should first consider where you could invest that money instead -- and what rate of return you could get. In general, if the rate you could earn is higher than your mortgage rate, you may be better off keeping the mortgage. For example, if you have a conventional 30-year fixed-rate mortgage with a 4.5% annual percentage rate (APR), but you could earn 5% on a fixed-rate bond, you'd might be better off investing the money in the bond.

This general rule applies even after tax is factored in. The interest portion of your mortgage payment is tax deductible, which reduces the effective interest rate on the mortgage and adds incentive to investing your money elsewhere. But income derived from any alternative investment is taxable, reducing its effective yield, so it's basically a wash.

The other factor to consider is flexibility. Money tied up in real estate is not liquid. If you want to tap into that money, you will either need to take out a mortgage or sell the property. Money held in a traded investment, however, is much more liquid. In the case of stocks or mutual funds, you can convert it to cash within days. And, should you need to draw down this money to pay for living expenses, it's fairly easy to do so if it's held in liquid investments.

Is Refinancing a Better Option?

Given today's historically low mortgage rates, you might want to consider refinancing rather than paying down the principal, especially if you currently have a mortgage with an APR of 6% or higher. If you are thinking of refinancing, be sure to compare rates and estimated closing costs. Also, keep in mind that although current bond yields may be low, long-term returns on more stable investments such as long-term U.S. government bonds have averaged 10.1% for the 30 years ended December 31, 2010.¹

So if you're thinking of paying off that mortgage, make sure you first check out the alternatives and consider what kind of cash cushion you may need in the years ahead.

Source/Disclaimer:

¹Source: Barclays Long-Term Government Bond Index. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

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