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Should You Pay Off Your Mortgage Early?

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Back when interest rates on home mortgages were in the double digits, it was an easy decision to pay down your mortgage early rather than invest that money in the marketplace. But with today's perennially low interest rates, homeowners are now faced with a more difficult decision. While some people are refinancing to shorten their mortgage term (e.g., from 30-year to 15-year mortgages), other people are doing the exact opposite--refinancing to extend the term of their mortgage (and lock in lower monthly payments) or even pulling cash out of their homes to invest it in the stock market (called a "cash-out refinancing"). So, who's right? My answer is that they can both be right depending upon two factors: 1) opportunity cost and 2) personal comfort level with debt.

Opportunity cost

Opportunity cost is simply comparing the difference between your mortgage interest rate and your expected rate of return if you were to invest your money instead. For example, if your mortgage interest rate is 3% (fixed) and you could invest your money and earn 8%, then the opportunity cost of paying down your mortgage is 5%. In short, you would be financially better off by investing your money. That being said, there is a lot of nuance to this decision that often goes unnoticed and unconsidered.

Do you have the discipline to invest your money consistently over a long period of time?

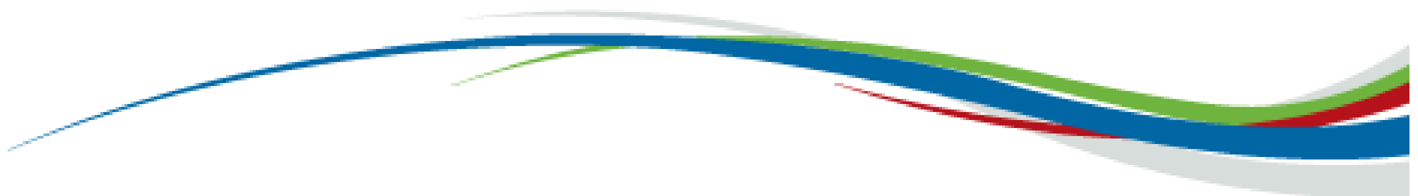
- If you are refinancing your mortgage to lower your monthly payment, it is incumbent that you invest the net savings each month. The problem with this is when you sit on your cash or worse yet, spend it!

Are you actually investing your money in high growth assets?

- To get an appropriately high expected rate of return, you have to be investing in higher risk assets. If you're a retiree with a balanced portfolio (e.g., 50% equity, 50% fixed income), your expected rate of return may not justify the use of "leverage"—that is, using borrowed money for an investment.

Risk vs. risk-free return

- Paying off debt ahead of schedule is a risk-free way of "earning" that rate of return. From my prior example, paying off a 3% mortgage early is equivalent to a "risk-free" 3% rate of return. If you instead decided to invest your excess cash with an expected return of 8%, make sure you understand that this is not a risk-free 8%, and therefore not an apples-to-apples comparison. In other words, your expected rate of return from investing must be higher than your mortgage to compensate for the risk of investing (called a "risk premium").



Personal comfort with debt

Owning your home free and clear comes with a huge psychological boost that you should not underestimate. If you don't think that you could stomach a downturn in the market while you still owe a fortune on your house, you're almost certainly better off focusing on paying down your mortgage.

Consider the following question: have you ever bought stocks on margin? Margin is just a fancy term for borrowing money to purchase more stocks than you otherwise could. For all intents and purposes, it is no different than doing a cash-out refinancing on your home in order to invest the cash—both involve the use leverage. For most people, their home mortgage is the only form of leverage they will ever have—and for good reason! While it can enhance your returns, keeping (or increasing) your mortgage to grow your portfolio should be done with careful consideration towards your overall financial picture.

Other Considerations

Accurately assessing a realistic opportunity cost and your personal comfort with debt are the main factors you need to think about, but there are a few others worth noting.

The first is the mortgage interest deduction, which can lower the effective interest rate that you pay on your mortgage.[1] Personally, I think the benefit is often exaggerated as it only benefits you to the extent that your itemized deductions are in excess of the standard deduction, which was doubled in 2017. In fact, about 90% of taxpayers have taken the standard deduction in recent years.

The second consideration is that a long-term fixed-rate mortgage functions as an inflation hedge to the borrower. As the cost of living increases, your mortgage payments stay the same and the lender receives payments that are less valuable, due to inflation. In essence, your debt gets "inflated away." If you're looking for ways to add an inflation hedge into your financial plan, keeping (or increasing) your mortgage is not the worst way that I can think of.

The Bottom Line

Deciding to pay off your mortgage early vs. investing your excess cash is not as cut and dry as many people would have you believe. The opportunity cost will be different for everyone depending upon personal circumstances; similarly, everyone is going to have a different comfort level with debt.

On the one hand, few people ever regret paying off debt. No matter what the historic track record of the stock market has been, there is no guarantee that your portfolio will perform at that level over the next 10 or 20 years. How much better would you sleep with no mortgage payment?

On the other hand, in a historically low interest rate environment like today, the math can be very compelling to take the longest mortgage term with the lowest payment and invest the difference in the market.

My recommendation is to do the math for yourself and quantify the cost of paying off your mortgage early. At least then you will know how much you are (potentially) giving up and can make an informed decision.

1—Effective mortgage interest rate calculation: mortgage interest rate x [(1 – marginal federal tax rate) – (1 – marginal federal tax rate) x state tax rate]. This assumes your itemized deductions are already in excess of the standard deduction. If they are not, the benefit from the mortgage interest deduction can be greatly reduced.

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