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Pre-Pay Your Mortgage vs. Investing

In the past, the question of whether to use extra cash to make additional mortgage payments or to invest was a no-brainer. In today's world of high yield investments and tax-deferred accounts, however, the issue becomes more complicated.

The answer to that question today is dependent upon many individual variables. It depends on your income and your amount of debt, as well as on your aversion to or fondness for risk. It also depends on how much you have left to pay on your mortgage, your expectations of the market's yields, and the current interest rates.

When You Should Pre-Pay Your Mortgage

There are several situations when it is in your best interest to put extra cash towards your mortgage payments. One example is if you've got a high interest rate on your mortgage. In this case, if you don't want to or cannot refinance into a lower rate, it will probably be better to pay down that mortgage and interest.

Another scenario where it would be better to pay your mortgage is if you have overstepped your means by buying more house than you can afford. If you are feeling like you've spread yourself thin financially, you may do better by putting any extra income towards your home payments, to ease the burden.

Also if you are close to retirement, you may want to pay off your home as soon as possible to ensure the home is yours free and clear during retirement years.

When You Should Invest

When you are considering the best use of your extra money, always remember that the interest on mortgage payments is tax deductible. So if you subtract your tax savings from the interest you pay, you might actually be making more by investing than by paying down the mortgage.

The key seems to be investing in an account that is tax-deferred. One example is the Roth IRA. Middle-aged people can put about $4000 per year into a tax-deferred Roth IRA and earn quite a bit each year for retirement.

Also, consider that money put into mortgage payments will be unusable again unless you sell your home or get an equity line of credit. Money that you invest into an average diversified portfolio can more easily be pulled out for emergencies or during unexpected periods of unemployment.

A recent study that looked at findings from the three latest Surveys of Consumer Finances, found that "more than 45% of U.S. households that are accelerating their mortgage payments instead of saving in tax-deferred accounts are making the wrong choice. For these households, reallocating their savings can yield a mean tax benefit of 11 to 17 cents per dollar, depending on the choice of investment assets in the TDA. In the aggregate, these mis-allocated savings are costing U.S. households as much as 1.7 billion dollars per year." You may be part of this 45% of Americans!

As stated earlier, there is no definite right or wrong answer to the general question. Because there are so many factors involved, talk with your financial advisor to determine the best course of action for your extra money.