Should You Prepay Your Mortgage or Invest?

If you happen to find yourself with extra money to throw around each month and you want to put it best financial use, should you tack it on to your mortgage payment or should you invest it? Unfortunately, figuring out the answer to this process can be very complicated. This article aims to spell out the fiscal benefits of each choice based on the simplest of assumptions. Remember that there are many more emotional and situational factors that might sway your decision.

Prepay Your Mortgage

The main benefit of putting more money towards your mortgage payment each month, or even each year, is that you will pay off that hefty loan faster. This means two things: first, by paying off your mortgage faster, you are then assumedly debt-free and can put all the money you were contributing to your loan towards other ventures and investments. Second, by paying off the loan faster you will accrue fewer interest charges, greatly increasing your overall savings. Consider this example. You take out a $200,000 mortgage fixed at 6% for 30 years. Your normal monthly payment would be about $1200 and after 30 years you would have paid approximately $231,100 in interest. Let's say that you tighten your financial belt and squeeze out an extra $100 to put towards your mortgage each month. In this situation you pay off your mortgage in 24.5 years and pay a total of $182,200 in interest. That is a savings of $48,900 – almost fifty grand – which you did not have to hand over to the mortgage lender. Obviously your savings would be even greater if you were able to put more money towards your mortgage monthly or yearly.

Yet remember this is a simplistic scenario. Many mortgages have prepayment penalties that might reduce your savings from prepaying. You should also realize that paying off your mortgage early you forfeit the potential tax deductions you would have held on to for the mortgage interest.

Invest Instead of Prepay

It may be more in your best interest to consider investing any extra funds you have rather than paying off your mortgage early. When you put more money towards your home, you are building equity in your home, but equity itself does not earn a rate of return. By prepaying you are taking money out of your bank account that could otherwise be earning you interest. And if you need to tap into some extra cash, you can pull out money at a cheaper rate from your savings or investments (unless it is a retirement fund) than you can from a home equity loan. Plus, the earlier you start investing or saving, the greater will be your returns when it comes time to pull the money out for retirement or other expenses later in life. And of course, as long as you have your mortgage you can take advantage of the interest tax deductions, which could mean huge savings if you are in one of the higher tax brackets.

There is a very simplified rule of thumb for deciding whether you would be better off investing than prepaying your mortgage. If your mortgage interest rate is lower than the rate of return you could get by investing, it is generally a good idea to invest. So if your current mortgage interest rate is 6% and you believe you could make 8% in interest by investing, it probably makes more sense to invest rather than prepay. Of course, real life is more complicated though. Your mortgage interest rate may actually be lower because your interest tax deductions bring down the total cost of the loan. So your actually interest rate may be something like 4.5%. And your investment rate may not actually be as high because if it is not a tax-free account, you will be taxed on your profits. So after taxes an 8% rate of return may look more like 6%. In this case the mortgage rate is still lower, but the numbers will vary based on your specific situation.

Be sure to take into account other factors like your age, the number of years before you retire, and how much consumer debt you have. The best idea is probably to consult with your financial advisor to work the numbers and discover which decision will be more profitable to you.