The Basics

Don't rush to pay off that mortgage

You've got better things to do with your money, like saving for retirement, building an emergency cushion or even living it up a little.

By Liz Pulliam Weston

You normally don't think of people who prepay their mortgages as being wasteful or careless.

But a recent study suggests these households blow more than $1.5 billion a year, or $400 per household, by accelerating their mortgage payments instead of contributing more to their retirement accounts.

The research found that at least 38% of those who were making extra payments on their mortgage were "making the wrong choice." Instead, these households would get back 11 to 17 cents more on the dollar by putting the money into a workplace retirement plan like a 401(k).

The study, titled "The Tradeoff Between Mortgage Prepayments and Tax-Deferred Retirement Savings," was conducted by Clemens Sialm of the University of Michigan's Ross School of Business, Gene Amromin of the Federal Reserve Bank of Chicago and Jennifer Huang of the University of Texas at Austin using Federal Reserve data.

If anything, I think the study underestimates how many people make a mistake by prepaying their mortgages. It didn't look at folks who were accelerating their mortgages while carrying higher-rate debt, or who failed to have an emergency fund, or who didn't have adequate life, health or disability insurance.

Most people, in short, have much better things to do with their money than to pay off a low-rate, tax-deductible loan.

The urge to be free of debt

It's not that I don't understand the impulse to speed up the day that you own your home free and clear. There's something psychologically satisfying about knowing the bank can't take your castle.

Besides, the numbers can seem pretty impressive. Let's say you have a 30-year, $250,000 mortgage at 6% interest. Your monthly payments are $1,498.88. By paying an extra:

- $100 a month, you could save nearly $52,000 in future interest and pay the loan off 4½ years early.
- $250 a month, you could save nearly $100,000 in future interest and pay the loan off nine years early.
- $500 a month, you could save nearly $144,000 in future interest and pay the loan off almost 14 years early.

So who wouldn't go for that, right? Indeed, the study estimated that almost one in six U.S. households (16%) pay extra on mortgages each year.

But anyone who really understands money would realize that the savings aren't all they're cracked up to be.

For one thing, mortgages tend to be some of the cheapest money you can get, and, as mentioned earlier, the interest is often deductible. If you're in the 25% federal tax bracket, that 6% interest rate may be costing you as little as 4.5% if you itemize. (Your tax break depends on the amount of interest you pay and the total of your other itemized deductions.) Even if you don't get any tax break at all on your mortgage, though, the rate is still dirt cheap compared with that on most other loans.

Furthermore, those seemingly impressive interest savings are way in the future, where their value will be substantially eroded by inflation. For example, $50,000 in 25 years would be worth less than $24,000 in today's dollars, even at a moderate 3.1% inflation rate.

Contributions to a workplace retirement plan will get you a lot further ahead, for a variety of reasons:

- Most workplace plans have matches, typically 50% of every dollar you put in up to 6% of your pay. If you're not contributing enough to at least get the full company match, you're leaving free money on the table (and missing out on an immediate 50% return).
- You save taxes on the money going in. Federal tax brackets range from 15% to 35%; there are also federal tax credits when lower-income folks make retirement contributions. When the money comes out, you'll owe taxes, but most people's tax rates fall in retirement compared with when they're working.
- Your money can earn better returns in the market compared with paying off low-rate debt. Based on historical returns, a mix of 60% stocks, 30% bonds and 10% cash would earn an average of more than 8% a year in most 20- to 30-year periods, according to market researcher Ibbotson Associates.

The study didn't mention Roth IRAs, but they're another account you should take advantage of if you possibly can. You don't get a tax break up front, but the money comes out tax free in retirement.

Even if you're contributing the max to your retirement accounts, though, your next step shouldn't be making another mortgage payment.

Establish priorities

You need to look first at all your other debt. Chances are if you have any, it's accruing at a higher interest rate than what you're paying on your home loan. That's especially true for credit card debt: It makes no sense to save less than 6% by prepaying a mortgage when you're paying 15%, 20% or even more on your plastic.

What if you're free of other debt, you can start to tackle that mortgage, right?

Not quite. There are other threats to your financial security you need to address, especially:

Financial inflexibility. Fewer than three in 10 households have enough savings to withstand even three months of unemployment. Half say they live paycheck to paycheck at least some of the time, according to a survey commissioned by the Consumer Federation of America. Having an emergency fund equal to at least three months' expenses (plus access to a home equity line of credit) can make the difference between a rough patch and financial disaster; *that* should be your priority after saving for retirement and retiring high-rate debt. Then there's the issue of:

Inadequate insurance. If you have people financially dependent on you -- a spouse who needs your paycheck to pay the mortgage, or minor children -- you need life insurance, and usually plenty of it. (You can use MSN Money's Life Insurance Calculator to see exactly how much.) In addition, you need adequate health insurance, since medical bills are a factor in half of all bankruptcies.

Also crucial: long-term disability insurance, which most Americans don't have. Fewer than 30% of all workers have long-term coverage, according to the U.S. Bureau of Labor Statistics. Yet our chances of disabling accident or injury are pretty high: At age 30, for example, you have more than a 50% chance of being disabled for three months or longer before you turn 65, according to the Council for Disability Awareness. One in seven U.S. workers are disabled for five years or more, and disabilities cause 50% of all mortgage foreclosures. Wouldn't it be ironic if you skipped disability coverage to prepay your mortgage, then wound up losing your house? The bottom line: If you have access to long-term disability coverage at work, buy it.

OK, so what if you're maxing out your 401(k) and Roth IRAs, sitting on a pile of emergency cash and insured up the ying yang? I still wouldn't necessarily attack that mortgage. If you have kids, for instance, you might want to be tucking more away into a 529 college savings plan to make sure they aren't saddled with students loans, as too many young graduates are today.

Again, assuming the money is invested prudently in a mix of stocks, bonds and cash, you should make a much better return than what you can get prepaying your mortgage, and the money is tax-free when used for college.

You've got to live a little

There's a final, much more subjective issue to address. Some of the folks I've run into who are determined to pay off their mortgages early are what I've come to consider "oversavers." They're putting aside prodigious amounts for all kinds of future goals, but spending precious little today. Sometimes they're even straining family relationships by their single-minded focus on being debt-free as early as possible.

That might be OK if any of us were guaranteed long, healthy lives. The reality is that no one is, and we need to strike a balance between saving for tomorrow and living today. The person who's set on paying off a mortgage in as few years as possible, even if that means skipping vacations and the occasional dinner out with the spouse, is just as out of balance as the person living on credit cards.All that said, I'm not one of those pundits who insists that no one should ever pay off a mortgage. I think retiring the home loan by the time you retire is a good goal. Just make sure it takes its proper place with all your other goals -- and that you get to live life a little along the way.

Liz Pulliam Weston's column appears every Monday and Thursday, exclusively on MSN Money. She also answers reader questions in the Your Money message board*.*