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Prepaying Mortgage May Not Trump Investing

By JILLIAN MINCER

Prepaying a mortgage in these uncertain times sounds perfect. It could shorten the term of the loan and offer a stable return when other investments are losing ground.

But it's not a slam dunk decision. Interest rates are low, unemployment high and property values slipping. That cash may come in handy if you lose your job or can't get credit. Long term, you may be better off investing the extra money in an easily accessible mutual fund or a tax-deferred retirement account, especially if your employer offers a match.

"Financial flexibility is at a premium right now so prepaying your mortgage, particularly if you have a low (interest) rate, really doesn't yield much in immediate benefits," says Greg McBride, senior financial analyst at Bankrate.com. "You have to look at the big financial picture. Americans in general are underinvested for retirement and over-invested in their homes."

First Things First

Don't even consider prepaying your mortgage if you haven't put aside an emergency nest egg or owe credit-card debt. Everyone needs at least three to six months worth of cash. Many advisors recommend saving even more if your job's at risk and may take time to replace.

Getting rid of the credit-card balance could improve your credit score and save you at least 10% -- far more than the potential savings on a mortgage.

Assuming you've got a nest egg and job security, you can consider boosting the amount you pay on your mortgage. It's appealing with the current market volatility especially because you can reduce the amount of interest you pay over the life of your loan without paying refinancing fees.

"Prepaying your mortgage is always a good thing to do," says David G. Kittle, chairman of the Mortgage Bankers Association, which represents the real estate financing industry.

He says borrowers could shorten a 30-year fixed rate mortgage by nine and a half years if they annually make an extra mortgage payment, spread over 12 payments. A similar strategy could cut four years off a 15-year mortgage.

Prepaying an adjustable-rate mortgage could have a much more immediate benefit, says Kittle. That's because the lower balance would be used in the calculations when the mortgage resets.

But he says never to prepay without checking your loan documents or with your mortgage servicer to make sure that you don't have a prepayment penalty. Almost no loans do.

McBride says there are a few scenarios in which he recommends paying ahead. One is if you have Private Mortgage Insurance and are close to paying off 20% of the loan. Lenders typically require the extra insurance if the loan is for more than 80% of the home's value.

Another time to consider prepayment is if you're close to bringing down your jumbo mortgage to the size of a conventional loan, which is $417,000 for most of the country but $625,500 in places like New York and Los Angeles. McBride says once you reach that threshold you could refinance the conventional mortgage for potentially a much lower rate.

Another time to prepay is if you're close to retirement and only have a small balance to pay on your mortgage.

One of the biggest drawbacks of prepaying is that it's extremely hard right now to get credit.

"Money you send to your mortgage company is very difficult to get your hands on again," says Stuart Ritter, a financial advisor at T. Rowe Price Group Inc. in Baltimore, Md.

Short term, you have two choices if you need cash from your home, get a second mortgage -- which has become harder to do -- or sell the house.

Cash, on the other hand, is easily accessible. If you've been socking away an extra $100 a month into a money market or savings account, it's there three years later if you lose your job.

In most instances, you need to have paid off the mortgage in full to get the real benefit from prepayment. "There's no discount because you prepaid (a portion of it) in the past," says Ritter.

He says it's not just about how much you're putting in, it's about how much potential gain you may be missing out on by not making other investments.

"If you're in your 30s, 40s, 50s, investing may potentially give you the higher returns," he says.

Even with the disastrous losses of 2008, the average return on the stock market for the last 15 years has been 6.5%, he says. Assuming you pay 6% interest on your mortgage and are in the 25% tax bracket, your after-tax cost for the mortgage is 4.5%, which is how much you benefit by prepaying.

Clemens Sialm, a finance professor at the University of Texas at Austin, says under certain circumstances, it's actually better to contribute to your 401(k), especially if your company offers a match.

He says one factor to consider is the interest rate, which right now is relatively low.

Using data from the Federal Reserve System's Survey of Consumer Finances, Sialm and his fellow researchers found that many people are so risk-averse that they opt for the lower returns of a prepaid mortgage rather than investing in a 401(k) plan.

Even assuming that the 401(k) investments are in conservative Treasury securities earning 5%, the researchers found that at least 38% of households would have earned 11 cents to 17 cents more on the dollar by investing in a 401(k) plan instead of prepaying the mortgage. Those extra earnings would have resulted in additional savings of $1.5 billion a year, or almost $400 per household.

Assuming the investors received a company match for their 401(k) of 50% on the first 6% of their contribution, they would add $2.6 billion in national savings, or $468 a year per household, if they contributed the maximum amount to an employer-sponsored retirement account.

McBride says investors make the mistake of staying away from the market when its down and moving in when it's up and prices are higher.

"This is the time to buy," he says. "The big picture is if you're in a 401(k), IRA or 529 saving with a long-term horizon, you should not let short-term volatility deter you from your long-term goals."

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