SHOULD YOU PAY OFF YOUR HOME BEFORE YOU RETIRE?

Before you make any extra mortgage payments, consider some factors.

Provided by Kristen L. Chirhart, Boom Planning

Should you own your home free and clear before you retire? At first glance, the answer would seem to be "absolutely, if at all possible." Retiring with less debt … isn't that a good thing? Why not make a few extra mortgage payments to get the job done?

In reality, things are not so cut and dried. There is a fundamental opportunity cost to consider. If you decide to put more money toward your mortgage, what could that money potentially do for you if you were to direct it elsewhere?

In a nutshell, the question is: should you pay down low-interest debt, or should you invest the money into a tax-advantaged account that could potentially bring you a strong return?

Relatively speaking, home loans are cheap debt. Compare the interest rate on your mortgage to the one on your credit card. Should you focus your attention on a debt with 6% interest or a debt with 15% interest?

You can usually deduct mortgage interest, so if your home loan carries a 6% interest rate, your after-tax borrowing rate could end up being 5% or lower.

If history is any barometer, your home's value may increase over time and inflation will effectively reduce the real amount of your mortgage over time.

A Chicago Fed study called mortgage prepayments "the wrong choice". In 2006, the Federal Reserve Bank of Chicago presented a white paper from three of its economists titled "The Tradeoff between Mortgage Prepayments and Tax-Deferred Retirement Savings". The study observed that 16% of American households with conventional 30-year home loans were making "discretionary prepayments" on their mortgages each year – that is, payments beyond their regular mortgage obligations. The authors concluded that almost 40% of these borrowers were "making the wrong choice." The white paper argued that the same households could get a mean benefit of 11-17¢ more per dollar by reallocating the money used for those extra mortgage payments into a tax-deferred retirement account.[1]

Other possibilities for the money. Let's talk taxes. You save taxes on each dollar you direct into IRAs, 401(k)s and other tax-deferred investment vehicles. Those invested dollars have the chance for tax-free growth. If you are like a lot of people, you may enter a lower tax bracket in retirement, so your taxable income and federal tax rate could be lower when you withdraw the money out of that account.

Another potential benefit of directing more funds toward your 401(k): If the company you work for provides an employer match, then you may be able to collect more of what is often dubbed "free money".

Let's turn from tax-deferred retirement investing altogether and consider insurance and college planning. Many families are underinsured and the money for extra mortgage payments could optionally be directed toward long term care insurance or disability coverage. If you've only recently started to build a college fund, putting the assets into that fund may be preferable.

Let's also remember that money you keep outside the mortgage is money that is easier to access.

What if you owe more than your house is worth? Prepaying an underwater mortgage may seem like folly to you – or maybe you really love the house and are in it for the long run. Even so, you could reallocate money that could be used for the home loan toward an emergency fund, or insurance, or some account with the potential for tax-deferred growth – when all the factors are weighed, it might look like the better move.

Think it over. It really comes down to what you believe. If you are bearish, then you may lean toward paying off your mortgage before you retire. There is no doubt about it - when you pay off debt you owe, you effectively get an instant return on your money for every dollar. If you are tantalizingly close to paying off your house, then you may just want to go ahead and do it because you love being free and clear.

On the other hand, model scenarios may tell you another story. After the numbers are run, you may want to direct the money to other financial priorities and opportunities, especially if you tend to be bullish and think the market will perform along the lines of its long-term historical averages.

No one path is right for everyone. If you're unsure which direction may be most beneficial to you, speak with a qualified Financial Professional.

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