STOP PAYING OFF YOUR HOME MORTGAGE EARLY

by: Tim Sullivan, CFP®, EA

Owning a home is a goal for many individuals — as well it should be. There is a sense of pride that comes with owning a piece of the American dream. It is more than a place to call home; birthdays are celebrated, dinners are served, and gardens are planted. If purple walls are the décor of choice, no permission is needed, just some paint and sweat equity. However, too many people conflate owning a home with investing. As such, when extra dollars are found in the budget, they "invest" them by paying down the mortgage. This needs to stop.

First though, consider some things that homeowners or homebuyers should be doing.

1. Homeowners should have at least 20% equity in their home. For new buyers, this likely means a 20% down payment. Maintaining this minimum equity target ensures that owners — except in extreme circumstances — will never be underwater in their home. It is not good to be underwater in any purchase but certainly never one as large as a home. If at least a 10% down payment is not possible, then a homebuyer may not be ready to make a purchase.

2. Homebuyers should be able to commit to a home for at least five years when purchasing. Yes, life happens and circumstances change — that is unavoidable. However, if a homebuyer knows they are going to move across the country in three years, they should rent.

3. Homeowners should have a fixed rate mortgage. One of the key financial advantages to homeownership is the ability to control future housing costs. A house payment of $1,400 today will be the same in 12 years with a fixed-rate mortgage. Do not agree to an ARM or balloon loan with the idea that you will be long gone as that may not happen. (My wife and I swore we were only going to be in our house for five years — that was 16 years ago!)

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These recommendations might seem like conservative guidance when it comes to homeownership, and that is fair. However, this cautious approach also supports the earlier recommendation for homeowners to stop paying down their mortgages early. Here are the reasons why.

First, financial decisions are driven by allocating precious resources, and for most, their resource — income — is not unlimited. This writer has witnessed many people putting extra money toward their house payment each month thinking that was a smart investment. At the same time, they were not maxing out their retirement plan at work (assuming they even had a retirement plan at work), or they had a car payment or student loans they were still paying off.

Second, having a mortgage with a fixed rate provides some inflation protection. Inflation has been tame for many years, but in case no one noticed, the government has pumped trillions of dollars into the economy over the last year. Inflation is one of those things that seems fine and under control — until it isn't. Maybe inflation stays in check, but if it were to spike for a period, borrowers win as they pay back the loan with cheaper dollars.

Lastly, having a fixed rate mortgage provides positive leverage. If a home is valued at $300,000 and appreciates 3% in the first year, the owner's net worth increased about $14,000, including appreciation and principal paid, despite only "investing" about $72,000 in the down payment and first year mortgage payments. Tying up $300,000 in an "investment" that historically returns slightly more than the rate of inflation is not a great investment.

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As an advisor, I remind people, "When retired, you will not be able to take a piece of your paid-for gutter to the grocery store and trade it for food — they will want money." As such, people need to focus on investing in assets that provide future cash flow. Those assets take time — typically decades — to grow, and that time cannot be replaced by saving more in the future. In other words, save and invest as much as possible, but remember that your home is not a piggy bank.

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