Do Not Pay Off Your Mortgage Early

Conventional Wisdom is Wrong

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For years I have told you not to pay off your mortgage, and especially to try not to pay it off early. In fact, I often suggest that you refinance whenever substantial equity accumulates in your house. The following story illustrates why this is your best option.

Jim and Clara (not their real names) came into my office recently. Jim plans to retire next month. Their goal was to have their mortgage paid off by the time Jim entered retirement, so 20 years ago, instead of contributing to their 401(k), they sent that money to their lender in the form of extra principal payments on their mortgage. When they became my clients in 1996, we recommended that they stop doing this and instead invest that money into their 401(k) plan. They rejected this advice.

Jim and Clara figured that by eliminating their mortgage prior to retirement, their postretirement expenses would be much lower, enabling them to live on less. Now, it appears they've met their goal: They own their home outright, as well as their cars. They both will receive Social Security, plus Clara's pension — a combined annual income of about $60,000. They have little to nothing in savings or investments, but with no mortgage or car payments, their monthly spending is only about $2,000 per month — easily affordable on their $60,000 retirement income.

Until they need a new car, that is. With little cash, they'll have no choice but to finance the purchase. They plan to buy a used car to keep the cost down. They'll also have to borrow to pay for inevitable major home repairs, as everything in the house is at least 15 years old — the roof, heating and air conditioning system, kitchen and bathrooms. New carpets, painting, driveway and other typical homeownership hassles are unavoidable, as are higher property taxes and fire insurance costs — none of which they've planned for in their monthly budget. And let's not talk about future health care costs.

Since both are only in their 60s, inflation will take its toll over the years. Clara's pension is not indexed with inflation, so even though her $3,000 monthly pension seems like plenty of income today, that income will pay for 25% fewer goods and services in 10 years than it provides today, assuming 3% annual inflation. By age 85, Clara's pension will effectively provide less than half of what it does now — which explains why the majority of those in poverty are the nation's elderly.

Sure, Jim and Clara own a home worth several hundred thousand dollars, but they can't easily tap into the equity. As retirees living on a fixed income, lenders are reluctant to give them a mortgage. A reverse mortgage would provide only a few hundred dollars per month — not enough to materially improve their situation. So they might be forced to sell the house to tap into its liquidity. Ironically, then, they could be forced to give up the one asset they were so determined to keep.

The story could have been much different. Had Jim and Clara placed into investments all the extra payments they sent to the lender over the years, today they'd still have a mortgage — but they'd also have hundreds of thousands of dollars in liquid investments. They'd be able to use that money to make their monthly mortgage payments and rely on the rest to sustain their lifestyle.

As they enter retirement, Jim and Clara realize their situation, and they hope to make the most of it. But they do realize that paying off their mortgage wasn't the best strategy. It's a realization that came 40 years too late.

It's not too late for you.

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