Don’t Be So Quick To Dismiss Paying Your Mortgage Off Early

People can tend to get dogmatic and dismissive of paying down a mortgage early. But I really think this is a function of pure ignorance. Maybe they don’t really understand how to evaluate this option against the conventional wisdom that is dished out on the daily. At first blush, it may appear that I have a bias since the GYFG household chose the path to become mortgage-free (accomplished in just under five years from when we set this goal). But wait – bias appearances can be deceiving!

In theory, I actually agree with those who advocate keeping a mortgage for as long as possible and to invest what it would have taken to pay off the mortgage into the stock market. Over decades, this approach has a very high probability of outperforming the interest you save on paying off your mortgage early. **BUT** when reality punches theory in the face, there are several flaws in this conventional advice:

> (1) The same people telling you to pay the minimum on your mortgage and invest the difference in stocks are also advising you to allocate your funds between stocks and bonds. The rule of thumb is to hold your age in bonds and the rest in stocks. Therefore, if you’re 32 years old, that means you hold 68% of your investments in stocks and 32% in bonds. Hmmm, what do bonds return these days? Isn’t a paid off mortgage synthetically equivalent to a bond? We will come back to these questions a bit later.
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> (2) An even bigger problem is that **most people *don’t* end up investing the difference.** They spend the difference! Based on all the stats, **many spend *more* than the difference** and actually dig themselves a big ole debt hole.

So, in one breath the “experts” say “invest the difference in stocks,” and in another breath, they say “allocate between stocks and bonds.” Do they not realize the conflicting advice they are preaching? Can we please pause for a moment and acknowledge the fact that a paid-off mortgage is equivalent to a bond? When you pay extra towards your mortgage, your “coupon rate” is equal to the interest rate on your mortgage. If you have a 30-year mortgage with a 3.5% interest rate, that equates to 3.5% interest on, say, a 30-year treasury.

Remember that the interest you earn from a bond is typically taxed at the federal and state level as ordinary income (unless you're investing in municipal bonds, which are usually tax-exempt). That being said, the current yield on the 30-year treasury is 3.36% but that is pre-tax. The GYFG household has a very high marginal tax rate of ~45% (federal, state, and FICA). Therefore, if we were to invest in 30-year treasuries today we would expect an after-tax return of ~1.85%.

Compare this to the 2.25% we are saving by paying our mortgage down early. I should state that this is a below market rate since we opted for an adjustable rate mortgage, knowing that we wouldn't have a mortgage for long. But let's ignore this fact for a moment. This is the after-tax rate of return and in order to find the gross return that is equivalent to the 3.36% we could earn if we invested in treasuries, it's going to require a little math to reverse engineer. If we divide the 2.25% by 0.55 (1 less marginal tax rate of 0.45) we find the gross pre-tax equivalent rate is 4.1%.

Of course, you didn't have to do that math as you could have just as easily concluded that 2.25% is greater than 1.85% (the after-tax treasury return).

Now let's back up and address the fact that our rate is below market. We bought our house in 2014 and had an initial 30-year rate of 3.75% plus 1.35% for PMI (because we did an FHA loan initially), which put our effective rate at 5.1% (before any tax benefits of course). We began our journey of strategic refinancings in late 2014 which have saved us tens of thousands of dollars in interest. At the time we did our last refinance (June 2016) the 30-year rate was around 4.25% – a full 2% above the 2.25% rate we currently have on our ARM. I say all of this because I actually view our real savings based on the more typical 4.25% we could have locked in if we had opted for a 30-year mortgage at the time of our last refinance.

So, instead of the 4.1% I calculated above, the gross return for us paying our mortgage down early is closer to 7.72%.

What's my point?

Nice, put the pressure on! I really have four main points I'm trying to get across:

> (1) In theory, paying the minimum mortgage payment over a 30-year term and investing the difference is most likely the optimal strategy to maximize returns. However, theory rarely comes to real-world fruition. If you opt to invest the difference and then allocate those funds between stocks and bonds, you're not really doing what is being recommended, and you may be better off treating your mortgage as your bond allocation for the same or superior results. You just have to do the math.
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> (2) Expanding further on #1 above, most people rarely invest the difference, and instead spend the difference. "Stupid human trick" of immediate gratification!
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> (3) Keep in mind where conventional wisdom comes from. Much of this advice originates from financial advisors and you have to look a level deeper into what may be driving their motivations. They can collect a fee for the money they manage in your stock and bond portfolio but collect nothing on the extra money you throw at your mortgage. I'm a big believer in following the money to get to the truth.
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> (4) Lastly, if your risk profile is such that a split between stocks and bonds makes sense, don't be so fast to dismiss the synthetic bond position you can build from a paid-off mortgage.

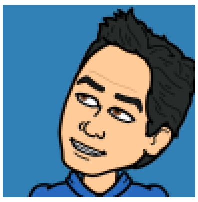
By all means, if you have the risk tolerance to hold the cheap debt, and invest all your additional capital into stocks, don't let me stop you. All I ask is that you don't blindly accept advice that may not be 100% accurate. **Do the math!**

It's no secret that the GYFG household aggressively paid down our mortgage to be mortgage-free in less than five years. Let me make it very clear that I'm not recommending you do this in place of investing in stocks. We have done this as ***part*** of a holistic approach to building a solid financial future, which includes ***also*** investing in stocks and other investments. But, we don't hold a traditional allocation to bonds because we have opted to build a synthetic one by paying off our mortgage.

We even follow the rule of thumb of holding our age in “bonds.” Today the equity in our house makes up about 39% of our total net worth (at 33 we are slightly over-allocated but that will work itself down over the remainder of 2019).

Not every financial decision needs to be optimized for maximum gain. There is a balance of addressing your tolerance for risk and working towards reaching your ultimate financial goals. It’s more important to find a strategy you can stomach for decades rather than one that simply promises the potential for higher returns, which typically comes with a lot more volatility. I can guarantee you that having our house paid off early ensures that we will be sleeping like babies through the next financial crisis. The peace of mind knowing that your house is **paid for** is priceless, in my opinion. And the math might be better than you think.

– Gen Y Finance Guy



Gen Y Finance Guy

Hey, I’m Dom - the man behind the cartoon. You’ll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I’m a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own financial stats. I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! Read More