Your mortgage

It rarely pays to prepay

Few Americans may burn their paid-off mortgages anymore, but many of us get a warm feeling thinking about the day that the biggest financial obligation of our lives will finally be behind us.

While paying your mortgage is definitely a good idea (the alternative being possible foreclosure), whether to take cash you might otherwise invest and pay the loan off ahead of time is a trickier calculation. The decision has become even more complex lately given the ups and downs of the stock market and the downs and more downs of the housing market.

We decided to put that choice to the test in the Consumer Reports Money Lab.

AN EXTRA $100

The question we posed was this: If a person had an extra $100 a month to either pay down a mortgage or play the stock market, which would be a better use of the money?

Our statisticians created a computer model to compare prepaying a mortgage with investing in a Standard & Poor's 500 Index mutual fund during a variety of market conditions.

We hypothesized a person buying an average-priced home with 20 percent down and a 30-year fixed-rate mortgage at 132 different points between January 1986 and December 1996.

We then sold the hypothetical home 10, 15, or 20 years later at the prevailing U.S. average price. We allowed our virtual borrower to refinance to a 15- or 30-year mortgage at appropriate points and catch lower rates.

Then we ran those numbers again, adding $100 to each monthly mortgage payment or putting $100 per month into the no-load, low-expense Vanguard 500 Index fund.

STOCKS ROCK, LOANS LAG

It turns out that while home may be where the heart is, it's usually not where the heartiest returns are. True, in recent years and for short periods since 1969, home prices have climbed as much as 16 to 27 percent a year in some regions. But on average, they rose only about 6.5 percent a year during that period.

The stock market, meanwhile, went through some dramatic swings. But over the last 20 years it averaged about a 10 percent annual gain, as measured by the S&P 500.

A reasonable comparison of the two options is more complex than that, of course. Mutual funds produce taxable dividends and capital gains distributions, while mortgage interest costs are generally tax-deductible. Selling a home typically involves a sales commission to the real-estate agent. Refinancing can lower your interest payments, but it also adds costs. And profits on a home sale of up to $250,000 for individuals ($500,000 for married couples filing jointly) are generally not taxable, while those on a mutual fund are. Our program took those variables into account.

In the scenarios in which the home was sold after 10 years, we usually got a bigger bang from investing the extra $100 in the mutual fund than adding it to the mortgage payment. On average over our trials, the fund investment produced a gain of $10,058 vs. $4,051 from the added mortgage payment.

The index fund didn't always win. In about a third of those 10-year periods, paying down the mortgage produced a better return. But it's worth noting that when prepaying had the edge, it was a small one, ranging from a meager $1 to $2,799. When the fund beat out prepayment, it did so by $70 to $16,763.

When we extended our trials to 15- and 20-year periods of home ownership, the mutual fund had the advantage 100 percent of the time. The average dollar gains from the stock investment grew from $10,058 in the 10-year trials to $19,613 in the 15-year competitions and $41,931 in the 20-year ones.

So the longer you own your home, the less likely it is that mortgage prepayment will be the better choice.

OTHER CONSIDERATIONS

Aside from the cold, hard numbers, there are other reasons you might choose one option over the other. If you need access to your money in an emergency, for example, it will be almost instantly obtainable if it's in a mutual fund and much harder to get to if it's tied up in your house.

On the other hand, many people find peace of mind in paying off their mortgages and owning their homes outright, especially as they approach retirement. That can make an investment in your mortgage a worthy choice, psychologically if not financially.

Still, the bottom line, according to our Money Lab, is this: Although there are exceptions, chances are you'll be better off putting extra money into a good mutual fund, not into prepaying your mortgage.

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