

Paying down a mortgage: not always the best thing to do

Have a low interest rate on your mortgage? Make sure you crunch the numbers before you pay down the principal.

Would the money used to pay down the mortgage make more than 3.25% (the effective rate of interest on a 5% mortgage after tax savings on interest and deductions) elsewhere? With interest rates going up as the Fed stops buying mortgage-backed bonds and we turn from the financial crisis to fighting a recession-based recovery, it stands to reason that money would be better invested in higher-yield investments than paying down a 5% mortgage to buildup wealth in home equity. This is especially true when the subsidized benefits of a tax deduction for mortgage interest payments in the early years of amortization are factored into the rate.

Paying down mortgage debt is emotionally satisfying, but puts a higher portion of the family's wealth in an illiquid asset; that is, you can't get to the money when you need it, as quickly as you can with a liquid savings account or bonds. The liquidity of savings and bonds provide more of a financial buffer than the illiquid equity in a home does against financial shocks such as unemployment, illness or loss of a primary breadwinner. This is especially the case since all decline in a home's value is first absorbed by the homeowner, not the lender.

To offset the risks of homeownership, the homeowner is best served by keeping his reserves liquid and his 30-year, fixed rate mortgage intact — at least for the first 10 to 15 years of payments.