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Pay It Down

DECIDING WHETHER to buy bonds or pay down the mortgage used to be a tricky decision. Not anymore: Paying extra on your home loan will almost always be the right choice.

This take some explaining—because it involves wrapping your head around the standard vs. itemized deduction, investment taxes, and a mortgage's shifting mix of principal and interest.

First, let's dispense with the obvious objection: Yes, if you're inclined to buy stocks rather than pay down the mortgage, that should indeed deliver a better long-run return. But that isn't what we're discussing here. Rather, at issue is whether to buy bonds or pay extra on your home loan.

This is a choice many folks face. Almost everybody should have at least some bonds in their portfolio. Meanwhile, 66% of homeowners carry a mortgage, according to Federal Reserve figures. To understand why paying down that mortgage will usually be better than buying bonds, imagine an elderly aunt just died and generously left you $100,000—and you're mulling three possibilities.

Option No. 1: Buy $100,000 of high-quality corporate bonds in your taxable account. The bonds yield 3%, so that'll mean earning $3,000 or so in annual interest. Problem is, you're in the 22% federal income-tax bracket and a 3% state bracket, so you'll lose a quarter of the interest to taxes. After that hit, you'd be left with $2,250 in annual interest, equal to a 2.25% after-tax yield. That doesn't sound so great.

Option No. 2: Buy the 3% bonds in a retirement account. That would allow you to avoid paying taxes each year on the interest. Problem is, there are annual contribution limits on retirement accounts, so it could take years to shovel the $100,000 into a retirement account.

Your cousin, however, suggests a clever alternative: Move $100,000 from stocks to bonds within your retirement account, while simultaneously using your $100,000 inheritance to buy a total U.S. stock market index fund in your taxable account. That would leave your overall stock exposure unchanged, while allowing you to hold your bonds in a tax-sheltered account.

The $100,000 in the total U.S. stock market index fund might pay some 2% in dividends. But those dividends should qualify for the special 15% federal tax rate, so the annual tax bill will be far less than if you'd used your taxable account to buy corporate bonds yielding 3%. Those corporate bonds will, instead, be sitting in your retirement account, where the 3% will compound tax-deferred. Let's say the bonds sit there for 20 years, at which point you pull the money out.

If it's a Roth account, there would be no tax bill on the withdrawal, so your 20-year annualized return would be an after-tax 3%. If it's a traditional retirement account, you'd have to pay tax on the $80,611 in interest you earned over the 20 years. If you're still in a 25% combined federal and state tax bracket, that would leave you with $60,458—equal to a 2.39% after-tax annualized return over the 20 years. (A nerdy aside: If you figure in the tax deduction from when you first funded the traditional retirement account, the effective after-tax annual gain would be 3%, the same as the Roth. To understand why, click here.)

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Option No. 3: Pay down your mortgage. Let's assume you have $100,000 still owed on your house, the same amount as the inheritance you just received. The mortgage has a fixed rate of 4% and you claim the standard deduction, so you're getting no tax benefit from all the mortgage interest you pay.

Result: You'll pay around $4,000 in mortgage interest over the next year and—because you aren't getting any deduction for that mortgage interest—you'll be out of pocket by the full $4,000. On top of that $4,000, you'll need additional money to pay that portion of each mortgage payment that gets put toward the loan's principal balance.

The upshot: Paying off the mortgage, and avoiding the $4,000 in interest, looks like a better deal than buying bonds, no matter which investment account you use. Seem reasonable? I can imagine four possible objections to the above analysis:

1. What if you itemize your tax deductions and hence you get some tax benefit from the mortgage interest you pay? In 2019, the standard deduction is $24,400 if you're married filing jointly, $18,350 if you file as head of household and $12,200 if you're a single individual. Your itemized deductions are only trimming your tax bill to the extent that they exceed your standard deduction. That's now less likely, thanks to 2017's tax law, which boosted the standard deduction while simultaneously capping the itemized deduction for state, local and property taxes at $10,000.

Let’s say you have a 4% mortgage, you’re in a 25% combined federal and state bracket, you pay $12,000 in annual mortgage interest—and your itemized deductions are $6,000 above your standard deduction. Result: Half your mortgage interest is effectively tax-deductible, so your after-tax mortgage rate would be 3.5%. (If all the interest was deductible, the after-tax rate would be 3%.) That 3.5%, which is the cost you’d avoid by paying down your mortgage, is still higher than what you could earn on corporate bonds—plus the return from paying down the mortgage is guaranteed, which isn’t the case with the bonds.

2. Is it safe to assume that your mortgage rate will be higher than the yield on corporate bonds? If you’d taken out a mortgage when rates were below today’s level, this won’t necessarily be true—but most of the time it will be. The fact is, you and I are considered less creditworthy than large corporations, so we typically pay a higher interest rate when we borrow.

3. What if you can stash money in an employer’s retirement plan where you get a matchingcontribution? If you fund a 401(k) or 403(b), you might get a match of, say, 50 cents for every $1 you contribute up to 6% of pay. That’s like an immediate 50% return on your money, so there’s no question you should take advantage. But once you’ve contributed that 6% of pay, you might direct additional dollars toward paying down your mortgage—unless you plan to use those additional retirement account contributions to buy stocks.

4. What if you’re far along with your fixed-rate mortgage and relatively little of each monthly payment is going toward interest? This is a misunderstanding that trips up many folks: Because they’re paying less in total mortgage interest each year as they gradually whittle down the loan balance, they imagine they’re also paying a lower interest rate.

That simply isn’t the case. Suppose you bought bonds yielding 4% and you sold some each year. The annual amount of interest you earn would decline, but the interest rate you’re earning remains the same. It’s the same with a mortgage—which means paying extra on the mortgage continues to make sense, even if the total dollar amount of interest you’re paying is relatively modest.