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On Personal Finance | Prepay mortgage or beef up 401(k)?

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If you've read this column for a while, you know I've often urged readers to think about making extra mortgage principal payments. This can dramatically cut the amount of interest you pay over the life of the loan and allow you to pay it off years early.

But obviously this cannot be the best move for everyone all the time. If the stock market were to soar, as it did in the late '90s, you would want your money there, not in the mortgage.

Because investment returns and mortgage-interest rates constantly change, a choice that's good one year may be bad the next.

A recent study by the National Bureau of Economic Research concludes that about 38 percent of homeowners who make extra mortgage-principal payments actually would be better off putting those dollars into retirement accounts such as 401(k)s.

The researchers conclude that, for these homeowners, a dollar put into a tax-deferred retirement account can, over time, earn an average of 11 to 17 cents more than it would in an extra principal payment.

Of course, that means 62 percent of the homeowners studied should continue making extra principal payments.

The research was done by Gene Amromin of the Federal Reserve Bank of Chicago, Jennifer Huang of the McCombs School of Business at the University of Texas, and Clemens Sialm of the University of Michigan Business School.

Tax benefits are similar

Although homeowners can choose among many types of investments as alternatives to mortgage prepayments, the researchers focused on 401(k)s and similar accounts to keep the tax situation on an apples-to-apples basis. The homeowner gets a similar benefit from the mortgage-interest tax deduction and the tax deferral on investment gains in a 401(k).

After doing a lot of complicated math, the researchers essentially endorsed the long-standing rule of thumb about mortgage prepayments: If the return on the 401(k) investment is higher than the interest rate on the mortgage, go with the investment. If not, prepay the mortgage.

So if you're paying 6 percent on your mortgage and can make 10 percent a year in a stock mutual fund in your 401(k), you should go with the 401(k).

Or should you?

You also ought to consider risk. There's no guarantee you'll make 10 percent in stocks; you could lose money. The mortgage prepayment, meanwhile, earns a *guaranteed* return equal to the interest rate.

If you could find a guaranteed investment that beats the mortgage rate - a generous government bond or certificate of deposit, for instance - putting your money there would be a no-brainer.

These days, you might get about 5 percent on a Treasury bond or CD. Chances are, your mortgage rate is higher, giving the edge to the mortgage prepayment if you want to play it safe.

Other issues to consider

But before starting a series of prepayments, consider some other issues.

First, no matter what, put enough into your 401(k) to get the maximum matching contribution offered by your employer, if any. Otherwise, you're just walking away from money.

Second, remember that money put into a mortgage is pretty hard to get back on short notice. To free it for another purpose, you would have to sell the home or take out a new mortgage or home-equity loan.

Money put into a 401(k) also is tied up, since most people face early-withdrawal penalties if they take money out before turning 591/2. But it is possible to borrow from your 401(k) on short notice, although this should be done only in a dire emergency.

Third, there's a special benefit to prepayments if you have an adjustable-rate mortgage. Reducing the debt causes the required monthly payments to go down when the loan terms are recalculated every 12 months. (With a fixed-rate loan, prepayments don't reduce the required payment, but the loan is paid off sooner.)

This would be nice if for some reason money gets tight.