Stop pre-paying the mortgage

Sarah Barmak, special to BNN.ca from Fidelity Investments

In today's low-interest-rate world, reducing your mortgage as fast as possible may not be the smartest move. Here's why you should invest first.

It's easy to think of real estate in Canada's heated urban centres as a solid investment. With the average cost of a detached home in Toronto soaring above $1.3-million in October – despite the introduction of new federal mortgage rules meant to dampen the out-of-control market – clients might be forgiven for seeing a splashy new residence as the best place to grow their net worth.

But aggressively paying off a home at the expense of growing other investments could come at a price, warn experts.

Right now, interest rates are so low that investors can make more money in the stock market. According to Ratehub.com, a site that compares mortgage rates, a number of companies are offering five-year fixed rates at below three per cent. The S&P/TSX Composite Index has returned nearly 18 per cent in 2016. Clearly, you would have done better investing in the market than aggressively paying off inexpensive debt.

Over the long term, investments have also outperformed real estate.

Between 1985 and 2015, the price of Canadian homes rose about 5.8 per cent annually on average. But the Canadian stock market rose nine per cent annually over that period on average, including dividends.

And while there's no guarantee of rising markets, people also forget that housing prices likely won't climb forever either. Canadian banks generally forecast that housing prices will plateau or perhaps even dip in the near future.

Housing is not a retirement plan

Seeing your home as your main nest egg means "you're dependent on what's happening with the real estate market when you retire," says Karin Mizgala, co-founder and CEO of Money Coaches Canada. "People's experience is that the market's up, up, up. But that's not always been the story."

A house is also where you live and raise a family, and that comes with emotional attachments. In many cases, when it comes time to sell the house and live off the proceeds, people decide not to pull the trigger.

"They say, 'When I get to retirement, I'll cash out of my house and use the equity to live on.' That often does not happen," says Ms. Mizgala. "You get to retirement and you love your house, you love your neighbourhood."

It’s also not a liquid investment that you can just cash out of. It can take time to find a buyer.

“You want to think of the liquidity considerations when you actually need that money,” she says.

Don’t overpay the mortgage

Considering where interest rates are at today, Scott. Plaskett, a CFP with Ironshield Financial Planning advises some clients to not pay off their mortgages more aggressively than they have to. He might encourage them to put their money in a savings account instead, because that allows them access to that cash in case of an emergency.

Also, if they can find an investment with a return that’s higher than today’s mortgage rates, then there will be a net gain. If clients think they may need the money, or if rates start to rise, they should select an investment that they can withdraw from without a penalty.

“If for any reason mortgage rates start to rise, take the money out and put it in the mortgage,” says Mr. Plaskett.

Remind clients of their choices

It’s important to tell clients that investing in RRSPs and TFSAs provides more flexibility than investing in a home. Remind them that there are plenty of options to choose from within those accounts, from stocks to mutual funds to bonds. And explain that as exciting as it is to pay down a mortgage, investing in other assets can be even more comforting.

“People feel good paying down their mortgage,” says Ms. Mizgala. “But people also feel good emotionally knowing there’s money available if something happens. If they have money in an investment account, they can breathe. If the worst happens and I lose my job, I still have some resources.”

Of course, this is easier said than done – paying down a mortgage has usually been the right thing to do, but that was when mortgage rates were much higher than they are today. If advisors can show clients that there are alternatives to mortgage reduction, their clients may also see that they can be wealthier and wiser in the long run.