



Mortgage Overpayments vs Investing: Where should you put your spare cash?

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As higher mortgage rates have become the new normal in recent years, following rapid interest rate rises by central banks, many homeowners are now asking the same question: Should I invest my spare cash, or pay off some of my mortgage?

I will analyse this seemingly simple question from several standpoints, from investment returns to the emotional value of being debt-free. Much like my previous article comparing pensions and ISAs, this article will attempt to outline what you should consider before answering this common question for yourself.

Returns

Let's start with the numbers. Over the last 20 years, the ARC Sterling Asset Balanced benchmark index (a measure of returns from a balanced risk portfolio) returned 4.34% (net of charges) on an annualised basis. According to Mortgageable, the average annual interest rate on a five-year fixed-rate mortgage (the most common mortgage in the UK) has been 3.55% over the same period. At first glance, this suggests that you will be 0.79% (before any tax) better off each year by investing.

The counter to this is that the "return" you get on paying down your mortgage is guaranteed each year, with the return from investments being extremely variable. The expected return that you should get on your house over time is not relevant here, as you will benefit from the growth in the property's value with or without a mortgage. Based purely on the numbers and the assumption that your time horizon is long enough to accept the short-term volatility with investment returns, investing likely wins out in this regard.

Psychology

Naturally, life is not all about the numbers – psychological factors matter equally as much. Some value, which will be different for everyone, must be placed on the idea of being debt-free. Most importantly, it offers the peace of mind and flexibility of not having to pay your creditors each month.

From a purely mathematical standpoint, saving 4% interest on your mortgage is equivalent to earning 4% on your investments, but growing an investment portfolio over time may give you more satisfaction. Behavioural finance does, however, show that people feel losses roughly twice as much as an equal gain. With this in mind, overpaying a mortgage has a zero chance of loss, whereas investing naturally comes with a chance of loss, especially over the shorter term. For this reason, overpaying your mortgage is likely better for you psychologically if you take a more cautious attitude to your finances.

Liquidity and Flexibility

Another key factor to consider is liquidity and flexibility. Liquidity here can be defined as how quickly an asset can be exchanged for cash. With most investments that can be accessed in conventional investment accounts, investors can go from holding an investment to money in their bank account in around a week. Clearly, this is not the case with your home. Additionally, you can choose to liquidate (exchange for cash)

only part of your investment portfolio, but you cannot simply sell part of your home to release funds when needed.

From another perspective, however, the ease of access you have with your investments might tempt you to withdraw funds, which will not only reduce the value of your savings, but you might be selling at a time when investment values are unfavourable. This forced discipline could mean building larger equity in your house than the comparative investment portfolio over the longer term. It is worth noting that some lenders do, in fact, let you withdraw your overpayments, but this is not the standard in the UK mortgage market. Based on this information, investing will offer you greater liquidity and flexibility.

Tax and Inflation

Next, I will consider the impact of both tax and inflation – the two main drags on increasing an individual's net worth.

Firstly, the “gains” on mortgage overpayments will always be tax-free while the tax on an investment portfolio will very much depend on the tax wrapper the investments are held in. Some accounts, such as ISAs and Pensions, offer tax free growth, but any investments held outside a tax-free wrapper will be subject to tax on both investment income and capital gains. The tax rules for each type of investment wrapper vary and a detailed description is beyond the scope of this article.

In terms of inflation, investing is generally more favourable. The first reason is that, over the long term, businesses often pass rising costs on to consumers, leading to their earnings (and typically their share prices) growing with inflation, although naturally this is not guaranteed. The second reason is that the real value of your monthly mortgage payments will reduce over time as inflation makes them relatively less expensive. Another win for investing.

Conclusion

In conclusion, and similarly to most questions in personal finance, the answer very much depends on your individual goals and circumstances.

The main questions you should be asking yourself should be: how much risk am I willing to take, and do I prefer a known rate of return? How much value do I place on being debt-free? And when will I want to access this money? The answers to these questions will likely dictate your desired outcome.

For some, a “bit of both” strategy may be optimal, others may prefer to do one or the other. From our perspective, we look at an individual's financial circumstances holistically and devise a plan to achieve their financial objectives in the most effective manner for them.

If further advice on this subject or any other aspect of your financial planning will be welcome, please do [contact us](#) and we will be delighted to help.

Harry Downing, Associate IFA
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This article is not a recommendation to invest and should not be construed as advice. The value of an investment can go down as well as up, and you may get less back than you invested.

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