

CERTIFIED MORTGAGE PLANNER®



Ron Fossum RFC
888-560-7119

HOME LOAN
EXPRESS

Downsize Your Downpayment

by Dave Muti

Less Can Leave More for Investing, Retirement

How much money should you put down when you purchase a home? This is one of the oldest questions faced when purchasing real estate. The rule of thumb has always been to put down 20% of the purchase price if you can. Of course, if you had more available, then you were advised to increase the amount. This article will offer a contrarian viewpoint to this established way of thinking. The general principle behind a large down payment is that you will have a smaller mortgage and therefore a smaller mortgage payment. While that may be true, the operative question is: does a large down payment make the best use of your money?

CERTIFIED MORTGAGEPLANNER®

	The Smiths	The Joneses
Purchase Price	\$250,000	\$250,000
Down Payment	\$200,000	\$50,000
Mortgage	\$50,000	\$200,000
10 YEARS LATER		
Future Home Value	\$411,752	\$411,752
Mortgage	\$50,000	\$200,000
Future Equity	\$361,752	\$211,752
Less Original Downpayment	\$200,000	\$50,000
Gain	\$161,752	\$161,752

Chart provided by Forgotten Equity, Inc. © 2004 all rights reserved

nal down payment of \$200,000 leaving them with a gain of \$161,752. The Joneses on the other hand will pay off their \$200,000 mortgage leaving them with \$211,752 from which they will deduct their original down payment of \$50,000 leaving them with a gain of \$161,752.

As counter intuitive as it seems, this illustration proves that regardless of the size of the down payment, the gain is always the difference between the original purchase price and the future value of the home.

In order to address this question, we must first visit a common misconception regarding home equity and its rate of return. No matter how much (or little) equity you have in your house, the rate of return is always the same: zero. This is important to understand because you would not put your hard earned money into a mutual fund that advertises a 0% rate of return, so why put it into your house? It is dead money that provides the same return as it would if you had literally buried it in your backyard or put it under your mattress.

Now you might think: How is that possible? I put down \$100,000 on the purchase of a \$500,000 home five years ago and it is now worth \$600,000. This is a 100% return on my investment of equity. The common mistake most people make is confusing return on equity with the appreciation of real estate values. True, the house went up in value, but you would have realized this gain regardless of whether you had a mortgage on the property. Indeed, you would have realized it even if you had financed the entire purchase. A home's appreciation in value does not depend upon the size of the down payment. Real estate values go up and down irrespective of the size of down payments and mortgages. Real estate value is a factor of market supply and demand. The analogy is that boats on the bay will rise and fall with the tide no matter how big or small they are.

Ten Years Later

As you can see, 10 years into the future both homes will appreciate to the same value of \$411,752. Remember, the value increases or decreases based upon market demand. It has nothing to do with the size of the mortgage or the amount of equity in a home. If they both then decided to sell, at the closing they would both have the same gain. The Smiths would pay off their mortgage of \$50,000 leaving them with \$361,752 from which they will deduct their origi-

After 10 years of the home appreciating at a rate of 5% per year, both homes have gained \$161,752 in value despite the different down payments. This analysis demonstrates that home equity has a 0% rate of return. Again, you would not put your hard earned money into a mutual fund that advertises a 0% rate of return. Why do the same with down-payment funds?

Now that we have illustrated this critical point, let's get back to the original question: how much should you put down? Obviously the smaller the down payment you make, the larger your mortgage and corresponding monthly payments. So I recommend that you take out as large a mortgage as you can comfortably afford and place the remaining money you had planned on using as a down payment in an investment account. I am not advocating that you buy a bigger house and place less down; I am saying that you should purchase your home within a range that gives you comfortable payments and invest the difference. The actual amount depends upon your household income viewed in respect to how many children you have along with the amount of assets you have earmarked for retirement and how much you contribute to those accounts each month.

The moral of the story: Don't put all of your money down on a house. Invest it in yourself instead and give yourself a chance at creating a retirement. ■

* This article is a summary of chapter 5 from the book *Mortgages: What You Need to Know, Strategies to Take Control of Your Financial Future* © Pocket Guide Press 2008 and it was reprinted with permission.



Ron Fossum RFC

Certified Mortgage
Planner

Smart Money Financial
Group
209 Ave D
Ste 200
Snohomish WA 98290

rffossum@
smartmoneyfinancialgr
oup.com

One of the greatest
compliments I can
receive is a personal
referral to one of your
friends who may

David Muti is the author of "Mortgages: What You Need to Know" and the President of Forgotten Equity, Inc. You can learn more about his book by visiting www.pocketguidepress.com.