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How Much Money Should You Put Down on a Purchase of a New Home or Investment Property?

by Dave Muti

This is one of the oldest questions faced when purchasing a piece of real estate. The general rule of thumb has always been to put down 20% of the purchase price if you can and of course if you have more available then you were advised to increase this number. While this has been the "established" way of thinking for generations, this article will offer a contrarian view point to this out-dated strategy. The general principal behind placing a large down payment on a piece of property is that you will have a smaller mortgage which will correlate into a smaller mortgage payment. While this may be true, is it the best use of your money?

In order to address this question we first must visit a common miss conception regarding equity in houses. No matter how much (or little) equity you have in your house the rate of return is always the same, zero. Now you might be thinking how is that possible?

I put down \$100,000 on my purchase of a \$500,000 home two years ago and it is now worth \$600,000. This is a 100% return on my investment of equity. The common mistake that most people make is that you confuse "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 or not you had a mortgage on the property; even if you financed the entire transaction. 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 this factor and how big or small your mortgage is. The chart below provides a clear explanation as to how this works. To make the math simpler, this example assumes an interest only mortgage in both cases:

	The Smith's	The Jones'
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 DOWN PAYMENT	\$200,000	\$50,000
GAIN	\$161,752	\$161,752

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 this case, after 10 years of the home appreciating at a rate of 5% per year, they have both gained \$161,752 in value despite the different down payments. As counter intuitive as it may seem, this demonstrates that home equity has a 0% rate of return. Now that we have illustrated this point, let's get back to the original question, how much should you put down?

Since we now know that equity does not go to work for us (it does not have a return) why don't we look at investing that down payment elsewhere so the money can work for us. In the

initial example above, instead of putting \$100,000 down on the purchase of the house, why not buy the house with no down payment? Take your money and invest it in a liquid, safe and conservative side fund. Assuming that this fund is invested tax deferred and it earns a 6% rate of return you will have \$134,884 after 5 years; \$181,940 after 10 years; \$245,409 after 15 years and \$602,258 after 30 years. In the mean time, the house is appreciating at what ever the market dictates and assuming a modest 5% return over the same time period it would be valued at \$641,679 after 5 years; \$823,505 after 10 years; \$1,056,852 after 15 years and \$2,223,872 after 30 years. Now this may

seem hard to swallow but it is simply the power of compounding interest over time. Remember when houses were only \$28,000 - \$40,000 in the early 70's? So by keeping your money separate, this example created an additional half a million dollars over thirty years that would not have been realized if placed as a down payment on the home.

Of course you are probably thinking, "Hey wait a minute, I would have a bigger mortgage payment so that needs to be factored in." True your gross payment will be larger but so too will the tax deduction you receive from Uncle Sam. While the gross payment is \$500 more per month, you get a tax savings of \$165 each month so the actual increase in cost is only \$335. This assumes you are in a combined federal and state tax bracket of 33%. Even if you invested this \$335 monthly instead of taking a larger mortgage the returns would pale in comparison. In addition, this strategy also addresses the concern of acquisition indebtedness under the IRS guidelines. The basic principal here is that you want to establish the biggest mortgage you can when you purchase the property for mortgage interest tax deductions.

This article only scratches the surface and a full discussion is beyond the scope



**Times have changed
and you need to be
open minded when
choosing how to
finance your home...**

permitted here. These principles can be well debated on both sides of the coin but the point that I am trying to make is that you need to question everything you are told by the real estate industry and the mass media. Times have changed and you need to be open minded when choosing how to finance your home or an investment property. This is often the largest financial decision you may ever make so make it wisely and find a qualified Mortgage Planner to assist you. A good Mortgage Planner should take the time to personally meet with you to investigate what the best option for you might be? Furthermore, this person should also be in consultation with your CPA and other financial advisors as part of a comprehensive financial strategy. Take the time to research, read and then sit down to discuss different options available with a qualified Mortgage Planner.



About the Author

David Muti, JD, RMA, a Senior Mortgage Planer with Millenium Home Mortgage, LLC, is a founding member and current President of Forgotten Equity, Inc.

He can be reached at 973.402.9112 or via email at dave@TeamMuti.com