

Forget the Mansion: Why Buying Bigger Doesn't Guarantee a Rich Retirement

By

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This is one tab the house won't pick up.

It's among today's most popular retirement-savings strategies: Buy the big house, hope the real-estate boom continues and then trade down at retirement, thus freeing up home equity that will pay for years of early-bird specials.

Sound appealing? Trouble is, you will fork over a heap of dollars -- and you'll end up with a surprisingly small nest egg.

Living large: To understand why, imagine you are age 35, have a \$400,000 home with a \$300,000 mortgage and are looking to retire at age 65.

What's the best way to build yourself a nest egg? You might stick with your current home, pay down that mortgage over the next 30 years and stash your spare cash in stock and bond mutual funds. Call this the "small-house strategy" (though, in many parts of the country, a \$400,000 home wouldn't be exactly small).

Alternatively, you could opt for the "big-house strategy" -- trading up to a \$1 million home and aiming to pay down the resulting \$900,000 mortgage between now and retirement. At age 65, you would then cash in a big chunk of your home equity by swapping back to the equivalent of a \$400,000 home.

Which strategy would leave you richer? To make sure today's real-estate junkies don't quibble too much, we'll make the assumptions favorable to the big-house strategy.

For starters, let's assume you could get a 30-year fixed-rate mortgage at 6.5%. The \$900,000 mortgage would cost you some \$5,700 a month, versus \$1,900 for the \$300,000 mortgage.

MONEY PIT

Buying, selling and owning real estate isn't cheap.

- Baby-boomer homeowners spent an average of \$2,200 on home improvements in 2003.
- On a \$200,000 mortgage, closing costs will typically cost you around \$3,000.
- In 2004, home sellers paid real-estate brokers an average of 5.1% in commissions.

Sources: Bankrate.com; Harvard's Joint Center for Housing Studies; REAL Trends

Meanwhile, we'll peg your home's price appreciation at 5% a year, versus 3% for inflation. That two-percentage-point annual real return is right in line with the historical average.

"People might look at this and say, 'Five percent on my house is ridiculous; I'm getting 14%,' " notes Charles Farrell, a financial consultant in Medina, Ohio, who helped me with this analysis. "But you aren't going to get 14% a year for 30 years."

Mr. Farrell calculates that, at age 65, your \$1 million home would be worth \$4.3 million [\$1.8 million in today's dollars] . At that point, you sell it and buy that \$400,000 home.

Because smaller homes would also be appreciating at two percentage points a year above inflation, a \$400,000 home by then would cost roughly \$1.7 million [\$700,000 in today's dollars]. That would leave you with \$1.1 million for retirement living expenses.

That might seem like a decent gain -- but it comes at a steep price. With the big-house strategy, not only would you face hefty mortgage payments, but you also would have to pony up for property taxes, maintenance costs, homeowner's insurance and utilities.

Let's lowball these ongoing expenses and put them at 2% a year of your property's value. Add that to the mortgage, and you would be coughing up \$88,000 in the first year you own the big house.

Staying small: To be sure, with the small-house strategy, you would also have ongoing expenses and monthly mortgage payments. The sums involved, however, would be far smaller. Suppose you took the money you saved by sticking with the small house and sunk it into a mix of mutual funds.

Let's be extremely conservative and assume these mutual funds clock a mere 5.2% [2.2 percentage points a year above inflation]. That is what you can earn today by buying 10-year inflation-indexed Treasury notes, possibly the safest long-term investment you can make. After 30 years, Mr. Farrell calculates that your portfolio would be worth \$2 million in today's dollars, almost twice what you would pocket with the big-house strategy.

True, we are ignoring the value of the mortgage-tax deduction with the big-house strategy, and we haven't figured in the taxes on the investment portfolio with the small-house strategy. On the other hand, if you followed the small-house strategy, you could get a tax deduction for contributing to an individual retirement account or 401(k) plan. Your 401(k) investments might also garner a matching contribution from your employer.

The bottom line: Unless you lose nearly half your investment portfolio to taxes, the small-house strategy wins hands down. And, of course, the margin of victory would be even larger if we use more realistic assumptions.

For instance, suppose the investment portfolio earned four percentage points a year above inflation, while maintenance, utilities and other costs ran at 3% of your home's value. Result: The small-house strategy would give you not double the spending money, but triple.

"The killer is the expenses on the big house," Mr. Farrell says. "It's costing you a lot to carry this \$1 million investment. That money is just going out the window, while the small-house guy is investing the money."

There is, however, an upside to buying the bigger home. For the next 30 years, you would live in a grander place. But that just highlights what this is all about. Buying a bigger house isn't an investment. Rather, it is a lifestyle choice -- and it comes with a brutally large price tag.

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