Why 20 per cent is a deposit for life

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You've probably heard of the 80:20 philosophy. Most often applied to those two great areas of human weakness, eating and spending, the idea is that if you are "responsible and good" 80 per cent of the time, you can "indulge" for the remaining 20 per cent.

Well, what happens if we turn it on its head and apply it to buying property? In other words, ensure that you always have a "responsible and good" deposit of 20 per cent, so you only ever need to "indulge" or borrow 80 per cent.

Firstly, you would avoid lenders' mortgage insurance, which is only levied if you borrow more than 80 per cent of a property's value. It costs thousands of dollars but does nothing to protect you and everything to protect the lender - so it's the epitome of wasting money.

Secondly, a 20 per cent deposit means a property can drop in value by that amount before you start owing more than it is worth - in other words, go into negative equity.

In falling markets such as some of those on the eastern seaboard for the past couple of years, this provides a healthy margin of safety.

Thirdly, the strategy gives you a to-the-dollar price limit. This is a natural ceiling that affords you protection from the banks - which will lend you far more than you should ever borrow.

Indeed, a report last week by J.P. Morgan and Fujitsu Consulting found that the amount banks will lend against the value of a property is heading ever higher as the required deposit carries on shrinking.

Just be sure to also perform a supplementary test that will tell you if borrowing even 80 per cent of a property's value is beyond your means: the repayment stress test. Could you afford it if rates go up once? Twice? Three times? As a rule of thumb, each time you will have to find an extra $32 a month for every $100,000 you borrow.

You should only sign on the dotted line if you are able to cope with at least four hikes.

The final advantage of waiting until you have a 20 per cent deposit is that you will buy only when you are ready rather than when you think you "have to" - say, because you are panicking the market is getting away from you.

Of course, the really hard part is building up that first 20 per cent deposit. Amassing it can take blood, sweat and tears.

But remember: you don't necessarily have to "buy to live". You could instead "buy to let".

This means you are not limited by location, so could start with a property in an area in which a 20 per cent deposit is affordable. Perhaps interstate and/or in a rural area that has good prospects.

A huge advantage to this approach is that your interest is tax deductible, so funding the loan will cost you less.

Assuming you rent in the meantime, remember also that this is probably costing you less than mortgage repayments would on that same property (the very reason we in Australia have the concept of negative gearing). This means you will be ahead on two fronts.

Add some property growth to these savings and in no time you should have built up enough equity to fund 20 per cent of either a property upgrade or a second property.

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