OWNING A HOME VERSUS RENTING

THE MONEY MARATHON BY ED DOUGLAS CFP® JUNE 2014

Before the housing bubble most everyone would say in the long run it is better to own a home rather than to rent. Since the housing bubble, that position is not quite so clear. The younger generation is less willing to buy a home than previous generations. Evidence of that are my three grown children, two of them (the single ones) choose to live in apartments-at least for now. Is it better to own than to rent? Here are some ideas on this subject.

One rule of thumb on this subject uses the price to rent ratio (P/R). The price to rent ratio compares the sale price of a home with the annual rent of a comparable rental property. As the rule states, if the price of the home is more than 15 times the annual rental it might make sense to rent. If the annual price is less than 15 times the annual rent it might make sense to own. As an example, if the sale price of a home were $150,000 and a comparable home cost $700 per month to rent or $8400 per year, the price to rent ratio would be 17.85 which means it might make sense to rent. Historically this ratio has run between 10 and 14, (which makes it better to own generally). During the housing bubble the ratio was at nearly 20 and in some cities much higher. (Time Magazine "Is it Better to Rent or Buy?" J.D. Roth December 3, 2012) In the 90's right up until the housing bubble the ratio ran between 14 and 15 nationwide.

It is sometime difficult to find comparable houses to buy versus rental properties so here are a few other items to consider that may help a person think through the best decision for his particular situation.

*When a person sells a home they may pay a 5% to 6% sales commission. On a $150,000 home this would be $7500 to $9,000. If a person doesn't think they will stay in the home at least a few years it may be better to rent.

*Property taxes, homeowner's insurance and maintenance costs can cost a homeowner about 3% of the home's value annually.

* Home values normally appreciate 3% to 4% per year historically, even taken in consideration the housing bubble. According to the National Association of Realtors, the median sales price of a single family home increased 81% from 1993 to 2013. (The Wall Street Journal- "The New Math of Paying for Your Dream "Anna Maria Andriotes, May 3-4 2014) If a home's value increases even 3% per year, on a 20%

down payment this can be a 15% annual return on a person’s equity and even a larger return if the down payment is smaller. On a $150,000 home with a $30,000 down payment this would be $4500 per year appreciation which is a 15% return on the down payment.

*If the rent a person pays is less than a home payment and they can save the difference between the house payment and the rent, a renter could possibly offset the leverage benefit of owning a home. As an example, assume a house payment on a $120,000 loan ($150,000 purchase price) were $1000 per month including insurance and taxes and alternately a person could rent for $600 per month. If the person rented and then saved and invested the $400 per month or $4800 per year difference, he could offset the appreciation of the home from the example in the paragraph above.

*Many people make note of the point that home loan interest is deductable, but this is only true if the person’s total deductions including home interest is more than the standard deduction which is $12,400 in 2014 for married couples.

*The rule of thumb for a loan is normally that a home loan total payment (principal, interest, taxes and insurance)should not be more than 30% of the borrower’s gross income. As an example if a couple earned $60,000 their total payment should not be more than $1500 per month which would be $18,000 per year which is 30% of $60,000.

*Another rule of thumb is that a borrower should not buy a home worth more than 2.5 times their gross income. So if a couple earns $60,000 they should be able to afford a $150,000 home (2.5 x $60,000)

*Interest rates are still at near historic lows which make a home payment more affordable than in many times in the past.

*Deutsche Bank has an index in which they calculate the average monthly rent as a percentage of the estimated monthly mortgage payment in each of 54 metropolitan areas. The national average is presently $1.05 which means a renter spends $1.05 for every dollar a new buyer spends on housing each month. However in some cities, it is much more expensive to rent, like St Louis in which the number is $1.32. In other cities, like Denver it is much more affordable to rent with the index at $.76.

As you can see there is a lot to consider financially. Of course there are non-financial decisions to consider also. Owning a home gives a person or couple stability, the ability to not be at the mercy of a landlord, plus the comforts and quality of life of home ownership. Rent provides flexibility, mobility and less upkeep. It should also be noted that generally, home owners have a significant higher net worth than renters. According to a Federal Reserve study (Shorewest Realtors “Homeowner’s Net Worth is over 30 times greater than Renters”   Theresa Foy October 6, 2013) the average home owner has a net worth of $174,500 whereas the average renter has a net worth of only $5,100. This is not always true but in general, home ownership leads to a growing stream of wealth as the house appreciates and the loan is paid down.

I am glad that my wife and I own a home. It has definitely been the right decision for us. But home ownership is not for everyone. So study the above material and think through your own specific situation before making your decision.

Remember that every investor's situation is unique and that it is important to review your specific situation with a financial professional.

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