

Some Thoughts on Real Estate

Here are some thoughts on buying a home from a holistic financial planning and socially responsible investing perspective. It doesn't matter what your values or vision are, buying a home is one of the most important financial decisions that you can make, from an investment, social, and conservation perspective.

To sum up the strategy in one sentence: buy a home, get as big a mortgage as you can, for as long as you can, and implement the maximum conservation efforts. I'll cover each of these points in turn.

The decision to buy a home should not be made lightly however, and should be made with consideration of your total financial situation, and your future financial situation. You must consider carefully your current and future income, provisions for children, and retirement planning. As a general rule you should not spend more than 28% of your gross income on mortgage payments. This leaves you a good allowance for saving for retirement, a child's education and upkeep on the house.

Buy a Home

Owning helps you avoid the rent black hole. Rent buys a roof over your head, but little more. A house is an investment. A well-built house in a good neighborhood is an asset that appreciates over time, becoming more valuable. The money that you spend each month for a mortgage buys you a roof over your head, and builds equity.

Buying a home, instead of renting, gives you a host of other benefits, some of which we will go into in more depth:

- Pride of ownership – you're a homeowner! Living the American Dream, you can change, design and decorate your home however you like.
- An owner's payment may eventually end, unlike a renter's which will continue until they die.
- Your monthly payment is locked in over the life of the mortgage (assuming you got a fixed rate), with no risk of increases. (An ARM can only go up so much over the life of the loan, unlike rent, which can go up and up and up!)
- A large portion of the monthly mortgage payment is interest, which is tax deductible.
- You can make (and afford to make) alterations to your home to make it more energy efficient, food producing, and to suit your lifestyle.

Get a Big Mortgage for as Long as You Can

You should get as big of a mortgage as you can afford, up to 80% of the total cost of your home. 80% is an important number because it helps you avoid paying mortgage insurance. If you make at least a 20% down payment you are exempted from mortgage insurance. Getting a big mortgage may seem counterintuitive; shouldn't you try to avoid paying all that money to the bank in the form of interest? Let's consider an example.

What if you want to buy a home that costs \$200,000, should you pay cash for it (assuming you have the cash) or finance its purchase? Let's take the example of Beth and Anne, who both have \$200,000 available from inheritance, and both want to buy a home. Beth pays cash, putting \$200,000 into the home, and has no monthly mortgage payment. Anne finances 80% of the cost of her home, \$160,000, at 7% and pays \$1064 a month. She invests the \$160,000 earning 8% interest on her money, which she uses to pay the monthly mortgage bill. The interest comes to \$1067 a month and just covers her mortgage payment. OK, that makes them pretty much even. But don't forget the tax savings that Anne will get on the interest she has paid on her loan. In the first year she will have paid \$11,148 in interest, which is tax deductible. Assuming she's in the 28% tax bracket, this saves her \$3,121 in taxes the first year. If she invests the tax savings that she gets each year, in 30 years she has approximately \$500,000. (The math is somewhat complicated on this since the tax savings declines each year, as do the years invested; that's why you hire a financial planner!)

If we assume that the housing market appreciates at a conservative 3.5% per year, both houses are worth \$600,000 in 30 years. In the end, Beth has a house worth \$600,000 and not much more. Anne has a house worth \$600,000, a \$500,000 investment portfolio, and her original \$160,000, for a net worth total of \$1,260,000. Anne ends up with twice the net worth of Beth.

But wait, you say, if Beth invests \$1064 a month in an investment portfolio earning 10% a year, she'll have \$2.4 million! Not so fast, Anne can play that game too. She could pay the \$1064 monthly mortgage payment out of her earnings, like Anne is doing, and invest the \$160,000. If she does that, and lets it sit for 30 years, it'll be worth \$3.17 million. And, she has that cool \$500,000 sitting there too, from her invested tax savings. In this situation, Beth ends up with \$3 million, and Anne with \$4.27 million.

An important piece of this is that Anne also has more options in her situation. What if both Beth and Anne have a major health crises one year after buying their homes? Or what if each loses their job? Beth is house rich and cash poor, so if she needs some significant money to cover medical expenses, she may have to sell her house. Anne isn't worried about losing her home, and can use some of her cash to cover whatever needs might come up.

Get the big mortgage.

But what if you don't have an inheritance, and are financing your home out of your current income, should you get a 30-year or 15-year mortgage? Here's another example. Say you are planning to buy a house for \$130,000. The monthly payment for a 15-year mortgage is \$1,150, financed at 6.75%. (Fifteen-year mortgages generally have slightly lower interest rates.) If you were to buy the same house but with a 30-year mortgage, at 7% interest, the numbers are quite different. Your monthly mortgage payment is \$865.

In each of these scenarios you spend almost the same amount on interest, between \$8616 and \$9058 in the first year. This saves you approximately \$2500 in taxes for the year, assuming you are in the 28% tax bracket.

The kicker is that in the 30-year scenario you have \$300 dollars a month available to spend as you like: paying off credit card debt, building cash reserves, or building an investment portfolio. You can even send the money to the bank if you like, as a prepayment on your mortgage. The point is that you have options when you take out a big mortgage for a long payment period.

Some folks think of their mortgage payment as a forced savings plan; the additional money they are sending the bank (\$300 a month in this example) is building their equity in the property for when they sell. But this forced savings plan pays no interest! Of course the bank is happy to take your money, they have it to use as they like (to make more money) but they don't have to pay you to use it. If you like forced payment discipline, set up an automatic withdrawal program with a money market or mutual fund.

A couple more financial points that lean in favor of home ownership:

- The amount of the mortgage on the house doesn't affect the value of the house. This is another reason to put down as little on the house and finance as much as you can. Those \$200,000 homes we talked about earlier each appreciate to \$600,000, (assuming that 3.5% yearly appreciation rate) regardless of the down payment made and current equity.
- Mortgage payments stay fixed over time but your income grows with inflation. Your income should keep pace with inflation, so you will be paying off the loan with "stronger" dollars. For example, if we assume a 3% inflation rate, which is quite conservative, that \$1150 monthly mortgage payment in 15 years will be the equivalent of \$735 today. In 30 years that same \$1150 is the equivalent of only \$470 of today's dollars.

Of course, all of this depends on your situation, and you may play this game differently. Talk to your financial planner to help think through all of the details.

Implement the Maximum Conservation Efforts

Owning a home maximizes your opportunities for conservation and is one of your best initial investment possibilities. If you invest \$1000 into weather stripping and insulation in your home, and it saves you \$250 a year in energy costs, you have an investment that returns 25% a year, tax free. You save resources, and create a higher standard of living for your family. If energy prices rise, as they will, your investment return increases. This strategy can create even greater returns if taken further. In the insulation example, sufficient insulation or some housing design changes may eliminate the need for a furnace and air conditioner, further increasing your return. Planting trees that can also shade the house and protect it from cold winter winds are also an excellent investment. If some of those trees also provide food, then you are all the more ahead.

Of course you cannot put your entire portfolio into home conservation efforts, insulation and weather stripping don't cost that much, but you do want to invest in it as soon and as much as you can. These kinds of things can be done on a smaller scale at a rental property, but it is more difficult to realize the full benefits. And who wants to invest \$1000 into improving a landlord's property?