

When Owning Your Home Doesn't Pay

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One of the most important decisions that you will ever have to make is whether to rent or buy a home. People who encourage buying a home instead of renting typically make the case that if you rent, you are throwing a significant amount of money down the drain. Unfortunately, these same people tend to overlook the significant costs of owning a home. However, two things that are certain is that many people are not familiar with all of the costs associated with owning a home, and many people do not know how to compare the costs of owning a home versus renting. Fortunately, we have a process that will allow you to evaluate your options in virtually any type of [housing](#) environment.

Owning a Home Requires Significant Cash Outlays

In order to determine the relative attractiveness of owning a home, seven primary costs need to be considered. First, if you take out a loan to buy a home, you will have to pay interest expense to the individual or institution that lent you the money. You can calculate this amount each year by multiplying your loan rate with the loan amount outstanding. For most people, the cost of the interest expense tends to be very large for many years at the beginning of the mortgage payment process, unless you make a very large down payment.

For example, a loan rate of 5.3040399% on a 30-year fixed rate loan will require you to pay back exactly twice the amount of the purchase price you agreed to pay when you bought the home, and a loan rate of 9.3967767% will require you to pay back exactly three times the amount. As you can see from

these examples, the cost of interest expense alone may be greater than what you will have to pay in order to rent a comparable place to live. When interest expense is taken into account with the costs of maintenance, property taxes, natural disaster insurance, PMI insurance, closing costs and brokerage fees, it becomes evident that the costs of owning a home are a heavy financial burden. (For more on this process, see *Will You Break Even on Your Home?*)

Tax Deduction Benefits Have Minimal Value for Most Homeowners

As an offset to the cost of owning a home, many real estate experts tout the tax deductibility of interest expense and property taxes as a financial benefit of owning a home. However, for most people, these tax breaks are of nominal value, because the amount of interest expenses that most people incur are of somewhat similar amounts to the standard deduction afforded to them by the federal government for purposes of calculating income taxes owed. Even then, the saving will only be the tax rate applied to the amount of interest expense paid that is above what you could have claimed through the use of the standard deduction. Therefore, unless you take out a large loan, and have a really high interest rate on your loan, the tax deduction benefit will be of marginal value.

Moreover, even if you can take advantage of the mortgage interest tax shield and the property tax shield, it does not make much sense for you to spend a dollar in order to save a quarter.

The Benefit of Equity Gained Through Home Appreciation is Overvalued

Some real estate experts will also tell you that you need to take into account the fact that, if you buy a home, you will benefit in the future as the home appreciates in value. However, in order to take advantage of the equity gained through the appreciation in the value of your home, you will have to sell your home at some time in the future in order to realize the gain. Unfortunately, once you sell your home, you are still going to need a place to live, and it is highly likely that the price of other homes in your area will have also appreciated. Therefore, any gain received through the appreciated value of your home will have to be put back into the cost of buying another home, unless you buy a home of lesser value, or move to another geographical locale where home prices are materially lower.

Furthermore, instead of moving, some real estate experts recommend that you tap the equity in your home by taking out a home equity loan, or a home equity line of credit. However, you should avoid these types of loans unless you have

an immediate financial hardship, because they are typically used to allow people to enjoy a standard of living that is beyond their means. (For information pertaining to home equity loans, check out *The Home-Equity Loan: What It Is And How It Works.*)

Most Homeowners Do Not Know How to Evaluate the Pricing Level of Homes in Their Area

Many people have been told by their parents, their friends and self-proclaimed real estate experts that they can make money by investing in the real estate market. However, the recent collapse of the housing market in many areas of the U.S. illustrates the true risk associated with owning a home. Therefore, if you want to invest in real estate, and would like to avoid being caught up in future housing market calamities, you need to become knowledgeable of the conventional loan lending standards that have been established by the prime mortgage lending institutions, and you should develop an understanding and appreciation of the proprietary household income multiples listed in the table below. By enhancing your knowledge and understanding in these areas, you will be much less likely to get caught up in an over-heated real estate market that could put you in a financial death spiral.

A Practical Approach to Analyzing the Real Estate Market in Your Area

As you may be aware, Fannie Mae and Freddie Mac established a maximum conventional debt-to-income front ratio of 28% in order to foster prudent mortgage lending standards. The front ratio caps the amount of gross income that you can spend on housing-related payments in order to cover the costs of principal repayment, interest expense, property taxes and insurance costs. Based on the front ratio, the following household income multiples were calculated in order to allow you to assess the level of home prices in your area, relative to what the people in your geographical locale can afford to own.

Maximum Median Home Price to Median Household Income Multiples							
Mortgage Loan Rate	Household Income Multiple	Mortgage Loan Rate	Household Income Multiple	Mortgage Loan Rate	Household Income Multiple	Mortgage Loan Rate	Household Income Multiple
4.75%	4.4730	5.20%	4.2493	5.60%	4.0645	7.25%	3.4204
4.80%	4.4473	5.25%	4.2255	5.65%	4.0423	7.50%	3.3371
4.85%	4.4218	5.30%	4.2019	5.70%	4.0202	8.00%	3.1799
4.90%	4.3965	5.3040399%	4.2000	5.75%	3.9984	8.25%	3.1059
4.95%	4.3714	5.35%	4.1785	6.00%	3.8918	8.50%	3.0346
5.00%	4.3466	5.40%	4.1553	6.25%	3.7896	8.75%	2.9660
5.05%	4.3219	5.45%	4.1323	6.50%	3.6916	9.00%	2.8999
5.10%	4.2975	5.50%	4.1095	6.75%	3.5975	9.25%	2.8363
5.15%	4.2733	5.55%	4.0869	7.00%	3.5072	9.3967767%	2.8000

Table multiples determined by Troy Adkins.
Table multiples based on Fannie Mae and Freddie Mac maximum conventional loan debt to income front ratio of 28%.
Table multiples based on a 30-year fixed rate fully amortized loan.
Table multiples are accurate for mortgage loans up to \$100 million.
Taxes and insurance vary by state and were not taken into account to generate the table multiples.

Figure 1

As a prospective real estate buyer, you can use the factors in the table above in order to assess the housing environment in your area. For example, if the current interest rate on a 30-year fixed rate loan is 5.25%, the cost of the median home price in your area should not exceed 4.2255-times the median household income in your area. Therefore, if you determine that the median home price in your area is \$200,000, then the median household income should be at least \$47,332 ($\$200,000/4.2255$). Conversely, if you determine that the median household income in your area is \$50,000, the median home price should not exceed \$211,275 ($\$50,000 \times 4.2255$).

In order to gather the information that you will need to apply this methodology, you should begin by finding the average rate on a 30-year fixed rate loan, which is typically available in your local newspaper, and then by finding both the median home price and median household income in your area.

Applying the Methodology

Once the necessary information has been gathered, you should begin your assessment of the housing market in your area by comparing the median home price to the median household income. If the relationship between the two is equal to the multiple in the table above, you should assume that your housing market is fully valued, and therefore you should not expect to make much money through the appreciation in the value of your home. Under this type of environment, your decision to buy or rent should be based upon your break-

even analysis between the two options.

In comparison, if your market analysis determines that the relationship between median household income and median home prices in your area reveals that houses are undervalued, the risk of owning a home should be considered attractive, and you may stand to make money as a real estate investor, assuming that the local economy remains free of any type of idiosyncratic risk that may hinder the ability of people in your area to own a home.

However, if you find that the median home price in your area exceeds the median household income multiples in the table above, you should be cautious in terms of investing in your local real estate market, because the higher multiple is telling you that the value of homes in your area is higher than what can be sustained by the household income generated by the people living in your area. In this type of environment, the real estate market is not conducive to owning a home, and if you purchase a home, you will most likely be paying too much money for it. In addition, when the housing market is valued at these levels, it is highly likely that you will be putting yourself in a position in which you will be stuck owning the home for a long period of time. As a result, you are probably better off renting in this type of environment.

Conclusion

Your decision to purchase a home will be one of the biggest financial transactions of your life. Therefore, it should be thought out well in advance, should not be based on emotion and should not be taken lightly. With that in mind, if you follow the advice outlined in this article, you should be in a much better position for making a prudent financial decision. (These mistakes will blow your cool - your budget is likely to follow. For more information, refer to Top 8 House-Hunting Mistakes.)