Chapter 1

Deciding Whether to Buy

In This Chapter

- Considering the pros and cons of owning and renting
- Avoiding common mistakes when deciding to buy or rent

Every month, week, and day, we buy things large and small: lunch, a new pair of shoes, and every now and then, a car.

Most people buy things without doing much comparison shopping, but instead draw upon their past experiences. When the counter help at the nearby coffeehouse is friendly and you like the brew, you go back for more.

Sometimes purchases lead you by association to related purchases. You get a pet cat or dog, for instance, and buying a collar and pet toys may naturally follow. By the same token, you buy a home, and before long you have a new television and gardening gloves.

You end up being really happy with some items you purchase. Others fall short of your expectations . . . or worse. When the items in question don't cost you much, it's no big deal. Perhaps you return them or simply don't buy more in the future. But when it comes to buying a home, that kind of sloppy shopping can lead to financial and emotional disaster.

If you're not willing to invest time, and if you don't work with and heed the advice of the best people, you could end up overpaying for a home you hate. Our goals in this book are simple: to ensure that you're happy with the home you buy, that you get the best deal you can, and that owning the home helps you accomplish your financial goals.

Weighing the Advantages of Owning versus Renting

Nearly everyone seems to have an opinion about buying a home. People in the real estate business — including agents, lenders, property inspectors, and other related people — endorse homeownership. Of course, why wouldn't they? Their livelihoods depend upon it! Therein lies one fundamental problem of nearly all home-buying books written by people who have a vested interest in convincing their readers to buy a home.

Homeownership isn't for everyone. One of our objectives in this chapter is to help you determine whether home buying is right for you.

Consider the case of Peter, who thought that owning a home was the best financial move he could make. What with tax write-offs and living in a place while it made money for him, how could he lose? Peter envied his colleagues at work who'd seemingly made piles of money with property they bought years ago. Peter was a busy man and didn't have time to research other ways to invest his money.

Unfortunately, Peter bought a place that stretched his budget and required lots of attention and maintenance. Adding insult to injury, Peter went to graduate school clear across the country (something he knew he was likely to do at the time he bought) three years after he purchased. During these three years of his ownership, home prices dropped 10 percent in Peter's neighborhood. So after paying the expenses of sale and closing costs, Peter ended up losing his entire down payment when he sold.

Conversely, some people who continue to rent should buy. In her 20s, Melody didn't want to buy a home, because she didn't like the idea of settling down. Her monthly rent seemed so cheap compared with the sticker prices on homes for sale.

As it always does, time passed. Melody's 20s turned into 30s, which melted into 40s and then 50s, and she was still renting. Her rent skyrocketed to eight times what it was when she first started renting — that insignificant $150 monthly rent was now over $1,200 per month. Even with the late 2000s real estate price declines, home prices really seemed out of sight compared with three decades earlier. She fearfully looked ahead to escalating rental rates in the decades when she hoped to be retired.

Ownership advantages

Most people should eventually buy homes, but not everyone and not at every point in their lives. To decide whether now's the time for you to buy, consider the advantages of buying and whether they apply to you.

Owning should be less expensive than renting

You probably didn't appreciate it growing up, but in addition to the diaper changes, patience during potty training, help with homework, bandaging bruised knees, and countless meals, your folks made sure that you had a roof over your head. Most of us take shelter for granted, unless we don't have it or are confronted for the first time with paying for it ourselves.

Remember your first apartment when you graduated from college or when your folks finally booted you out? That place probably made you appreciate the good deal you had before — even those cramped college dormitories may have seemed more attractive!

But even if you pay several hundred to a thousand dollars or more per month in rent, that expense may not seem so steep if you happen to peek at a home for sale. In most parts of the U.S., we're talking about a big number — $150,000, $225,000, $350,000, or more for the sticker price. (Of course, if you're a medical doctor, lawyer, management consultant, or investment banker, you probably think that you can't find a habitable place to live for less than a half-million dollars, especially if you live in costly places such as New York City, Boston, Los Angeles, or San Francisco.)

Here's a guideline that may change the way you view your seemingly cheap monthly rent. To figure out the price of a home you could buy for approximately the same monthly cost as your current rent, simply do the following calculation:

Take your monthly rent and multiply by 200, and you come up with the purchase price of a home.

$ ________ per month	x	200 = $ ______________
Example: $ 1,000	x	200 = $200,000

So in the preceding example, if you were paying rent of $1,000 per month, you would pay approximately the same amount per month to own a $200,000 home (factoring in tax savings). Now your monthly rent doesn't sound quite so cheap compared with the cost of buying a home, does it? (Note that in Chapter 3 we show you how to accurately calculate the total costs of owning a home.)

Even more important than the cost *today* of buying versus renting is the cost in the *future.* As a renter, your rent is fully exposed to increases in the cost of living, also known as *inflation.* A reasonable expectation for annual increases in your rent is 4 percent per year. Figure 1-1 shows what happens to a $1,000 monthly rent at just 4 percent annual inflation.

When you're in your 20s or 30s, you may not be thinking or caring about your golden years, but look what happens to your rent over the decades ahead with just modest inflation! Then remember that paying $1,000 rent per month now is the equivalent of buying a home for $200,000. Well, in 40 years, with 4 percent inflation per year, your $1,000-per-month rent will balloon to $4,800 per month. That's like buying a house for $960,000!

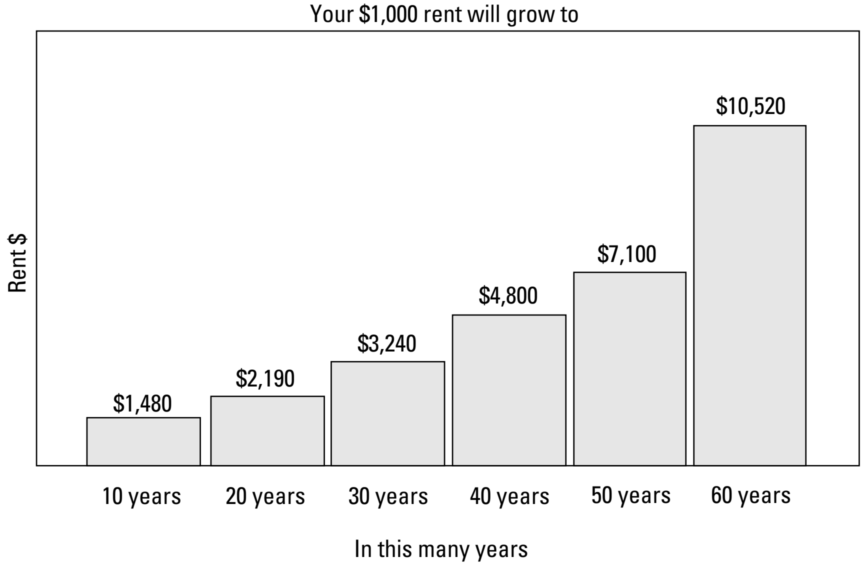

Figure 1-1: The sky-rocketing cost of renting.

In our example, we picked $1,000 for rent to show you what happens to that rent with a modest 4 percent annual rate of inflation. To see what may happen to your current rent at that rate of inflation (as well as at a slightly higher one), simply complete Table 1-1.

Table 1-1 Figuring Future Rent

Your Current Monthly Rent	*Multiplication Factor to Determine Rent in Future Years at 4 Percent Annual Inflation Rate*	*Projected Future Rent*
$	× 1.48	= $ in 10 years
$	× 2.19	= $ in 20 years
$	× 3.24	= $ in 30 years
$	× 4.80	= $ in 40 years
$	× 7.11	= $ in 50 years
$	× 10.52	= $ in 60 years
$	× 1.79	= $ in 10 years
$	× 3.21	= $ in 20 years
$	× 5.74	= $ in 30 years

Your Current Monthly Rent	***Multiplication Factor to Determine Rent in Future Years at 4 Percent Annual Inflation Rate***	***Projected Future Rent***
$	× 10.29	= $ in 40 years
$	× 18.42	= $ in 50 years
$	× 32.99	= $ in 60 years

If you're middle-aged or retired, you may not plan on having 40 to 60 years ahead of you. On the other hand, don't underestimate how many more years of housing you'll need. U.S. health statistics indicate that at age 50, you have a life expectancy of nearly 30 more years, and at age 65, nearly 20 more years.

Although the cost of purchasing a home generally increases over the years, after you purchase a home, the bulk of your housing costs aren't exposed to inflation if you use a fixed-rate mortgage to finance the purchase. As we explain in Chapter 6, a *fixed-rate mortgage* locks your mortgage payment in at a fixed amount (as opposed to an adjustable-rate mortgage payment that fluctuates in value with changes in interest rates). Therefore, only the comparatively smaller property taxes, insurance, and maintenance expenses will increase over time with inflation. (In Chapter 3, we cover in excruciating detail what buying and owning a home costs.)

You're always going to need a place to live. And over the long term, inflation has almost always been around. Even if you must stretch a little to buy a home today, in the decades ahead, you'll be glad that you did. The financial danger with renting long term is that *all* your housing costs (rent) increase over time. We're not saying that everyone should buy because of inflation, but we do think that if you're not going to buy, you should be careful to plan your finances accordingly. We discuss the pros and cons of renting later in this chapter.

You can make your house your own

Think back to all the places you ever rented, including the rental in which you may currently be living. For each unit, make a list of the things you really didn't like that you could have changed if the property were yours: ugly carpeting, yucky exterior paint job, outdated appliances that didn't work well, and so on.

Although we know some tenants who actually do some work on their own apartments, we don't generally endorse this approach, because it takes your money and time but financially benefits the building's owner. If, through persistence and nagging, you can get your landlord to make the improvements and repairs at her expense, great! Otherwise, you're out of luck or cash!

Uses for the wealth you build up in your home

Over the many years that you're likely to own it, your home should become an important part of your financial *net worth* — that is, the difference between your *assets* (financial things of value that you own, such as bank accounts, retirement accounts, stocks, bonds, mutual funds, and so on) and your *liabilities* (debts). Why? Because homes generally increase in value over the decades while you're paying down the loan used to buy the home. Remember, we're talking about the long term here — decades, not just a few years. The housing market goes through downturns — the late 2000s being the most recent down period — but the long-term trend has always been higher.

Even if you're one of those rare people who owns a home but doesn't see much *appreciation* (increase in the home's value) over the decades of your adult ownership, you still benefit from the monthly forced savings that result from paying down the remaining balance due on your mortgage. Older folks can tell you that owning a home free and clear of a mortgage is a joy.

All that home *equity* (the difference between the market value of a home and the outstanding loan on the home) can help your personal and financial situation in a number of ways. If, like most people, you hope to someday retire but (also like most people) saving doesn't come easily, your home's equity can help supplement your other sources of retirement income.

How can you tap into your home's equity? Here are three main ways:

- Some people choose to *trade down* — that is, to move to a less costly home in retirement. Sell your home for $500,000, replace it with one that costs $300,000, and you've freed up $200,000. Subject to certain requirements, you can sell your home and realize up to $250,000 in tax-free profits if you're single, or $500,000 if married. (See Chapter 17 to find out more about this home-ownership tax break.)
- Another way to tap your home's equity is through borrowing. Your home's equity may be an easily tapped and low-cost source of cash (the interest you pay is generally tax-deductible — see Chapter 3).
- Some retirees also consider what's called a *reverse mortgage.* Under this arrangement, the lender sends you a monthly check that you can spend however you want. Meanwhile, a debt balance (that will be paid off when the property is finally sold) is built up against the property.

What can you do with all this home equity? Help pay for your children's college education, start your own business, remodel your home, or whatever!

When you own your own place, however, you can do whatever you want to it. Want hardwood floors instead of ugly, green shag carpeting? Tear it out. Love neon-orange carpeting and pink exterior paint? You can add it!

In your zest and enthusiasm to buy a place and make it your own, be careful of two things:

- **Don't make the place too weird.** You probably want or need to sell your home someday, and the more outrageous you make it, the fewer buyers it will appeal to — and the lower the price it will likely fetch. If you don't mind throwing money away or are convinced that you can find a buyer with similarly (ahem) sophisticated tastes, be as weird as you want. If you do make improvements, focus on those that add value: skylights, a deck addition for an outdoor living area, updated kitchens and bathrooms, and so on.
- **Beware of running yourself into financial ruin.** Changing, improving, remodeling, or whatever you want to call it costs money. We know many home buyers who neglect other important financial goals (such as saving for retirement and their kids' college costs) in order to endlessly renovate their homes. Others rack up significant debts that hang like financial weights over their heads. In the worst cases, homes become money pits that cause owners to build up high-interest consumer debt as a prelude to bankruptcy or foreclosure.

You avoid unpleasant landlords

A final (and not inconsequential) benefit of owning your own home is that you don't have to subject yourself to the whims of an evil landlord. Much is made among real estate investors of the challenges of finding good tenants. As a tenant, perhaps you've already discovered that finding a good landlord isn't easy, either.

REMEMBER

The fundamental problem with some landlords is that they're slow to fix problems and make improvements. The best (and smartest) landlords realize that keeping the building shipshape helps attract and keep good tenants and maximizes rents and profits. But to some landlords, like Leona Helmsley, maximizing profits means being stingy with repairs and improvements (although some of Leona's tenants took her to court for her "excessive thriftiness").

When you own your home, the good news is that you're generally in control — you can get your stopped-up toilet fixed or your ugly walls painted whenever and however you like. No more hassling with unresponsive, obnoxious landlords. The bad news is that you're responsible for paying for and ensuring completion of the work. Even if you hire someone else to do it, you still must find competent contractors and oversee their work, neither of which is an easy responsibility.

Another risk of renting is that landlords may decide to sell the building and put you out on the street. You should ask your prospective landlords whether they have plans to sell. Some landlords won't give you a truthful answer, but the question is worth asking if this issue is a concern to you.

One way to avoid being jilted by a wayward landlord is to request that the lease contract guarantee you the right to renew your annual lease for a certain number of years, even with a change in building ownership. Unless landlords are planning on selling, and perhaps want to be able to boot you out, they should be delighted with a request that shows you're interested in staying a while. Also, by knowing if and when a landlord desires to sell, you may be able to be the buyer!

Renting advantages

Buying and owning a home throughout most of your adult life makes good financial and personal sense for most people — but not all people and not at all times. Renting works better for some people. The benefits of renting are many:

- **Simplicity:** Yes, searching for a rental unit that meets your needs can take more than a few days (especially if you're in a tight rental market), but it should be a heck of a lot easier than finding a place to buy. When you buy, you must line up financing, conduct inspections, and deal with myriad other issues that renters never have to face. When you do it right, finding and buying a good home can be a time-consuming pain in the posterior.
- **Convenience:** After you find and move into your rental, your landlord is responsible for the never-ending task of property maintenance and upkeep. Buildings and appliances age, and bad stuff happens: Fuses blow, plumbing backs up, heaters break in the middle of winter, roofs spring leaks during record-breaking rainfalls, trees come crashing down during windstorms. The list goes on and on and on. As a renter, you can kick back in the old recliner with your feet up, a glass of wine in one hand and the remote control in the other, and say, "Ahhhhh, the joys of *not* being part of the landed gentry!"
- **Flexibility:** If you're the footloose and fancy-free type, you dislike feeling tied down. With a rental, so long as your lease allows (and most leases don't run longer than a year), you can move on. As a homeowner, if you want to move, you must deal with the significant chores of selling your home or finding a tenant to rent it.
- **Increased liquidity:** Unless you're the beneficiary of a large inheritance or work at a high-paying job, you'll probably be financially stretched when you buy your first home. Coming up with the down payment and closing costs usually cleans out most people's financial reserves. In addition, when you buy a home, you must meet your monthly mortgage payments, property taxes, insurance, and maintenance and repair expenses. As a renter, you can keep your extra cash to yourself, and budgeting is also easier without the upkeep-expense surprises that homeowners enjoy, such as the sudden urge to replace a leaking roof or old furnace.

You don't need to buy a home to cut your taxes. Should you have access to a retirement account such as a 401(k), 403(b), SEP-IRA, or Keogh plan (see Chapter 2), you can slash your taxes while you save and invest your extra cash *as a renter.* So saving on taxes shouldn't be the sole motivation for you to buy a home.

- **Better diversification:** Many homeowners who are financially stretched have the bulk of their wealth tied up in their homes. As a renter, you can invest your money in a variety of sound investments, such as stocks, bonds, and perhaps your own small business. You can even invest a small amount of money in real estate through stocks or mutual funds if you want (see Chapter 16). Over the long term, the stock market has produced comparable rates of return to investing in the real estate market.
- **Maybe lower cost:** If you live in an area where home prices have rocketed ahead much faster than rental rates, real estate may be overpriced and not a good buy. This happened in some areas (portions of California, Florida, and Nevada, for example) in the U.S. in the mid-2000s. In Chapter 4, we explain how to compare the cost of owning to the cost of renting in your area and how to spot a potentially overpriced real estate market.

Renting should also be cheaper than buying if you expect to move soon. Buying and selling property costs big bucks. With real estate agent commissions, loan fees, title insurance, inspections, and all sorts of other costs, your property must appreciate approximately 15 percent just for you to break even and recoup these costs. Therefore, buying property that you don't expect to hold onto for at least three (and preferably five or more) years doesn't make much economic sense. Although you may sometimes experience appreciation in excess of 15 percent over a year or two, most of the time, you won't. If you're counting on such high appreciation, you're setting yourself up for disappointment.

The Pitfalls of the Rent-versus-Buy Decision

When you're considering purchasing a home, you can do lots of reflecting, crunch plenty of numbers, and conduct copious research to help you with your decision. We encourage these activities and show you how to do them in later chapters.

In reality, we know that many people are tempted to jump into making a decision about buying or continuing to rent without setting all their ducks in a row. At a minimum, we want to keep you from making common costly mistakes, so in the following sections, we go over the biggies to avoid.

Renting because it seems cheaper

As we discuss earlier in this chapter, in the long run, owning should save you money compared with renting a comparable abode. But come on, we're Americans, after all, and we live on — nay, thrive on — instant gratification. We're not generally long-term thinkers — we too often live for today. Well, when you go out to look at homes on the market *today,* the sticker prices are typically in the hundreds of thousands of dollars. Your monthly rent seems dirt-cheap by comparison.

REMEMBER

You must compare the *monthly* cost of homeownership with the monthly cost of renting. And you must factor in the tax savings you'll realize from homeownership tax deductions. (We show you how to make these calculations in Chapter 3.) But you must also think about the future. Just as your educational training affects your career prospects and income-earning ability for years to come, your rent-versus-buy decision affects your housing costs — not just this year, but also for years and decades to come.

Fretting too much over job security

Being insecure about your job is natural. Most people are — even corporate chief executives, superstar athletes, and movie stars. And buying a home seems like such a permanent thing to do. Job-loss fears can easily make you feel a financial noose tightening around your neck when you sit down to sign a contract to purchase a home.

Although a few people have real reasons to worry about losing their jobs, the reality is that the vast majority of people shouldn't worry about job loss. We don't mean to say that you *can't* lose your job — almost anyone can, in reality. Just remember that within a reasonable time, your skills and abilities will allow you to land back on your feet in a new, comparable position. We're not career experts, but we've witnessed thousands of people bounce back in just this way.

TIP

When losing your job is a high likelihood, and especially if you'd have to relocate for a new job, consider postponing the purchase of a home until your employment situation stabilizes. (If you haven't demonstrated a recent history of stable employment, most mortgage lenders won't want to lend you money anyway — see Chapters 6 and 7.) When you must move to find an acceptable or desirable job, selling your home and then buying another one can cost you thousands, if not tens of thousands, of dollars in transaction fees.

Buying when you expect to move soon

People move for many reasons other than job loss. You may want to move soon to advance your career, to be nearer to (or farther from!) family, to try living somewhere new, or just to get away from someplace old. Unless you're planning to hold onto your home and convert it to a rental when you move, buying a home rarely makes sound financial sense when you expect to move within three years. (Ideally, stay put for at least five years.)

Succumbing to pushy salespeople

When you buy a house, you're the one who'll be coming home to it day after day — and you're the one on the hook for all the expenses. Don't ever forget these facts when you plunge into the thick of purchasing a home. If you have lingering doubts about buying a home, apply the brakes.

Many people involved in home-buying transactions have a vested interest in getting you to buy. They may push you to buy sooner (and buy more) than you intend to or can afford, given your other financial goals and obligations. The reasons: Many people who make their living in the real estate trade get paid only if and when you buy, and the size of their earnings depends upon how much you spend. In Chapter 9, we show you how to put together the best team to assist you in making a decision rather than push you into making a deal.

Ignoring logistics

Sometimes, when looking at homes, you can lose your perspective on big-picture issues. After months of searching, Frederick finally found a home that met his needs for both space and cost. He bought the home and moved in on a Saturday. Come Monday morning, Frederick hopped in his car and spent the next hour commuting. At the end of his workday, it was the same thing coming home. He was tired and grumpy when he arrived home Monday evening, and after making dinner for himself, he soon had to hit the hay to rise early enough to do it all over again on Tuesday.

Initially, Frederick hoped that the trying traffic was an aberration that would go away — but no such luck. In fact, on many days, his commute was worse than an hour each way. Frederick grew to hate his commute, his job, and his new home.

When you buy a home, you're also buying the commute, the neighborhood, its amenities, and all the other stuff that comes along for the literal and figurative ride. Understand these issues *before* you buy. In the end, after 18 months of commuter purgatory, Frederick sold his home and went back to renting much closer to his job. Forgetting to consider what the commute from a home to his job would entail was an expensive lesson for Frederick. Don't make the same mistake Frederick made; take your time, and consider all the important factors about the home you're thinking about purchasing.

Overbuying

Many first-time home buyers discover that their desires outstrip their budgets. Nelson and his wife, Laura, had good jobs in the computer industry and together made in excess of $100,000 per year. They got used to buying what they desired — they ate at fancy restaurants, took luxury vacations, and otherwise indulged themselves.

When it came time to purchase a home, they spent the maximum amount and borrowed the maximum amount that the mortgage person told them they could. After the home purchase, Laura got pregnant and eventually left her job to spend more time at home. With the high home-ownership expenses, kid costs, and reduced household income, Nelson and Laura soon found themselves struggling to pay their monthly bills and started accumulating significant credit card debts. Ultimately, they ended up filing bankruptcy.

Either you own the home, or it owns you. Get your finances in order, and understand how much you can truly afford to spend on a home before you buy (see Chapters 2 and 3).

Underbuying

Remember in the story "Goldilocks and the Three Bears" how Goldilocks had difficulty finding porridge to her liking? In one case, it was too cold, and in another, too hot. Well, just as you can overbuy when selecting a home, you can underbuy. That's what Nathan and Rebecca did when they bought their first home. They believed in living within their means — a good thing — but they took it to an extreme.

Nathan and Rebecca bought a home whose cost was far below the maximum amount they could have afforded. They borrowed $70,000 when they could have afforded to borrow three times that amount. They knew when they bought the home that they'd want to move to a bigger house within just a few years. Although this made the real estate agents and lenders happy, all the costs of buying and then selling soon after gobbled a huge chunk of Nathan and Rebecca's original down payment.

Buying because it's a grown-up thing to do

Peer pressure can be subtle or explicit. Some people even impose pressure on themselves. Buying a home is a major milestone and a tangible display of financial maturity and success. If your friends, siblings, and coworkers all seem to be homeowners, you may sometimes feel as though you're being a tad juvenile by not jumping on the same train.

Everyone has different needs, but not everyone should own a home, and certainly not at every point in their adult lives. Besides, although they may never admit it, some homeowning friends and colleagues are jealous of you and other financially footloose and fancy-free renters.

A study even supports the notion that the life of a typical renter is, in some respects, better than that of the average homeowner. Peter Rossi and Eleanor Weber of the University of Massachusetts Social and Demographic Research Institute conducted a survey of thousands of people. Here are some of their findings:

- Homeowners are less social, on average, than renters — spending less time with friends, neighbors, and coworkers.
- Homeowners spend more time on household chores.
- Perhaps for the preceding reasons, renters have more sex and less marital discord and cope better with parenting than homeowners do!

Buying because you're afraid that escalating prices will lock you out

From time to time, particular local real estate markets experience rapidly escalating prices. During such times, some prospective buyers panic, often with encouragement from those with a vested interest in converting prospective renters to buyers. Escalating housing prices make some renters feel left out of the party. Booming housing prices make the front page of the newspaper and the local TV news. And gloating homeowners cluck over their equity.

Never in the history of the real estate business have prices risen so high as to price vast numbers of people out of the market. In fact, patient buyers who can wait out a market that has increased sharply in value are often rewarded with steadying and, in some cases, declining prices (witness what happened in the late 2000s). Although you won't be locked out of the market forever, you should keep in mind that if you postpone buying for many years, you'll likely be able to buy less home for your money thanks to home prices increasing faster than the rate of inflation.

Misunderstanding what you can afford

When you make a major decision, be it personal or financial, it's perfectly natural and human to feel uncomfortable if you're flying by the seat of your pants and don't have enough background. With a home purchase, if you haven't examined your overall financial situation and goals, you're just guessing how much you should be spending on a home.

Again, the vested-interest folks won't generally bring this issue to your attention — partly because of their agendas and motivations, but also because it's not what they're trained and expert at doing. Look in the mirror to see the person who can help you with these important issues. (Chapter 2 walks you through all the important personal financial considerations you should explore before you set out on your buying expedition.)