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Grow Your Wealth with Peace of Mind

When should you own your Home?

By Gil Hanoch, December 1, 2007

The previous article "Why should you own your Home?" (Hanoch, Oct. 2007), described many benefits of homeownership. Despite the long list of benefits, not everyone should own their own home as soon as they can afford the down payment.

Let's say you found a property that you like and it passed a thorough inspection with no major findings. Here are some financial risks and potential problems to look for:

1. **A need to move again.** A need to move has several risks:
 - a. Selling and buying a house involves very high expenses, and you might not be able to afford them right as you need to move.
 - b. Even if you can afford the costs, a move after a few years makes the homeownership much less appealing financially.
 - c. If the home value declined, or you paid less than the interest on the loan while you owned the home, you might end up owing more than you own. You will have to come up with money out of pocket to sell your home!
2. **Being unable to make the mortgage payments,** resulting in a default on your loan and losing your home and/or declaring bankruptcy. This can happen for many reasons. Here are some of the main ones:
 - a. You lost your job and cannot find another one quickly enough.
 - b. Your mortgage has a variable interest rate (ARM) and interest rates have gone up.
 - c. The 'teaser rate' period on your mortgage ended, and now the payments are much higher.
 - d. You took a mortgage that allows you to pay only part of the interest on the loan (e.g., Option ARM) for some time. The period ended and your payment jumped significantly.
3. **Major repairs come up.** Over the years, every home needs to be repaired and kept up. Some repairs can be very expensive and put you at financial risk if you don't have large reserves prepared for them.

When should you own your home? Considering all the risks mentioned above, there are certain conditions to reduce the financial risks of owning a home:

1. **Long Stay.** You are likely to stay in the house for a good number of years.
 - a. Any stay under 3-5 years will make the transaction costs very significant. A 6% transaction cost (just realtor fee, not counting other costs) spread over 3 years comes out to 2% per year!
 - b. Since real estate recessions tend to be very long, any stay shorter than 10 years can result in a selling price lower than the purchase price (just looking at the recent 1990's recession). In that case, you might have to add money to sell your home.

Alternatively, if you need to move after a few years, you are willing to do one of the following:

- a. Rent out the house and rent a house in a new location for several years. I would not recommend taking this approach unless you are ready for extra work and risks related to renting out a house.
- b. Rent out the house and *buy* a house in a new location. In addition to the extra work related to renting out a house, this option requires significantly higher financial means to own both properties. A future article will discuss this option in more detail.

If you are not sure you are going to stay in one place for long, consider renting. You can always buy a house a year later, after you 'tested' the area for a while. You can even look for a place for rent with an option to buy (sometimes called: lease-option or rent-to-own).

2. **Money to cover move-in expenses.** You have money to cover the down payment, closing costs and moving expenses. You also have money for repairs, furniture and anything else you might need as you move in.
3. **Ongoing cash reserves.** After paying for the costs mentioned above, you still have cash reserves to cover the mortgage payments. Make sure to consider the payment:
 - a. After the expiration of any 'teaser rate' period.
 - b. Based on the full interest amount, in case you initially pay partial interest for an Option ARM. To be conservative, you may want to consider the full amortization (principal + interest).
 - c. For variable interest rate, based on an index rate higher than the long-term average. For example, for loans based on the prime rate, I would consider a prime rate of about 8%, maybe even 9% to be conservative. This is based on the following historic averages of the prime rate:

Period	Average Rate
1929-2006	5.83%
1970-2006	8.73%
1990-2006	7.25%

In addition, remember that there could be spikes in this rate (18.9% average in 1981).

4. **Money for property taxes.** The property tax bill is typically about 1.25%, but can be much higher in certain cases. Make sure to check!
5. **Money for repairs.** Plan on 1% or more of the house value per year. If that sounds high, think about the following relatively infrequent but expensive items: new roof, repairs related to flooding, repainting (interior and exterior), kitchen and bathroom remodel, and many more.

It is much safer to buy a cheap home. Note that the financial risks of homeownership are much smaller for cheaper homes. With a cheap home, more job options can provide income that is adequate to afford the home. If you want to live in an expensive home, you might do best by waiting until you have substantial savings, and in the meantime choosing between buying a cheaper home or renting the more expensive home. A future article will discuss the price of a home you may consider depending on your savings.

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