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How Much Should You Spend Buying a Home?

By Gil Hanoch, April 1, 2008

Conventional wisdom says that owning a home is a smart financial move. It is smart because you can borrow most of its value, leaving most of your money to grow in faster growing investments like stocks, while eliminating rent payments and enjoying the growth of your home value. You get the maximal benefit if you can borrow most of the home value or even all of it.

The catch is that buying a home with a large mortgage introduces substantial financial risks, if not done right. The article "When should you own your Home?" (Hanoch, December 2007) presents a long list of these risks, and a list of rules to help you determine whether you can afford buying a home without taking excessive risk.

This article goes one step further and presents a calculation for the amount of money you should have in disciplined stock investments, so when combined with your income, you can buy your home with limited financial risk.

Assumptions:

1. You borrow as much as the bank will lend you up to 100% of the home value.
2. You fulfilled the full list of requirements for holding a mortgage together with stock investments, presented in the article "Should you Pay Off your Mortgage or Hold Stocks?" (Hanoch, February 2008). Please read carefully the full article, including the strict investment requirements. If you do not follow these principles, you might end up losing your home in the next severe recession.
3. You invest in Long-Term Component by QAM, or any other portfolio that can sustain 5% annual withdrawals, growing with inflation, without any harm to the long-term growth of the portfolio during periods worse than all recessions in recent decades (including 1973-1974 and 2000-2002). Note that most portfolios are far too risky to handle 5% withdrawals, including the common 60% US Large / 40% Bonds.
4. The annual homeownership cost is approximately 10% = mortgage interest (8% fixed) + property tax (1%) + repairs (1%). You can adjust this based on your specific case.
5. You have income to cover expenses other than homeownership costs.

Rules of thumb: Based on these assumptions, we provide rules of thumb for the size of stock investments needed for buying a home. Let's start by demonstrating the rule for different homes:

| Rule of Thumb: Minimum Recommended Stock Investments for Buying a Home With Maximal Borrowing (100% of the home value) | | | |
|---|---------------------------|-------------------------------|---|
| Home Value | Needed Investments | Calculation | Based on Rule |
| \$200,000 | \$40,000 | $0.2 \times \$0.2M = \$0.04M$ | X times Home Value costing \$X million |
| \$500,000 | \$250,000 | $0.5 \times \$0.5M = \$0.25M$ | |
| \$1,000,000 | \$1,000,000 | $1 \times \$1M = \$1M$ | |
| \$2,000,000 | \$4,000,000 | $2 \times \$2M = \$4M$ | |
| \$3,000,000 | \$9,000,000 | $3 \times \$3M = \$9M$ | |
| \$5,000,000 | \$15,000,000 | $3 \times \$5M = \$15M$ | 3 times Home Value |

Expensive homes (\$3M+): Before buying a very expensive home, it would be wise to save enough money to cover all homeownership costs + reasonable living expenses, regardless of income from work. Since such an expensive home is typically a luxury rather than a necessity, you wouldn't want a loss of job or business to put you in serious financial trouble.

To summarize: a rule of thumb for the total assets you should have for expensive homes:

Homes above \$3M: Minimum stock investments recommended = 3 times home value

Cheaper homes: The cheaper the home, the more it is reasonable to count on your income from work. Lower home values have lower maintenance costs, and require a lower paying job which is typically easier to find even if your job is lost during a recession.

A rule of thumb for depending on more income (and less stock investments) for lower home values is:

Homes below \$3M costing X million: Minimum stock investments recommended = X times home value

Examples: The following table summarizes the maintenance financing of different homes. Given a Home Price, its Maintenance is estimated at 10% of the home price. The Recommended Investment is taken from the formulas above. The investment is assumed to provide 5% in annual income. The last two columns show the maintenance cost that is left to be covered through other sources of income.

| Home Price | Maintenance (10%) | Recommended Investment | Investment Income (5%) | Other Income (Maintenance – Investment Income) | |
|-------------|-------------------|------------------------|------------------------|--|---------------------|
| | | | | Amount | Pct. of Maintenance |
| \$200,000 | \$20,000 | \$40,000 | \$2,000 | \$18,000 | 90% |
| \$500,000 | \$50,000 | \$250,000 | \$12,500 | \$37,500 | 75% |
| \$1,000,000 | \$100,000 | \$1,000,000 | \$50,000 | \$50,000 | 50% |
| \$3,000,000 | \$300,000 | \$9,000,000 | \$450,000 | -\$150,000 | < 0% |

1. As you can see, with relatively cheap houses costing \$200,000, we can mostly depend on income from work, since many jobs can provide \$18,000 to cover homeownership costs.
2. As we go into more expensive homes of \$500,000 and \$1,000,000, we want to be less dependent on income from work (75% and 50%, respectively).
3. Once we reach the luxury home of \$3,000,000, we would like to have investments that can cover the full maintenance of the home and leave us with \$150,000 for other living expenses.

Summary

The article presented quick rules-of-thumb for calculating the price of home you can afford while maintaining high short-term and long-term financial security. This may be a good starting point for a detailed analysis.

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