"Do you think everything that could be said about housing has already been said? Think again. The Smiths offer a perspective on home buying that is fresh, sensible, and very much needed these days."

Alan Blinder, Princeton University

HOUSEONOMICS

WHY OWNING A HOME IS STILL A GREAT INVESTMENT

GARY N. SMITH AND MARGARET H. SMITH

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Publishing as FT Press
Upper Saddle River, New Jersey 07458

FT Press offers excellent discounts on this book when ordered in quantity for bulk purchases or special sales. For more information, please contact U.S. Corporate and Government Sales, 1-800-382-3419, corpsales@pearsontechgroup.com. For sales outside the U.S., please contact International Sales at international@pearsoned.com.

Printed in the United States of America
First Printing March 2008

ISBN-10: 0-13-713378-2
ISBN-13: 978-0-13-713378-9

Pearson Education LTD.
Pearson Education Australia PTY, Limited.
Pearson Education Singapore, Pte. Ltd.
Pearson Education North Asia, Ltd.
Pearson Education Canada, Ltd.
Pearson Educatión de Mexico, S.A. de C.V.
Pearson Education—Japan
Pearson Education Malaysia, Pte. Ltd.

Library of Congress Cataloging-in-Publication Data

Smith, Gary, 1945-
Houseonomics : why owning a home is still a great investment / Gary N. Smith, Margaret H. Smith.
p. cm.
ISBN 0-13-713378-2 (pbk. : alk. paper) 1. Real estate investment—United States. 2. Residential real estate—Purchasing—United States. 3. Home ownership—United States. 4. House buying—United States. 5. House selling—United States. I. Smith, Margaret H., 1969- II. Title.
HD259.S65 2008
332.63'240973—dc22
2007049563

INTRODUCTION

The American Dream is to own your own home, whether it is a log cabin in Oregon, a farmhouse in Iowa, or a penthouse in Manhattan. Your home is where you eat, sleep, play, love, laugh, and cry. Where you read books, grow tomatoes, and play cards. Where you can be alone or with your family. Where you can be yourself. Your home is the biggest investment that you will ever make and can be the most profitable one, too. Over the years, millions of ordinary hardworking people have prospered simply by owning the home they live in. They didn't win a lottery or find gold in their backyard. They didn't inherit a million dollars from a long-lost relative. They simply made monthly mortgage payments instead of rent payments. You can do it, too.

When you are thinking about buying or selling a home, there is a lot to think about. Is now a good time to buy? Should you sell your home and rent while you wait for home prices to fall? Should you buy a new home or a fixer upper? Should you make a larger or smaller down payment? Should you trade up or downsize? Should you use a real-estate broker or try to do it yourself? Should you choose a fixed rate or an adjustable rate mortgage? A 30-year or 15-year loan? Should you refinance now that interest rates have fallen? Should you pay off your mortgage early? Should you remodel the kitchen? Is a vacation home worth it? What about a rental property? What can you do when you are retired and barely have enough

money to buy food, but live in a home worth hundreds of thousands of dollars?

We wrote this book to help you answer these questions—and many more. We want to help you make smart decisions about your home, so that you can enjoy your home and profit from it, too.

What Is Houseonomics?

We could have called this book *Home Economics* because a home can be a single-family house, apartment, condominium, duplex—pretty much anything you live in. But the term *home economics* has traditionally been associated with making biscuits and sewing clothes, and this book is definitely not about cooking and sewing. So we considered *House Economics* and thought it would be interesting to merge the words into *Houseonomics,* pronounced house-o-nomics. This book is about houses (and other homes too) and about many of the big financial decisions you make about your home.

This book is not encyclopedic. That would be boring to write and tedious to read. Instead, we put together a collection of useful principles, handy tips, and memorable stories—about things that can really make a difference.

Who's Looking Out for You?

A lot of people make a profit from other people's homes: the contractors who build and remodel homes, the real estate agents who bring together buyers and sellers; the bankers who lend money to home buyers; the fund managers who trade mortgages among themselves, the agents who sell homeowner's insurance. They offer you advice on building, remodeling, buying, selling, financing, refinancing, and insuring a home. But their advice is suspect. Are their recommendations for your benefit or for theirs?

We don't have any conflicts of interest. We won't make a dime if you buy a home, remodel your kitchen, or choose a 10-year mortgage. Our goal is to give you useful tools and insights that you can use to make informed decisions.

Our Stories

Financial decisions involve some unfamiliar principles. Even professionals make mistakes. So what can we expect from amateurs who will only buy and sell a few homes in their lifetime? A lot! We wrote this book because we know that *anyone* can learn to make reasonable financial decisions about homeownership. One way to learn how to make the right financial decisions is to identify ways to do it incorrectly. This book identifies several pitfalls to avoid.

Houseonomics includes many stories to show you the typical kinds of housing decisions that people face and how others have dealt with them—sometimes wisely, sometimes foolishly. All our stories are real. The reason we tell these stories is not to embarrass anyone, but to learn from their experiences. Heck, some of these stories are about mistakes that *we* have made. The names and some unimportant details in the stories are changed to protect the individuals' identities, and we sometimes combine two stories into one or split one story into two or three. Again, we want to do whatever will be most helpful to you.

Now, let's get started.

CHAPTER 1

The Million-Dollar Question

Your home is your castle, an immense source of pride where you can live securely and comfortably. But your home is also a very important investment, probably the most important investment you will ever make. Your home can make you rich in a way that renting never can. To do so, you need to think of your home as an investment.

Suppose that you decide to buy a home and find the perfect home on a lovely street with beautiful trees. This house isn't the biggest on the street, nor the smallest. Every home in the neighborhood is in good condition: mowed lawns, pruned roses, no barking dogs behind chain-link fences, and no rusted-out cars on blocks. When your realtor showed you the house, several neighbors stopped to chat and they all seemed very friendly.

This house is close to parks, shopping, and your job. The schools have a good reputation and the city has long prided itself on doing what it takes to improve the community and enhance property values—sponsoring youth sports programs and popular activities for adults and senior citizens, having summer concerts in the park, purchasing open spaces, supporting local businesses, and blocking strip-mall blight.

The house is a cute bungalow, with three bedrooms and two baths—just what you have spent months looking for in a home. The modern kitchen is spacious, with a cork floor and granite countertops. The doors are solid hardwood,

the windows are double paned, and the ceilings are 10-feet high. The walls and attic are well insulated, which will help lower the heating and air-conditioning bills. The big backyard has room for children to play and a sunny spot for a vegetable garden. And this home will look even better with your furniture inside and with a different color of paint on the outside. The asking price is in line with what similar homes are selling for in this area.

Is there anything else to think about? Yes! You need to think of your home as an investment.

First, can you really afford it? You have saved money for a down payment, but you're still about $10,000 short. You can possibly borrow some money from relatives, but how will you pay them back and what strings will be attached? Or maybe you can borrow money with one of your credit cards. What about the monthly mortgage payments? It seems like a real stretch, but maybe you can cut back elsewhere: fewer restaurants and no new clothes or vacations for awhile. Or maybe you can use your credit cards to help with the monthly payments as well as the down payment. How do you know if you can really afford to buy a home?

A friendly mortgage broker, Linda, said that she could get you a low interest rate for the first year and the rate probably won't go up much the second year. Plus, Linda said that this home's value will surely go up, so that next year you can use a home equity loan to make your mortgage payments. Is that sensible or foolish?

Another consideration is whether this house will be a profitable investment. Linda said that home prices will surely go up. But by how much? What if she is wrong? Maybe she's optimistic because she wants to lend you money. But why would Linda want to lend you money if you can't pay it back? Is it because she gets a commission if you borrow money from her company?

What if Linda is right and the value of your home does go up every year? How much does it have to go up to make this a good investment? You invested the money you're saving for your down payment in stocks and the stock market is doing fine. You saw a smart guy on TV who said that now is a great time to be in the stock market. You saw a smart gal on TV who said that home prices have historically *not* increased as fast as stock prices. Does that mean that stocks are a better investment than homes?

Yes, homeownership involves more than just finding the right house in the right location and painting it the right color. We are going to help you analyze all the questions that you should ask yourself before you buy a home.

Our Homes Are Our Castles

There are many good reasons to own your home. Your home is a special place, and it is even more special if your home is really yours.

Your home supports your lifestyle. Your yard gives your children a safe place to play. Your home provides a place to entertain your friends. The location of your home determines how far you have to travel to get to work, shopping, and entertainment. If your children go to a neighborhood school that you love, your home's location makes this possible.

If you own your own home, you don't have to be satisfied with the landlord's boring paint colors. You don't have to nag the landlord to fix a leaky faucet or sue the landlord to get the moldy carpet replaced. You don't have to pay unconscionable heating bills because of leaky windows and an obsolete furnace. You can put in modern windows and an energy-efficient furnace and know that you will reap the benefits from many years of lower heating bills and a higher resale value for your home. You can add another

bedroom, put in a patio, or plant a garden. If you own your own home, you will have more freedom and more privacy.

On the other hand, making a rational decision about something that is so important to you is difficult. Some people don't buy a home because they fear commitment. To them, buying a home seems so permanent, like marrying or having children. Others who buy a home are then paralyzed by the idea that they might buy the wrong furniture or paint their home the wrong color. So, they live with what they have rather than with what they want. And some people get so excited about buying furniture that they fill their homes with so many tables, chairs, sofas, and cabinets that it is a challenge getting from one room to the next. Some are so excited about painting their walls that they create what look to be large-scale replicas of the preschool art normally displayed on refrigerator doors. Still others can't upgrade because it seems wasteful to replace things. "*Why do we need a more efficient water heater? The old one still works.*"

There is nothing wrong with experiencing any of these feelings. One very good reason for buying a home is the emotional pleasure you will derive from being a homeowner. However, if you think of your home as an investment, you will think a little more rationally and a little less emotionally about your home.

An Engine to Prosperity

You've seen infomercials and eye-catching books about how to become a millionaire in a booming housing market (hint: buy low and sell high a short while later) or how to become a millionaire in a depressed housing market (hint: buy low and sell high a short while later). This "advice" makes sense, but if it is so easy, then why do these authors

spend their time writing books instead of following their own advice?

Our advice is quite different and, unlike the infomercial pitchmen, we definitely follow our own advice. We own the home we live in. So should you if you can afford the down payment and the numbers make sense. You don't have to become a speculator or become a slumlord to get rich. You can become a millionaire simply by owning your home. This is great news because you would probably not be happy being a speculator or a slumlord, but you will be very happy living in your own home.

After the 2000–2003 dot-com crash in the stock market, many people jumped into the real estate game. Some bought foreclosed properties. Some rehabbed fixer-uppers. Some accumulated rental properties. If home prices are rising rapidly, you can make money pretty easily by *flipping homes*—buying homes and selling them a few months, weeks, or even days later for a quick profit. Oddly enough, although many people are familiar with the idea of making money by playing the real estate game, they don't think about their own home—the home they live in—as an engine to prosperity. They say, "Everyone has to live somewhere, right? My home isn't a real investment like stocks and bonds. It is just where I live."

No, your home *is* an incredibly important investment. All you have to do is buy a home to live in and make prudent, sensible financial decisions about your purchase, your mortgage, and your remodeling.

Your home is *not* a lottery ticket—don't buy a home thinking that it will make you rich overnight. Your home is *not* a brokerage account—don't day trade homes (or stocks, for that matter). Your home is *not* an ATM—don't use home equity loans to buy things you don't need. Your home *is* an investment that can make you rich and that you can enjoy all your life.

You should think of your home as a retirement account, like an Individual Retirement Account (IRA). Let's call it a Home Retirement Account (HRA). Ordinary retirement accounts have great tax advantages. So does your home. Ordinary retirement accounts can provide financial security for you when you are retired. So can your home.

Homes are different from stocks, bonds, and most other investments in that you can't really enjoy your stocks and bonds much beyond watching their prices fluctuate daily. (Is that fun or scary?) But you can enjoy your home. You can live in your home. You can paint the walls and rearrange the furniture. You can remodel your home. You can show off your home. And you can take pride in being a homeowner.

In this book, we show you how to think about your home as an investment, indeed as an HRA. You will learn how to determine the rate of return on your home investment and you will understand how your home investment is an important component of your wealth and how it can contribute to your overall financial prosperity and security.

Uncle Sam Wants You to Be a Homeowner

The average renter in the United States has less than $5,000 in wealth. The average homeowner has nearly $200,000, which is 40 times as much wealth as a renter. Is this because homeowners earn 40 times what renters earn? No. Homeowners, on average, earn about twice as much as renters, $50,000 a year versus $25,000 a year. The main reason homeowners are 40 times wealthier than renters is because they are homeowners! Most of their wealth is their home and they built up this wealth by owning a home instead of renting one. The easiest way to become wealthy is to become a homeowner. It really is as simple as that.

The government provides a variety of subsidies and tax breaks that make it easy and profitable to become a homeowner. Three of the most important ones are

1. You don't pay taxes on the income you get from your home.
2. You pay minimal taxes on the profit you make when you sell your home.
3. You can deduct the interest you pay on your mortgage from your taxable income.

Let's look at these three incentives one by one.

Most people are not aware of the first incentive, which is usually the most important of the three. If you have a savings account or a portfolio of stocks and bonds, your income is the interest and dividends you earn and you have to pay taxes on this income. If you own a home, you get income too, but it is harder to see and it goes untaxed.

The income from your home is the rent you save by being a homeowner. If you pay $1,500 a month to rent a home, this is $1,500 that you no longer have. If you own this home instead of renting it, you keep an extra $1,500 a month. This money is real cash that you can put in your bank account instead of your landlord's pocket—and you don't pay a penny of taxes on it. Later in this book, when we examine how owning a home builds your wealth, you will see that this untaxed income is the secret that can make you rich.

The second incentive is that you pay minimal taxes when you sell your home. If you sell a stock for more than you paid for it, your profit is called a *capital gain* and you have to pay a capital gains tax on your profit. Homeowners, however, get a big tax break. If you live in your home for at least two of the five years before you sell it, your profit is not taxed up to $250,000 if you are single or up to $500,000 if you are married.

So, at the current 15 percent capital gains tax rate, if you sell your stock portfolio for a $500,000 profit, you pay a $75,000 tax. If you are married and sell your home for a $500,000 profit, you don't pay any capital gains tax. If you sell your home for more than a $500,000 profit, you pay a tax on the excess, but please don't complain if you make more than a $500,000 profit on your home!

The third incentive is that your mortgage interest is tax-deductible. Suppose you have a $200,000 mortgage at a 6 percent interest rate. In the first year, your mortgage payments will be $14,900, of which about $12,000 is interest. You can report this interest on your federal tax return as an itemized deduction and it might reduce your taxable income by $12,000. (We say "might" because of the Alternative Minimum Tax and other complexities of the tax code). If you are in a 25 percent tax bracket, you will save $3,000 in taxes. That's right. Uncle Sam will pay a quarter of your interest payments for you. Why? Because the government wants to encourage you to do the right thing and become a homeowner.

What about the $2,900 of your mortgage payment that is not interest? This $2,900 is a "principal payment" that pays down your mortgage and builds up equity in your home. If your home is worth $300,000 and you have a $200,000 mortgage, your equity is the $100,000 you would keep if you sold your home and paid off your mortgage. Principal payments reduce your mortgage balance and increase your equity.

Because principal payments reduce your mortgage, they also reduce the interest you owe on your mortgage. If you have a 6 percent mortgage, every dollar reduction in your mortgage is a dollar you no longer have to pay 6 percent interest on. Because paying down your mortgage saves you 6 percent interest, paying down your mortgage is an investment that earns a 6 percent return.

This remarkable fact bears repeating because it is not well known. Think of your home as a special bank account and think of your principal payments as bank deposits. Your principal payments are savings that build up equity in your home, the same way that savings deposited in a bank build up your bank account. *Paying down a mortgage with a 6 percent interest rate is an investment with a 6 percent return.*

Thus, when you make mortgage payments, you not only pay the interest on your loan, you are also saving and investing. When your mortgage is paid off, you will have saved and invested a total of $200,000. This is forced saving because you have to do it—you have to make your mortgage payments or the bank will foreclose (sell your home to pay off the mortgage). For many people, this is another advantage of buying a home. It forces you to save money when you might otherwise not be sufficiently disciplined to do so.

The Million-Dollar Question

So, a lot can be said in favor of home ownership. But what about the costs? *Houseonomics* begins with a very fundamental question—Does it still make sense to own a home? *Houseonomics* wasn't written for dreamers who think real estate can make them rich overnight. *Houseonomics* is for people like you who already own a home or are thinking about buying a home to live in for many years. You do not need to hear get-rich-quick schemes that are literally too good to be true. You want to know if it is still okay to own a home. Our answer is a resounding yes.

We hear two kinds of concerns about buying a home. The first is, "I've heard that home prices are too high." This usually means that home prices are higher than they used to be, which does not necessarily mean they are too

high. We are convinced that, in most cities, home prices in the past were actually too low! What we mean is that in most locations and during most time periods, homes were cheap in that people who bought homes made a great investment—often the best investment in their whole life. If your home is a great investment, its price is not too high.

Homes aren't as cheap as they used to be, but that doesn't mean that prices are too high. The million-dollar question is whether, at today's prices, a home is *still* a good investment. Our answer is that homes are still attractively priced in most of the United States and are likely to give homeowners an impressive rate of return. That does *not* mean that you should buy a home no matter what the price. You need to be able to identify the firm ground and the quicksand. We will show you how.

The second concern we hear is, "Real estate is not a good investment where I live." For example, an Indianapolis resident told us that he didn't think Indianapolis was a good place to buy a home because home prices there only go up 2% to 3% a year. We are going to show you that Indianapolis home prices don't have to go up at all in order for Indianapolis to be a great place to be a homeowner. And lots of Indianapolis's exist all over this country—wonderful places to live where home prices don't have to rise for a home to be a good investment.

Both of these concerns—that home prices are higher than they used to be and that home prices might only go up a few percent a year—tell us that home buyers are looking at the wrong metric: how fast home prices are rising. *Houseonomics* will explain why you should be looking at something quite different, what we call your home dividend. If you look at your home dividend, you will find that in most of the country a home is still well worth owning—not because home prices are going to increase rapidly but because your home dividend is your engine to prosperity.

Slow and Steady Wins the Race

Anne and Mary grew up together in Wisconsin. They lived on the same street, went to the same schools, and have been lifelong friends. They are now 39 years old and have only one really important difference in their lives. Anne bought a house when she was 21. Seven years later, she sold this house and bought an even bigger one. Now she is living in a house that is worth $420,000. She still has a $118,000 mortgage, but she could sell her home and walk away with $300,000. Mary never bought a house. She has been paying rent for 18 years and all she has to show for it is hundreds of faded rent receipts.

Over the past 18 years, Mary paid rent and Anne made mortgage payments and it hasn't been easy for either of them. They spent roughly the same amount on food, shelter, clothing, and entertainment and had roughly the same standard of living. But Anne has built up equity in her home and Mary has collected rent receipts. Now Anne is living in a half-million dollar home that will soon be paid for and Mary will most likely go on paying rent for the rest of her life because she can't afford to make a down payment on a house at today's prices.

Anne didn't inherit a fortune or find a winning lottery ticket. Like millions of people all across this great country, she built her wealth slowly but surely by paying off the mortgage on her home one month at a time.

The Bottom Line

1. Your home is your castle, especially if you own your home.
2. Your home can be a major engine to prosperity—if you own your home.

3. Your home is not a lottery ticket, a speculative bet, or an ATM.
4. Renting can't make you rich; owning the home you live in can make you a millionaire.

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