Don't Buy a House Until You Read This

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Photo: Image Money

It is an empirical fact that on average, homeowners have a higher net worth than those who rent. Home ownership is a major part of the American dream. It increases community, creates stability for raising a family, and gives you the warm and fuzzies inside your heart when you gaze out onto your half-acre empire.

But don't for one second think that home ownership is all sunshine, rainbows, and ice cream sandwiches. There are serious trade-offs that you should know, understand, and accept before signing on the dotted line.

1. Mortgage debt -- a marriage you can't divorce

According to the Census Bureau, the average home price in 2010 was $272,900. A traditional mortgage will finance 80% of that, or just over $218,000. At the same time, the Census Bureau also reported that median household income in the U.S. was just over $51,000.

Are you comfortable owing over four times your total gross income (before taxes, mind you)?

And don't forget that you'll most likely be signing that I-Owe-You to a megabank like **Bank of America** (NYSE: BAC) , **Wells Fargo** (NYSE: WFC) , or **JPMorgan Chase** (NYSE: JPM) .

According to industry publisher "Inside Mortgage Finance" and reported by *The Wall Street Journal*, these three banks alone commanded 38% of the mortgage origination market in the third quarter.

And if you decide to go with a smaller bank, don't be surprised if your mortgage ends up being sold to one of the government-sponsored housing entities, **Freddie Mac** (NASDAQOTCBB: FMCC) or **Fannie Mae** (NASDAQOTCBB: FNMA) . These names may sound familiar -- $130 billion of your tax dollars went to bail them out just a few short years ago.

Don't forget the pain and suffering created by these giants of the financial world. Are you comfortable signing up for a 30-year mortgage with one of these companies?

Perhaps you're reading this and thinking, "But if I don't buy a house, I'm throwing away my money to a landlord with rent!"

Would you rather be "throwing away" your money to a landlord, or to a bank? Because if you bought that $272,000 average American house with a $218,000 loan at 5% for 30 years, you'd pay over $52,000 in interest to your bank of choice over the first five years alone!

Before the house was paid in full, you will have paid that bank over $203,000 dollars -- in interest alone!

And speaking of landlords...

2. When you own the house, you pay for the maintenance and repairs
Landlords, in my view, get a bad rap. A respectable, professional landlord can make life orders of magnitude easier. They are your on-call repairman, plumber, hardware store, and lawn maintenance company.

Air conditioner compressor breaks on the hottest summer day? Landlord will take care of it. Snow storm knocks a large branch into the yard? Landlord will take care of it. Bathroom drain cloggs? Landloard will take care of it.

You know your landlord. He or she is a part of your community. They live, work, invest, spend time, and generally care about the quality of life in your town.

Did I mention they'll make life exponentially easier when something breaks? Your landlord will even pay the property taxes for you!

Would the Vice President of Mortgage banking at Wells Fargo replace the broken burner on your stove for you? Certainly not, even though you're paying him $50,000 over the first five years of your mortgage.

Would Bank of America's mortgage operations executive in Charlotte help you buy that new $5,000 A/C unit when the old one kicks the bucket? Maybe, but only by giving you another loan with a healthy dose of interest payments (assuming you qualify -- you do have $218,000 of outstanding debt already -- over 4 times your annual gross income).

Nothing like a surprise $5,000 expense (with interest) to ruin those summer barbecue plans.

3. How long did it take to save up that down payment?
In our "average American" example, our potential homebuyer would have to put down a payment of $54,000 to qualify for the traditional mortgage. After closing costs and miscellaneous expenses, lets call this a round $60,000 just to purchase the home and get a loan approval.

That means that in truth, this buyer needs a decent bit more than $60,000, though. The bank, you see, will not make a loan for a borrower who is putting 100% of their liquid assets into the home. Banks like back-up plans, and without some cash cushion, there is no real back-up plan.

So now, our typical American, making a hair over $50,000 a year, must save somewhere in the neighborhood of 150% of her annual income to comfortably afford the down payment.

Yes, you can get a loan that requires a lower down payment, whether it be through government programs through the FHA, USDA, or others, or by purchasing mortgage insurance to mitigate the higher loan-to-value ratio.

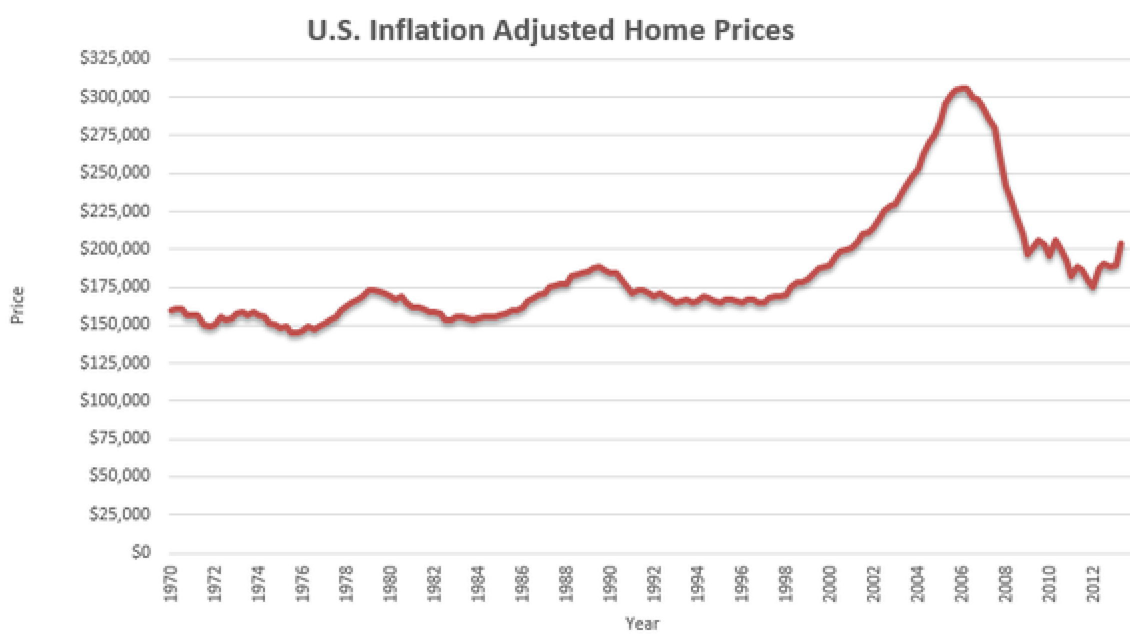
But these alternatives are not necessarily ideal, either -- more debt, for one, and more money being "thrown away" on bank-required (and possibly bank-sold) insurance. One step forward, but two steps back.

It may make more sense to take that $60k to $75k savings and invest in a target date fund, or an index fund, or maybe even in some of the bank stocks (if you can't beat them, at least profit with them?). Those investments are liquid, they can be rebalanced, they don't require property taxes, and their toilets won't overflow, forcing you to pay a plumber to come out on a holiday.

4. Buying a home is not an investment

This final point will be hard to swallow. Buying a home is not buying an investment. It's buying a highly leveraged forced-savings account.

According to data from Freddie Mac, the FHFA, and the S&P/Case-Shiller Home Prices Index, the inflation adjusted return for an investment in a home bought in 1970 is just over 27% through the second quarter of this year. That's a 27% return over a 43-year holding period!



To understand just how bad this return is, consider that **General Electric** stock purchased in 1970, with dividends reinvested, [would have returned 3,775% through 2009](). The S&P 500 has returned on average 9.7% per year over the same period.

If buying a home isn't an investment, then what is it?

It's a forced savings account. Along with that healthy dose of interest that goes to the bank every month is also a sliver of principal pay-down. Over 10 to 20 years, those principal payments can add up to a good bit of equity. So for those individuals who have trouble putting money aside in savings every month, this is an attractive feature.

But the point is, don't buy a house thinking it is a panacea for financial woe. If you want to maximize your investments, look elsewhere. If you want real estate exposure, consider a REIT. Don't be fooled into thinking that buying a home is a one-way ticket to the good life.

Now, feel free to sign on the dotted line

If, after reading this, you are still sure you want to join the ranks of homeowners, then I salute you. Your decision is thoughtfully considered, you've done the research into the upsides and the downsides, and you're making your own decision.

Personal finance and managing money is as much or more art than it is science. There is never a single right answer that applies across the board. We must all consider the risks, the rewards, and our own personal situations, and then act thoughtfully.

And if you're going to take out that big loan, please consider your local credit union. It would be a shame to "throw away" all that money to the big banks that have caused our economy so much hardship these past few years.