LEGEND REAL ESTATE & FINANCE

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Stretching

Stretching for an expensive home can pay off

Starting out: Should you buy the most expensive home you can afford?

At the end of the 1980s, homebuyers had a more cavalier attitude about home buying. Home prices were rising so rapidly that it was hard to imagine losing money on a house. Conventional wisdom was to buy the most expensive home you could afford.

Here's why it seemed to make sense to stretch financially. Most homebuyers don't pay all cash for a home. They usually invest some of their own cash (often 10 to 20 percent of the purchase price) and borrow the balance from a lender.

When you use someone else's money to buy an investment, it's called leverage. The beauty of leaverage is that when your home appreciates (increases in value), you earn appreciation on the entire asset, not just on the amount you invested.

For example, let's suppose you buy a home for $400,000 with a 10 percent cash down payment. Home prices then go up 10 percent during the next two years. The value of your home increase by $40,000 to $440,000. You earn 100 percent on the cash you invested. But if you paid all cash, the rate of return on your cash invested would only be 10 percent ($40,000 profit divided by $400,000 initial investment).

Suppose that instead of buying a $400,000 home, you stretch and pay $500,000 for a lager home with 10% down. If home prices go up 10 percent in the next two years, you earn $50,000. You earn the same rate of return on your cash (100 percent in this case). But you buy a more expensive asset and you earn more in appreciation ($50,000 instead of $40,000).

Owning an asset that appreciates is one way to build wealth. Leveraging that asset can result in building wealth at a faster rate. However, there's an element of risk involved. Real estate values like stock prices go up and down. Some homeowners lost the cash they invested in their homes when the market turned down during 2008 and they were forced to sell because of personal reasons. But since home prices are rising in many areas, this may be a good time for you to stretch to buy a more expensive home.

FIRST-TIME TIP

One of the strongest arguments in favor of buying the most expensive home you can afford is that it will enable you to stay put longer. Moving is disruptive, time-consuming and costly. The less often you have to move, the more time and money you have to devote to other interests.

In addition to the down payment, buyers must also pay closing costs. Closing costs vary from one location to the next, but they include such costs as fees associated with taking out a mortgage, title insurance, escrow and settlement charges, inspection fees and transfer taxes. These fees can total as much as 4 percent of the purchase price.

Sellers also pay closing costs when they sell a home. These fees also vary depending on the location but they usually include the brokerage fee, settlement charges, transfer taxes and fees associated with compliance requirements. These costs can total 6 or 7 percent of the sale price or more.

Let’s say you decide not to stretch now and you go ahead and buy the smaller $400,000 home. You pay about $16,000 (4 percent) in closing costs to complete the purchase. In a few years, however, you find that you’ve outgrown this home. You want to move to something larger. So you sell your home for $500,000, paying $35,000 (7 percent) in closing costs on the sale.

Your new home, which would have cost $500,000 if you’d stretched a few years ago, now costs $625,000 (assume same appreciation) + $25,000 (4 percent in closing costs) or $650,000.

The total of your closing costs for these three transactions is now up to $76,000 and this doesn’t include the cost of moving again. If you’d stretched to buy the $500,000 home to begin with, you would have paid approximately $20,000 in closing costs. You would have saved over $56,000 in expenses, by eliminating the need for the second move. In addition your home would have appreciated by an additional $25,000 pushing the total cost of delaying the larger house purchase to over $81,000.

The CLOSING

Ultimately, deciding whether it’s smart to stretch financially to buy a more expensive home is a personal decision. It’s certainly not wise to stretch beyond what you can reasonably afford. If in doubt, seek the advice of a financial advisor.

This analysis has been slightly updated from a newspaper article which appeared several years ago:
S.F. Examiner & Chronicle

Originally written by Dian Hymer, an East Bay real estate broker and author of “Buying and Selling a Home in California” and “Starting Out, The Complete Home Buyer’s Guide.”