The Beauty of Your Home: A Financial Perspective

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Three years ago, it was a challenge to find a homeowner who didn't count their home among their greatest assets. Today, although many still hold much of their net worth in their home, these same individuals who only a few years ago crowed about their "greatest" asset are now having trouble valuing their asset at all. The collapse of the real estate market has created a sense of uncertainty, even frustration, about the beauty of your home as a financial tool. Like an old penny that was once shiny and new, many have begun to see their homes, with high taxes and depreciating value as tarnished. It is time to shine up that penny and remember its true beauty.

Appreciation

Perhaps the greatest benefit of home ownership that has been forgotten by many during this housing slump is the appreciation in value of your home. This benefit is difficult to get excited about, since we have recently seen double-digit declines in home values.

However, it is important to put this decline in context and remember that the sharp decline in values is a well-overdue response to an even sharper increase of home prices in the five years leading up to this pull back. Many homeowners saw their homes more than double in value during the early part of this decade. This tremendous rise was unprecedented and overdone.

Most investors want their assets to increase in value gradually and consistently over time. This, however, is unrealistic. If you want outsized returns from your assets, it is common to sit through booms and busts. However, once this bust cycle has worked itself out, you can bet you will begin to see housing values appreciate again. History shows that if you hold onto your home for an extended period of time, you can expect an increase in value on average of somewhere between 4% and 6%, depending on the property and the area of the country.

Leverage

Another advantage that is only an advantage if used properly is leverage. Leverage is the purchasing of an asset using only a portion of your own money and borrowing the remaining cost. It is that double-edged sword that can cut both ways if it is not wielded with caution. Most Americans have a mortgage on their house allowing the bank to finance a portion of their home purchase. This means that they pay back the loan (plus interest) to the bank over time, but the owner gets to capture all the appreciation of the home. Let's look at an example. If you purchased a home for $300,000, put down 20% ($60,0000) as your down payment and watched the home appreciate 5% ($15,000) in your first year of ownership, you would have made a 25% return (or $15,000) on your $60,000 investment. Let's see Wall Street beat that. Not to mention that you lived in the home as it appreciated in value.

Unfortunately, during a time like this, too much leverage can lead to serious problems. If, like many Americans in the past few years, you purchased your home with a small down payment expecting the house to appreciate and the home value falls 10%, you could owe more money to the

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bank than the home is worth. This creates problems for the owner, the bank, and the economy when the homeowner decides to walk away from his home, leaving the mortgage holder with a $285,000 receivable and a house worth only $270,000… before selling costs.

Leverage is a dangerous tool, but if used properly in moderation, it can significantly enhance the return of your real estate investment.

Tax Advantages
Perhaps the most recognized benefit of home ownership is the various tax advantages. Mortgage interest, property taxes, and appreciation are all tax efficient. We have all seen the scary calculations of home mortgage interest. If you borrow $200,000 on a 30-year mortgage at 6% you actually end up paying the bank $386,511. That is over $231.676 in interest alone! But the interest is usually tax-deductible. If you fall in a 25% tax bracket, Uncle Sam pays $57,919 of your interest costs, bringing your share of the interest rate down to only 4.5%. It is important to remember that a mortgage is paid back over time, 30 years in this case. So, you are paying back future dollars. As we learned in Econ 101, future dollars are worth less than today's dollars. Don't believe me? Take $4, which today will buy you a gallon of milk, and put it under your mattress for 30 years. Then, go try to buy a gallon of milk with your $4. I can promise you it won't be possible. Just how much do prices rise? Well, inflation can be very high, as in the 1970s, or it can be very low, like today. You can assume over the long run that the average rate of inflation will between 3% and 4%. So, if you subtract 3% from our 4.5%, you see that your 6% mortgage now has a real cost of only 1.5%--not a bad rate. Ultimately, when you sell your house, you receive a benefit from the government in a zero capital gains tax for the first $250,000 in appreciation per individual, $500,000 for married couples.

Despite all the economic uncertainty of these times, homeownership still holds the same economic benefits it always has. And ultimately, don't forget the pride of ownership that allows you to live in a comfortable home where you can raise your family and making lasting memories. Isn't this the true value after all? The financial benefits are just the icing on the cake.

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