TRIVETT WEALTH MANAGEMENT

HOME OWNERSHIP: ASSET OR INVESTMENT?

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THIS WRITING WILL ADDRESS 3 QUESTIONS:

1. How good of an investment is your house?
2. What is the best way to structure your mortgage?
3. How expensive of a house should you buy?

HOW GOOD OF AN INVESTMENT IS YOUR HOUSE?

Let me state my bias upfront: **I don't believe your house is a good investment**. There, I said it (admittedly with much hesitation, as I understand emotions run high regarding Americans' attitudes toward their home). When I first came to this career, my mentor at the time told me something very valuable. He taught me that everyone has a bias. And the closest we can come to objectivity is achieved by stating our bias upfront, and then articulating an intellectually honest case in support of the stated belief. In that spirit, in light of my bias, I will attempt to convey solid evidence for my belief.

First, I will say that I believe your house is a quality asset that generally holds its value and hopefully keeps pace with inflation. But a good "investment"? Not so much. Of course, there are exceptions, but the overwhelming historical data shows that wealth is better created through other avenues.

Let me pause here to emphasize that this writing is regarding your primary residence, not commercial real estate or other investment properties.

*Also, I'm not saying you shouldn't buy a house. In fact, I advise the majority of clients to buy a home. We all need a place to live and, as I will argue**, buying a house tends to be the wisest financial decision for most** (especially when compared to renting).*

My belief is essentially that one should look at a home purchase as a <u>consumption decision</u>, not an investment decision.

<u>THE PURE NUMBERS</u>

Here are the facts: According to the US Census Bureau, the median home price in **1978 was $55,700**. In **2018 that figure is $337,200.** Pretty good investment, huh? It certainly sounds good, right? I hate to burst your proverbial bubble, but we're only looking at a **4.6%** return. That's what that the increase amounts to, a 4.6% annualized rate of return. And that's if we're being generous. The real figure is much lower after the round-trip cost of property taxes, closing cost, never-ending maintenance, and so on.

Now, how does that compare to the S&P 500 over the same time? From 1978 thru 2018, the **S&P 500 generated a return of 11.99%** (assuming reinvested dividends). This means that in January 1978 if you had invested the $55,700 in the S&P 500, today it would be worth approximately **$5,164,000**. Now that feels more like an actual investment.

By the way, I didn't cherry pick the dates. I just had my 39th birthday and simply decided to use my lifetime as the observed timeframe. But for argument's sake, let's take the worst 40-year period since 1926. What do you suppose the S&P 500 generated during that time frame? ***It's around 8.9%*** *(in case your curious, that particular 40-year period began during the peak of the roaring twenties and ran through the Great Depression). So, even if you were the worst market timer in the history of investing, you could still have taken that $55,700 and Forest-Gumped your way to* ***$1,686,000****. I think that still qualifies as an "investment."*

Now let's pause for a second and examine the reason that it *feels* like your house is an investment. **It feels like your house is a good investment because it's a large asset**. You see, when a large asset increases, even slightly in value, the impact is felt much more. Think about it. If your $200,000 house appreciates by 2% this year (a rate we all agree isn't great), it's now worth $204,000. Voilá! Your net worth just increased by $4,000! Meanwhile, your $50,000 401k grew at 6% over the same time. Well that's only a $3,000 gain. So, what's the better investment? Clearly, the 401k is the better investment. But in the absence of elementary level math, it feels like the house is better since the house got you $4,000 and the 401k only fetched $3,000. But what happens when there's a fair fight and each asset is equal in value? Well, if the 401k starts at $200,000 and earns 6%, then you just made $12,000 (far better than the house did). So again, the mere size of an asset can create the illusion that something is better than it really is.

<u>A REAL LIFE STORY</u>

My wife and I purchased our dream home in 2014. Because I'm a nerd, I checked the tax records and found what the previous owners paid for the house in 1980. Turns out **we paid 3X what they had paid 34 years earlier**! Sounds like a great investment for them, right? Well let's run the numbers. With a basic time-value-of-money calculation, we see that **the home's growth over those 34 years turns out to be <u>only 3.32</u>%, even though it tripled in value**! And that doesn't even factor in the addition of a bedroom, a large stone retaining wall, and at least two separate bathroom remodels. So, no. I don't consider my own home a good investment. We love living there and have no intentions of selling. Also, I believe it was smarter than renting a place for 30 years. But I'm not kidding myself. Every time I put down a bag of mulch or install a slab of granite, I know it's only going to be partially recovered if/when we sell.

<u>LIQUIDITY FACTOR</u>

The ease of which an asset can be converted to cash is what's known as *liquidity*. This is big for me and should be seriously considered anytime that you're saying goodbye to your dollars in exchange for something else**. The truth about home ownership is that you can't just sell it at a moment's notice**. I can't tell you how many clients I've had that find themselves being property managers after they're unable to sell condos & homes where they once lived. Heck! I even fall into that category. My wife and I still own the condos we each purchased before our marriage in 2008. Both units are currently rented but only because we've had trouble selling them. Sure, we net a little money each month as landlords and receive some tax deductions, but I'd gladly give it up to rid myself of the "hassle factor." Plus, a busted heat pump or a couple vacant months, and we merely break even for the year. It's just not worth it for us.

You might think you can easily sell your house. After all, surely your dream home is everyone else's dream too. But I wouldn't be so sure. **We tend to overvalue things we own**. It's human nature (this is what's known as the "***ENDOWMENT EFFECT***" - a phrase coined by the famed behavioral economist Richard Thaler PhD in 1990). Thaler's research suggests that ownership of an item creates a link between that item and our identity. That's why you see otherwise rational people, acting so irrationally when it comes to selling their home. Just watch someone's reaction to a lowball offer on their house! It's just business, right?

And yes, you probably could sell your house in a pinch. But there's a term for situations when there's a highly motivated seller and a not-so-motivated buyer. The term is ***selling cheap***; even cheaper after the 6% commission to your realtor.

My advice to clients has always been that **when you put money into your house, you are essentially placing those dollars in jail, albeit temporarily**. You can and will likely get them back one day. But once they've left your fingertips on the front-end, they become not-so-immediately retrievable.

Most traditional investments such as stocks and mutual funds are relatively liquid. If a client calls me this morning needing money from their brokerage account, they will generally have the funds within a few days, and in some cases within 24 hours.

WHAT IS THE BEST TYPE OF MORTGAGE?

Since I'm already in the mood of stating beliefs right up front, here is another one**: In most cases I favor a 30-year fixed mortgage**.

Let me start by making the following claim: I doubt that you know anyone who hates debt more than me. I've seen firsthand what consumer debt does to damage lives and rattle the psyche of otherwise stable people. I am regularly ushered into the financial lives of my clients and therefore am uniquely positioned to see **the dark recesses that debt conjures, and by contrast, the glorious weightlessness that debt elimination can create**. But I'm also a pragmatist, and I'm paid to examine things objectively in best interest of my clients. Therefore, I have a fiduciary duty to ask, "*what is the most efficient use of your discretionary dollar in the pursuit of financial security*." After all, it seems to me that this is what we seek. We may have varying descriptions of it. But *financial security* is the thing we reach for.

Please understand that financial security is a function of net worth, NOT debt reduction. Debt reduction is merely a component of financial security. But the two terms are not synonymous.

As Stephen Covey's '7 Habits,' second principle states, we should always "*begin with the end in mind*." So, if the end is establishing financial security, it only reasons that all decisions ought to be made with that aim.

Next follows the 4 reasons I believe one should consider a 30-year mortgage over shorter termed alternatives.

1) *Wealth Creation*

Your payment will be less with a 30-year mortgage vs. the 15-year. If you cultivate the discipline to invest the difference – and I emphasize "IF" – you will likely create more long-term wealth than compared to doing a 15-year mortgage. You see the 15-year mortgage demands more of your money today. This carries a high ***opportunity cost***. In other words, every dollar you pay on your mortgage, is a dollar not being invested. If you understand compounding interest and it's profound economic impact on your long-term net worth, this begins making more sense.

2) A Safer Option

What happens if you lose your job? I'd rather know that my minimum mortgage payment is a lower amount if disaster strikes. Banks are far more interested in your ability to meet your monthly payment and less interested in the home's existing equity. Some argue that if you lost your job you could always access your home's equity. But, can you really? Well, maybe, but not necessarily. **A home equity loan is not a loan on your house. It's a loan against your income.** The house is merely the collateral. Again, the bank mostly cares about your ability to repay the loan, and less interested in your home's equity.

EXAMPLE

Take Jim and Sarah. They each buy a $200,000 house. Sarah goes with a 15-year mortgage. Her payment is $1700 per month. Jim elects a 30-year mortgage with a payment of $1200 and decides to invest the $500-month difference in a balanced mutual fund. Ten years later they each experience a job loss. Sarah finds herself with little savings since the majority of her discretionary income was going to her larger mortgage payment. Finding another job is proving tougher than expected, and she now has trouble making her larger monthly payment. Sure, she has equity in the house but the bank only cares about receiving timely payments. Eventually she is forced to sell her house . . . quickly and for less than she'd like. Jim however, finds himself with an $83,000 cushion from investing (assuming the mutual fund earned 7%). This amounts to 5 ½ years worth of mortgage payments. . . plenty of time find another job and/or get full asking price for his house.

3) Tax Benefits

As currently legislated, the interest payments on your mortgage are fully deductible as an itemized expense on your Schedule A. But in fairness, the recent passing of the Tax Cuts and Jobs Act made this deduction less likely for many Americans since one's itemized deductions might not exceed the standard deduction – which was doubled by the TCJA (for more information read my previous whitepaper titled "What to Expect from the New Tax Bill").

4) Ability to Accelerate Payments

There's no rule that says you can't pay extra on your mortgage. At the end of the day, all mortgage loans are basic amortization schedules. So, if you chose the 30-year, and 5 years later decide to pay it off early (against your friendly financial advisor's counsel), you can always pay extra on your 30-year mortgage, essentially making it a 15-year mortgage. But it doesn't work the other way around. You can't turn a 15-year mortgage into a 30-year.

One last point on this matter. I understand that many people are so anti-debt that despite how strong the evidence may be, they just simply refuse to hear any message that says you shouldn't get in a hurry to pay down your mortgage. I was once prohibited from speaking to a group of medical students because the financial aid director didn't agree with my advice regarding student loans. At the time, student loan rates were around 2.5%, so I advised all my physician clients to not pay extra on their loans and instead invest the difference. (something I would never advise now, since graduate Stafford rates are at an absurd 6.8% and the Grad-Plus is 8.5%). But this was obviously the best advice at the time. Well, somehow this advice did not fit in her belief system. So irrespective of what historical data, simple mathematics, and all other objective metrics would have shown, she was anchored in the narrative that medical students should save nothing until all student loans were extinguished ***– by the way, the term for this dysfunctional neuroeconomic condition is called "anchoring."*** *Subsequently I was unjustly banned from talking with "her" students. But you know what? That's understandable. She was only doing what she though was necessary to protect the students based on her principles – as misguided as they were.*

*You must understand that my job is to determine the best use of your dollar. Sure, I may think using your extra money to make a 401k contribution is far better than paying extra on your mortgage****, but that doesn't make your decision bad. Both options are productive. I applaud anyone who wants to pay down debt****. Furthermore, no one can put a price tag on a good night's sleep; and if having mortgage debt is keeping you up at night, then pay the sucker off! Besides, even though we may disagree on the mortgage topic, we both will be laughing at the person who used their extra money needlessly on cars and boats, all at the expense of neglecting debt, retirement, and their kids' college fund.*

Now let's geek out on a case study of 2 people who each choose a different mortgage.

	30-Year Person A					15-Year Person B				
End of Year	Home Value	Remaining Mortgage	House Equity	Side Account	Net Worth	Home Value	Remaining Mortgage	House Equity	Side Account	Net Worth
1	208000	196852	11148	5472	16620	208000	190120	17880	0	17880
2	216,320	193556	22764	11381	34145	216,320	179830	36490	0	36490
3	224,973	190103	34870	17,764	52634	224,973	169114	55859	0	55859
4	233,972	186487	47485	24,657	72142	233,972	157954	76018	0	76018
5	243,331	182699	60632	32,102	92734	243,331	146330	97001	0	97001
6	253,064	178732	74332	40,142	114474	253,064	134225	118839	0	118839
7	263,186	174576	88610	48,825	137435	263,186	121618	141568	0	141568
8	273,714	170224	103490	58,203	161693	273,714	108488	165226	0	165226
9	284,662	165665	118997	68,331	187328	284,662	94813	189849	0	189849
10	296,049	160891	135158	79,270	214428	296,049	80571	215478	0	215478
11	307,891	155890	152001	91,084	243085	307,891	65739	242152	0	242152
12	320,206	150651	169555	103,842	273397	320,206	50292	269914	0	269914
13	333,015	145165	187850	117,622	305472	333,015	34204	298811	0	298811
14	346,335	139419	206916	132,504	339420	346,335	17449	328886	0	328886
15	360,189	133400	226789	148,576	375365	360,189	0	360189	0	360189
16	374,596	127096	247500	165,934	413434	374,596	0	374596	17832	392428
17	389,580	120493	269087	184,681	453768	389,580	0	389580	37090	426670
18	405,163	113577	291586	204,927	496513	405,163	0	405163	57889	463052
19	421,370	106334	315036	226,793	541829	421,370	0	421370	80352	501722
20	438,225	98746	339479	250,409	589888	438,225	0	438225	104613	542838
21	455,754	90800	364954	275,914	640868	455,754	0	455754	130814	586568
22	473,984	82477	391507	303,459	694966	473,984	0	473984	159111	633095
23	492,943	73759	419184	333,208	752392	492,943	0	492943	189672	682615
24	512,661	64628	448033	365,336	813369	512,661	0	512661	222678	735339
25	533,167	55064	478103	400,035	878138	533,167	0	533167	258324	791491
26	554,494	45047	509447	437,510	946957	554,494	0	554494	296822	851316
27	576,674	34555	542119	477,983	1020102	576,674	0	576674	338400	915074
28	599,741	23565	576176	521,694	1097870	599,741	0	599741	383304	983045
29	623,730	12055	611675	568,901	1180576	623,730	0	623730	431800	1055530
30	648,680	0	648680	619885	1268565	648,680	0	648680	484176	1132856

Assumptions: 3% home appreciation, 30-year rate 4.64% ($1,030) source: bank rate, 15-year rate 4.07 ($1,486) source: bank rate, side account return 8%, ignores property tax, HO insurance

The person who opted for a 30-year mortgage has a $125,796 higher net worth at the end. Also, look at the "side account." This tells us their liquidity level (assuming it's in a non-retirement account). So, if there's an emergency during the 30 years, person A is better positioned to withstand that sudden need for cash – especially during the first 15 years. Let's also remember the tax benefits. Person A maintains the tax deduction for all 30 years. Finally, if person A gets four years down the road and decides to begin paying extra, they haven't painted themselves into a corner. They can simply pay more each month and effectively shorten the loan. But person B doesn't have the reverse luxury.

<u>HOW MUCH SHOULD YOU SPEND ON YOUR HOUSE?</u>

There are 2 prevailing rules in this department.

Rule #1: **your total payments on long term debt (any debt that will remain 12 months from now) should not exceed 36% of gross income**. Take the following example:

Monthly income	\$10,000
Student loan payment	\$1,000
Car payment	\$500
Personal loan payment	\$250

Based on these figures and using the 36% rule, your maximum monthly mortgage payment should not exceed \$1,850. Now it's just a matter of reverse engineering. Assuming a 4.5% interest rate on a 30-year fixed you're looking at approximately borrowing no more than \$210,000. Notice I said "borrow." The purchase price could theoretically exceed this if you put down the standard 20%. But ultimately you should mortgage no more than \$210,000.

Rule #2: **Your mortgage payment should never exceed 28% of gross income.** Plain and simple. If you earn \$100,000 you should be paying no more than \$28,000 annually (\$2,333 month).

A word about the *2 rules*: **First,** you should use both formulas and utilize the one that results in the lower amount. **Second**, these rules are for determining the maximum borrowed amount. <u>Your goal should be to stay well below these figures.</u> Under no circumstance would you ever want to be in a bad marriage with your house, and an excessively burdensome mortgage payment will lessen the joy of homeownership in a hurry.

"A mortgage casts a shadow on the sunniest field."

-Robert Green Ingersoll

FINAL THOUGHTS

In closing, I think it's important to note that I believe your home is a wonderful thing. My message is not intended to discourage your home purchase (to the contrary, in fact). But it is designed to give you a healthy understanding of the facts, and to frame the issue as a consumption decision in lieu of an investment one.

I love driving home every day through our densely wooded subdivision to arrive at the place where Shawna & I brought home our newborn son on a snowy January day in 2016. It's special. Little else symbolizes the American Dream better than one's home. There is something about having a safe and peaceful place that offers retreat. And I'm glad we spent the money to be there. It gives us a peaceful place to lay our heads. But you know what else provides peace? It's knowing we can afford our payment and understanding that our house exists to serve our needs, not the other way around. **So, go pursue your dream of homeownership. But do it responsibly. See it as a purchase, not an investment. Choose the right mortgage structure. And for goodness sake, be honest with yourself about how much you should spend.**

It is my hope that you found this helpful. Please feel free to reach out with feedback. As always, please send me any topics you'd like me to address in future writings/white papers. My mid-year newsletter is slated to be released in early July which will provide commentary on the overall global economy and state of the equity markets. I hope everyone is enjoying the beginning of summer!

Sincerely,

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