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PERSONAL BUSINESS

By Peter Coy

Your Home By The Numbers

Some basic tools can help you calculate how good an investment your house is

A house is most Americans' most valuable asset, and lately it has been the best-performing. In some ways, though, it's the least understood component of the average investment portfolio. Financial advice on homeownership consists mainly of real estate agents' truisms: Buy the most house you can afford.... The housingse market never crashes.... Houses are better to own than stocks and bonds because they're tangible. These sales slogans are a poor substitute for serious analysis of an asset that's critical to your financial future.

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To evaluate housing as part of your portfolio, set aside your affection for home, sweet home. Shake off the delusion that the recent leaps and bounds in home prices in many markets are sure to continue. Instead, look at the property you own -- or want to buy -- with the same cold detachment as you would 1,000 shares of IBM (IBM). Employ basic concepts of investing: total return, risk reduction, transaction costs, liquidity, forced savings, leverage, market depth, tax treatment, and net present value. Few people are that rational about houses. "People buy with their gut, and then they bring out their wallet," says Julie Garton-Good, an author of books on real estate. And when they do toss around investment terminology, it's usually because they have dollar signs in their eyes. "A tendency to view housing as an investment is a defining characteristic of a 'housing bubble,'" economists Robert Shiller of Yale University and Karl Case of Wellesley College wrote in a Brookings Institution paper last year.

A good green-eyeshade analysis of housing might well lead you to the conclusion that house prices in some of the hottest markets -- from New York and Washington to San Francisco, Los Angeles, and San Diego -- are dangerously high. The warning signs are abundant: Prices have climbed much faster than incomes, interest rates appear to be rising from historic lows, and homeownership rates are already at record highs.

But regardless of whether the market you live in is frothy or flat, the purpose of this article is to show how tools of financial analysis developed by economists and top investors can help you make better decisions about the place you call home.

A good starting point is **total return**. Like the return on a stock, the return on a house has two parts. First, there's the "dividend." That's the annual cash flow you get from the property. The dividend from a house is not a check payable to you. It's the

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money you save each year by not having to pay rent to a landlord to live there, minus annual homeowner expenses such as utilities, insurance, and upkeep. This dividend is roughly 6% or 7% a year before property or income taxes, according to Wellesley's Case.

PALTRY GAINS
The other part of your return is the capital gain or loss, which you get when you sell the house for more (or less) than you paid for it. From 1975 through 2003, house prices rose at a compound rate of 5.8% a year, according to data from the Office of Federal Housing Enterprise Oversight. Put the dividend and the capital gain together, and you get a highly respectable annual pretax return from housing of about 12%. That compares with the 13% annual pretax return from stocks over the same period, including both dividends and capital gains, according to Ibbotson Associates. For ease of comparison, these calculations assume that both the house and the stocks are bought with cash. In reality most houses are bought with borrowed money. After taxes, housing beat stocks over the period for high-income people whose stock returns were heavily taxed.

There is one important difference between the return on houses and the return on stocks: Although many people have gotten rich recently from housing, nationally, over the whole period, capital gains accounted for just 5.8 percentage points of housing's total return, vs. 9.4 percentage points of stocks' total return. Housing's capital gains look even smaller when inflation is stripped out. From 1975 through 1995, the annual rate of appreciation after inflation for a typical single-family house was just 0.4%. Extending the period through 2003 gets you up to only a 1.3% annual rate. And even these modest figures overstate the annual capital gains by about half a percentage point because the price increases are partly the result of money spent by homeowners on renovations, according to OFHEO economists.

If history since 1975 repeats itself, boomers who aren't already sitting on a pile of housing wealth had better sock away lots of money in their 401(k)s, because they won't be able to count much on future gains from rising home prices. On the other hand, Gen-Xers who are still renting might actually be able to afford a house some day, because prices won't keep growing forever faster than the rate of inflation or the rate of income growth.

There's a subtler implication here as well. Many people make big sacrifices to buy the most expensive house they can afford, figuring that the bigger the house, the bigger the gain that it will someday produce. But that could be a mistake: History suggests that future after-inflation gains for most house sellers are likely to be modest.

So if you really like big houses, buy one. But if you hate dusting empty bedrooms and using intercoms to communicate with your children, purchase a smaller house -- and don't worry that you're missing out on big profits. Buying a smaller house will leave you with more money for things that will make your house more enjoyable. "People end up being house-poor," says Susan Hirshman, financial planning strategist with JPMorgan Fleming Asset Management (JPM). "You walk into a beautiful house and there's no furniture."

RENT HEDGE
Smart investors also use houses as a means of **risk reduction**. Since homeownership protects you from having to pay rent, in effect it's a hedge against future rent increases. So the longer you plan to remain in one place, the more logical it is for you to buy rather than rent. A house can also stabilize an investment portfolio because the housing market's ups and downs aren't closely correlated with those of stocks and bonds. The trouble is that many people, especially young

families just starting out, have the bulk of their wealth tied up in housing. Marjorie Flavin, an economist at the University of California at San Diego, advises that people whose assets are skewed toward housing should offset the high risk inherent in their housing investment by tilting the rest of their portfolio toward bonds and away from riskier stocks.

One of the best ways to improve your returns from housing is to minimize **transaction costs**, which are much higher for houses than for other assets. To sell $500,000 of stocks costs approximately $350 in brokerage commissions. In contrast, to sell a $500,000 house might cost more like $40,000 in fees, estimates Mike Sklarz, chief valuation officer for Fidelity National Financial (FNF), a real estate services company based in Jacksonville, Fla. Add to that sum the cost in money, time, and aggravation of preparing the property for sale and moving. Because transaction expenses are so high, it makes sense to move infrequently -- just as you save money on brokerage fees by not churning your account.

Many people underestimate the value of **liquidity** in housing until they need a lot of money in a hurry. Fortunately, the liquidity of housing has improved in recent years with the spread of rapid refinancing as well as home-equity loans and lines of credit. Most useful of all are home-equity lines of credit, which cost you nothing until you need to tap them in an emergency. If you don't already have one, get one.

Ironically, though, the ease of borrowing against equity takes away what was always one of homeownership's greatest advantages: **forced savings**. While people must still make principal payments every month, they can -- and do -- offset the equity accumulation by simultaneously borrowing.

Houses are money machines in good times because they're bought with enormous **leverage**. Assuming a downpayment of 5%, a one-year increase of 10% in a house's price gives you a 200% return on equity. That extreme degree of leverage would be fine if the truism about houses being a stable investment were correct. But that's only true of the national average. Prices are more volatile by region -- and more volatile still on a house-by-house basis. In a 1993 study, Yale School of Management economist William Goetzmann found that there was a one-third chance that the price of any given house in San Francisco would increase or decline 12.7% vs. the long-term trend in the course of just one year. The fluctuations were only slightly smaller for other cities.

Although leverage can be abused, there's nothing dangerous about a zero downpayment, per se, as long as you save the money you would have spent on the downpayment or put it back into the property. For example, Eric Kliem, 30, a loan agent, and his wife, Erin, 31, a high school teacher, put nothing down last year when they bought a $385,000 townhouse in Huntington Beach, Calif. They had money for a downpayment but chose to use it instead for renovations after the purchase. That raised the townhouse's value and gave them equity.

The mistake many people make is in thinking that the more leverage they're allowed to take on, the more they can afford to pay for a house. That's getting things backward. The prudent move is to figure out first how much you can afford to spend on a house, taking into account your income and other variables, then choose the balance between loan and downpayment. "What you're qualified for and what you can afford are two different cases," says Paula Nichols, a Coldwell Banker broker on Chicago's North Side.

CLEVELAND'S VIRTUES

Of course, it's hard to stick to vows of prudence when faced with the exorbitant prices of houses in today's hottest markets. *BusinessWeek*'s Luxury Housing

Affordability Index shows that while houses at the top end of the market are still easily affordable to upper-income households in places like Cleveland, St. Louis, and Atlanta, they're scarily high relative to top incomes in such cities as San Francisco, Washington, Los Angeles, and San Diego, where construction falls short of demand. Worried about getting suckered by buying at the top in one of those markets? Then settle for a smaller house, or rent and wait for a downturn -- or take another look at the virtues of Cleveland.

People who are buying houses in the top tier of the market are at the greatest risk of overpaying. That's because **market depth** is poor -- in other words, there are few transactions, so small fluctuations in supply and demand can cause big swings in prices. Don't assume the price that you're quoted is anywhere near what the market will bear. For example, Palladium Construction in Lake Forest, Ill., recently raised the asking price for a luxury house in the Chicago suburb of Highland Park to $8 million, even though it had been on the market at $6 million since 2000 with no takers.

Tax treatment is what decisively tips the balance toward homeownership for many families: Mortgage-interest payments are deductible. Also, there's no tax on the dividend of housing -- that is, the shelter value it provides you. And the first $250,000 in capital gains from a sale for an individual, or $500,000 for a couple, is tax-free if the house sold is a primary residence and the owner has lived in it for two of the previous five years. There's no limit on how often you can take this tax break. Plus, the 2003 tax law lowered taxes on capital gains over the limit to a modest 15%, from 20%. "This is making housing a more attractive asset than it used to be," says Jonathan Noonan, chief investment strategist at Boston money manager Appleton Partners.

One family that has taken full advantage of the tax-law changes is Edmond and Jennifer Sahm and their two children, who in March closed on a new, $620,000 four-bedroom house in Carlsbad, Calif. Sahm, a certified public accountant, always buys newly built homes because, he says, builders sell them at a discount of 10% to 20% to existing homes. The Sahms have bought and sold two residences in the past five years, earning handsome capital gains both times, and have already contracted for another one for $1.1 million. A tip from Edmond Sahm: To get into new developments, "get on the builder priority lists."

THE BEST TOOL

While all the tools mentioned above are useful, if you had to pick one technique for evaluating a house, it would be **net present value**. That's the value in today's dollars of the house's stream of cash flows. The negative cash flows each year are the mortgage payments, property taxes, utilities, and maintenance. The positive cash flows are savings generated by income-tax deductions and -- the big element -- avoided rent. The flows are netted out for each year, and discounted by the going interest rate. Typically, the longer you plan to stay in a house, the bigger the net present value will be.

You don't need an MBA to figure all this out. A program for calculating a house's net present value, which can be tried for free, is available at www.smithfinancialplace.com, created by Pomona College economists Gary and Margaret Smith. Reassuringly, the calculator produces answers that accord with common sense. For example, it shows that how much you pay for a house is a crucial factor in whether its net present value to you is positive or negative. (The message: Beware of bubbles and don't overpay.)

Wrestling with difficult questions such as a house's net present value isn't fun. But you owe it to yourself to make the smartest possible decisions about your biggest

investment.

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