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## A Home Buyer's Froth Detector

### Checking out rental rates can help you determine whether housing prices are inflated

You're ready to buy a house, but you wonder if the price is fair. Sure, it's in line with other properties in the area. But how do you know the whole market isn't inflated? Maybe prices have gotten out of line with fundamentals because buyers have been bidding them up in a frenzy.

There's a method that can help you figure out how much of a house's price represents core value vs. how much is speculative froth. The calculation isn't widely used by home buyers, but it probably should be. It's simply this: Check out how much similar houses are renting for in your area. If the annual cost of renting a similar house is much lower than the annual aftertax carrying cost of purchasing the house you want, then think twice before you sign a contract. On the other hand, if buying comes out cheaper, then by all means, dive in.

Many home shoppers ignore the rental market because they're sure they want to buy, not rent. But even if you plan to purchase, knowing rental rates can help you locate markets where sale prices are the most reasonable and calibrate just how much you ought to be spending.

#### UNCLOUDED VISION

The advantage of paying attention to the rental market is that it's pure. People who rent don't have their judgment clouded by visions of selling out in a few years at a big profit. Renters care about a dwelling's living space, amenities, and location, including the quality of schools and other public services. Those factors help to set the going rental rate. They also affect sales prices. As a result, sales prices and rental rates should be in sync. Paying attention to what the rental market is saying is "much better than just mindless speculation," says Gary Smith, an economics professor at Pomona College in Claremont, Calif.

What does the rental-equivalent method say about house prices in various parts of the U.S. today? It shows that in most of the country, houses are still fairly valued despite the runup in prices of the past few years (table). The method also shows wide price disparities. In the expensive San Diego metro area, for instance, the median single-family house price this year is \$393,000, while the estimated median monthly rent for a single-family house is a relative bargain at \$1,752. In the Dallas area, on the other hand, the median single-family house price this year is \$139,000, while the estimated median rent is \$1,360. Since the rent isn't all that much lower than in San Diego, that makes Dallas houses look relatively cheap.


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## WHERE THE BARGAINS ARE

In the city-by-city table, the higher the home-ownership costs come in as a percentage of rental costs, the worse a deal it is to purchase a house in that area. The table was put together by Mike Sklarz, the Honolulu-based chief valuation officer of Fidelity National Information Solutions, a real estate data company in Santa Barbara, Calif. Sklarz assembled data on house prices, mortgage rates, and taxes, then estimated how much a median single-family house would rent for in each market by applying a 60% markup to the known rent on a median two-bedroom apartment in the metropolitan area.

Don't take these numbers as gospel. For one thing, they overstate the cost of home ownership by leaving out the tax break for mortgage interest, which varies by income and state tax rates. As a result, numbers a bit higher than 100% aren't necessarily red flags. The estimates for rents for single-family houses are imprecise as well, because they're estimated on the basis of apartment rentals. There's no guarantee that the ratio of apartment rents and house rents will be the same in every city. And even if the numbers are right for a metropolitan area as a whole, they could be wrong for the neighborhood you're investigating. All that said, Sklarz's analysis is revealing. For instance, it's a good bet that houses are a better bargain in Atlanta or Dallas than in, say, San Diego or Honolulu.

To make your own calculation, start by finding out how much houses rent for in the area where you're shopping. Ask a real estate agent for listings or check the classified ads. It is critical to locate a house for rent that roughly matches the one you're thinking of purchasing.

That's not as difficult as you might think. Even upscale areas with few or no apartments usually have some single-family houses for rent -- and not just in the lower price ranges. *The New York Times*, for instance, recently listed 22 single-family houses in the New York City suburbs for rent at \$5,000 or more a month. You can find rental equivalents even for very expensive houses. Weston (Conn.) builder Stephen Rapaport is offering a 13,000-square-foot Georgian mansion on eight acres in Weston for rent at \$25,000 a month -- or for sale at \$4.5 million. (The formula shows that this particular house is a better deal if you purchase, rather than rent, it.)

Once you've found a roughly equivalent property for rent, use the rental rate to figure out the fair purchase price for the house you want to acquire. You can locate several online calculators by searching the Web. Pomona College's Smith has a useful one (<http://www.economics.pomona.edu/GarySmith/PF/programs/houses.html>).

## HOUSE DIVIDENDS

The concept underlying most of the calculators is simple: Think of a house as though it were a share of stock (table). Its value stems from the annual benefit you get from owning it, which can be thought of as a dividend. The benefit consists of the rent you save by living in the house (instead of renting an equivalent one), minus expenses for insurance, maintenance, and so on that renters don't have. The calculation is easiest if you pay cash for the house, but the same principles apply if you have a mortgage. That's where the calculators come in handy.

Naturally, the "dividend" you receive from living in your house goes up when rents in the neighborhood increase, because you're saving more money by staying in your own home instead of renting. If the dividend that your house produces increases by, say, 5%, the value of your house goes up by an identical 5%. Think of that as a "capital gain" to you. Combine the annual dividend and the annual capital gain, and you have the total return on your investment.

Of course, all this depends on your ability to predict what will happen to local rental rates. (If you're uncertain, assume they'll increase at the rate of inflation.) Moreover, real estate markets can depart from fundamentals for long periods, so the actual amount of money you

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make could deviate substantially from these calculations.

No system is perfect. But since figuring out how much to pay for your home is such an important decision, it's worthwhile to add this method to your toolbox of valuation methods.

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By Peter Coy

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