HESPERIAN Wealth

Buying A Home

INFORMATIONAL HANDOUT

Considering a home purchase? Here is (1) how to determine how much home you can afford; (2) what factors you should weigh in making a decision; and (3) how to compare buying and renting from an economic perspective. We also share the steps of the typical homebuying process.

Are You Ready Financially?

Here are financial planners' rules of thumb:

Ideally, your Homeownership Costs* should be ≤ 28% of your Gross Income

Homeownership Costs* PLUS Other Debt Payments Should Be <= 36% of your Gross Income

**Homeownership Costs = mortgage payment plus home insurance premium and property tax*

These benchmarks are based on the ones used by loan officers when determining your creditworthiness to purchase a home. If you can keep your homeownership costs under them, you should comfortably afford to buy.

Hesperian Tip

Don't worry too much about mortgage rates as long as you can comfortably afford your payment. If rates rise from here, you're locked in at a lower rate; if they go down, you can refinance and lower your interest expense or take money out of your home.

Additional Considerations

- Your overall financial situation (down payment saved; other goals, debts, and expenses)
- Change in quality of life (home size, amenities, neighborhood, commute, etc.)
- Do you have good credit? Have you avoided opening new lines of credit in the last few months?
- How stable is your income and industry of employment?
- How long do you plan to live in the home?
- Hidden costs of homeownership (higher utility bills, higher insurance costs, HOA fees, maintenance & repairs, etc.)

Buying vs. Renting Example

If your homeownership costs would stay under our benchmarks, you've answered the question of whether you *can* buy, not necessarily whether you *should* buy. For that, we need to calculate the true *economic* cost of buying. This analysis properly excludes the "investment" portion of your mortgage payment (and makes other adjustments) to make an apples-to-apples comparison of the monthly cost of buying and renting.

The median home price in the US was recently $467,700. Assuming you make a 20% down payment, the total homeownership costs for such a property would be around $2,805 per month at today's rates, higher than the current average rent of $2,500. But the economics indicate buying is actually more attractive (pending factors related to the property you choose):

Monthly Expense or Adjustment	Assumption	Buy	Rent
Interest Portion of Mortgage Payment / Rent	6.42% 30-Year Fixed Mortgage Rate	($2,002)	($2,500)
Home / Renter's Insurance	0.3% x Home Value	($117)	($15)
Property Tax	1% x Home Value	($390)	N/A
Maintenance Reserve	0.5% x Home Value	($195)	N/A
Est. After-Tax Return Investing the Down Payment and Closing Costs	3.60% 30-Year Treasury Rate, 22% Tax Rate, Closing Costs 3% of Loan Amount	N/A	$271
Est. Annual Change in Home Value	4.29%	$1,672	N/A
HOA Fees	Property-Specific	TBD	N/A
Change in Utility Costs	Property-Specific	TBD	N/A
Change in Commuting Costs	Location-Specific	TBD	N/A
Change in Childcare Costs	Location-Specific	TBD	N/A
Carrying Costs of Partner (If Changing Living Arrangement)	Equivalence Scale	TBD	N/A
Additional Home Move-In Costs	Client Estimate	TBD	N/A
Economic Benefit of Increased (Decreased) Living Space By Buying	Property-Specific	TBD	N/A
TOTAL COST		**($1,031)**	**($2,244)**

The above table is presented for illustration purposes only. It is based on many assumptions and should not be relied upon as a forecast. Much depends on the specific property you end up selecting, your creditworthiness, your loan type, interest rates at the time of purchase and loan origination (which change daily), and the future path of home prices in your area. Some intangible benefits or downsides of buying or renting cannot be modeled here. And this exhibit consists only of a snapshot of the first month after a home purchase. For more detailed cash flow projections, see the next exhibit.

Buy vs. Rent Historical Home Price Appreciation Scenario

Buying

Purchase Price	$467,700	Maintenance	0.5%	Tax Rate	22.00%	Other Benefits (Hidden Costs)	$0	**NPV**	**($169,715)**
Down Payment	20.00%	Agent Fees (% Value)	6.00%	Property Tax Rate	1.00%	Property Tax Increase	2.29%	Sell After	10
Loan Size	$374,160	Home Appreciation First Year	4.29%	Itemizing?	NO	Discount Rate	3.60%		
Interest Rate	6.42%	Home Appreciation Next 4 Years	4.29%	Insurance Rate	0.30%	Mortgage Pmt	($2,345)		
Closing Costs	3.00%	Home Appreciation Next 25	4.29%	Term	30	Section 121 Exclusion Amt	$500,000		

Year	Down Payment	Closing Costs	Other Upfront Costs	Principal Paid	Interest Paid	Home Insurance	Property Taxes	Tax Savings	Maintenance	Other Benefits (Hidden Costs)	Loan Balance	Home Value	Home Equity	Section 121 Exclusion Amount	Sale Price	Agent Commission	Payoff Mortgage	Basis	Tax on Sale	Net Cash Flow	Cumulative Cash Flow
0	($93,540)	($11,225)	$0									$467,700	$93,540							($104,765)	
1				($4,246)	($23,898)	($1,403)	($4,667)	$0	($2,415)	$0	$369,914	$487,764	$117,850							($36,639)	
2				($4,527)	($23,617)	($1,463)	($4,784)	$0	($2,495)	$0	$365,387	$508,689	$143,302							($36,886)	
3				($4,826)	($23,318)	($1,526)	($4,894)	$0	($2,577)	$0	$360,561	$530,512	$169,951							($37,140)	
4				($5,145)	($22,998)	($1,592)	($5,006)	$0	($2,662)	$0	$355,416	$553,271	$197,855							($37,403)	
5				($5,485)	($22,658)	($1,660)	($5,120)	$0	($2,749)	$0	$349,931	$577,007	$227,076							($37,673)	
6				($5,848)	($22,295)	($1,731)	($5,238)	$0	($2,840)	$0	$344,083	$601,760	$257,677							($37,952)	
7				($6,235)	($21,909)	($1,805)	($5,358)	$0	($2,933)	$0	$337,848	$627,576	$289,728							($38,240)	
8				($6,647)	($21,497)	($1,883)	($5,480)	$0	($3,030)	$0	$331,201	$654,499	$323,298							($38,536)	
9				($7,087)	($21,057)	($1,963)	($5,606)	$0	($3,129)	$0	$324,114	$682,577	$358,462							($38,842)	
10				($7,555)	($20,588)	($2,048)	($5,734)	$0	($3,232)	$0	$316,559	$711,859	$395,300	$500,000	$711,859	($42,712)	($316,559)	$467,700	$0	$313,431	($130,645)

Renting

Rent	($2,500)		Tax Rate	22.00%	**NPV**	**($262,944)**
Down Payment	20.00%		Term	30		
Rent Inflation	2.90%					
Move after	10	Years				
Discount Rate	3.60%					

Year	Invest Down Payment / Savings	Rent	Renter's Insurance	Portfolio Return	Tax on Portfolio Return	Portfolio	Sale of Portfolio	Net Cash Flow	Final Economics
0	($104,765)					$104,765		($104,765)	
1		($30,000)	($180)	$3,772	($830)	$107,707		($27,238)	
2		($30,871)	($185)	$3,877	($853)	$110,731		($28,032)	
3		($31,767)	($191)	$3,986	($877)	$113,840		($28,848)	
4		($32,689)	($196)	$4,098	($902)	$117,037		($29,688)	
5		($33,638)	($202)	$4,213	($927)	$120,323		($30,553)	
6		($34,614)	($208)	$4,332	($953)	$123,702		($31,443)	
7		($35,619)	($214)	$4,453	($980)	$127,176		($32,359)	
8		($36,652)	($220)	$4,578	($1,007)	$130,747		($33,301)	
9		($37,716)	($226)	$4,707	($1,036)	$134,418		($34,271)	
10		($38,811)	($233)	$4,839	($1,065)	$138,193	$138,193	$102,923	($277,575)

Table concept inspired by HonestMath.com

Notes & Assumptions

The preceding cash flow projection models the annual economics of a home purchase for the following scenario:

Home prices rise by 4.29% annually and the homeowner plans to sell/move after 10 years.

This is just an example projection. For clients, we usually model more conservative and pessimistic scenarios as well.

Compare the Net Present Value (NPV) of the cost of buying and renting to see which would be superior over the time the house is held (which will change based on your personal plans).

Here are the assumptions underlying our hypothetical analysis (data as of March 24, 2023):

- Married couple purchasing their first home in the Greater Sacramento area
- As renters, they could invest the money for a down payment and closing costs in long-term Treasury bonds instead.
- Median home price in US: $467,700 (Source: Federal Reserve)
- Mortgage rate: 30-year fixed rate at 6.42%, sourced from the Primary Mortgage Market Survey® published by Freddie Mac; weekly data as of March 23, 2023
- Closing costs: 3% of home value, paid upfront (possible partial tax deductibility ignored for simplicity)
- Marginal ordinary income tax bracket: 22%
- Property tax and insurance rates assumed for the Sacramento area. Property tax increases with inflation; insurance rates adjust with home value projection.
- Maintenance costs are estimated to be 0.5% of the value of the home annually (which may be higher for an older home)
- Future inflation: 2.29%; latest available 30-year breakeven inflation reported by the Federal Reserve
- Home prices assumed to appreciate by 2% over the market's inflation expectation, similar to the historical real appreciation over the last 50+ years according to the national Case-Shiller Index (Source: Robert Shiller).
- Rent inflation: 2.83% (historical inflation-adjusted rent inflation since 1954 from [TradingEconomics.com]() plus our inflation assumption)
- Discount/investment return rate: 3.60%; the latest available 30-year Treasury yield at the time the analysis was run per [Treasury.gov]()
- Mortgage deductibility: We assume the buyer does not itemize deductions or have enough deductions to push part or all of their mortgage interest payments above the standard deduction everyone already receives. If some or all mortgage interest will be deductible over the next 10 years, buying would look even *more* attractive.
- Agent's fees at sale: 6% of home value
- IRC Section 121 permits qualifying married homeowners to exclude up to $500,000 in gains from selling their home.

The Typical Homebuying Process

1. Shop around/negotiate for a mortgage rate (you generally have 30 days to shop for rates without experiencing additional credit pulls, which can impact your credit score)

2. Decide on a mortgage type and lender

3. Receive a closing cost worksheet and preapproval letter (good for 60-90 days)

4. Discuss the pros and cons of locking your rate with your loan officer/mortgage broker

5. Select a real estate agent you like

6. Shop for a home and make an offer/counteroffer(s)

7. Pay earnest money into escrow, or “hold money” for a new build (typically 1%-3% of the purchase price)

8. Obtain a home insurance quote

9. Schedule a home inspection (request a referral from your realtor)

10. Obtain a home appraisal if required (your loan officer/broker will coordinate this)

11. Negotiate concessions if needed/possible through your agent

12. Review the closing statement 5 days prior to close; check it against your loan estimate

13. Conduct a final walkthrough

14. Select the correct titling for your property and your state (if you already possess a living trust, you may be able to take title in your trust directly; discuss it with your loan officer/broker)

15. Sign title and other final paperwork

16. Close and take possession of the property

17. If you’ve not already done so, consider transferring your home’s title to a living trust with your county recorder’s office (contact us or your estate attorney or ask us for a referral to a legal professional in our network)

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