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Should You Buy or Rent a Home?

Homes aren't always the best investments, but there advantages to buying.

Homes are unlike other investments in many ways, but they generally appreciate in value over time.

By Daniel Solin -- Feb. 12, 2014

A perennially hot topic in personal finance is the debate over whether to buy or rent a home. Today, my point of view is likely a minority one. I believe you should seriously consider owning your home.

This is a significant issue. For most people, housing is their biggest expense.

Homes are not great investments. As I explain in my book, "The Smartest Money Book You'll Ever Read," it's difficult to make the case that owning a home is a good investment. For several decades, home appreciation was good, but reality set in with the housing bust in 2008. Homeowners then met the perfect storm: a decline in home prices, a poor resale market, the recession and an over-leveraging by homeowners who borrowed using equity in their homes as credit. Millions of homeowners were "underwater." Many lost their jobs as well as their homes.

Homes have many disadvantages as an investment. They are illiquid and indivisible. You can't just sell your bedroom. If you own a portfolio of publicly traded stocks, you can sell all or a portion of it, at any time.

It's difficult to compare the returns of home ownership with a portfolio of stocks. Real estate is local. The price and appreciation of homes is far different in Los Angeles than in Detroit. Nevertheless, there is no doubt that, over the long term, the return on stocks is superior. **Jack Clark Francis**, a finance and economics professor at **Baruch College**, compared the annual returns of real estate from 1978 to 2004 with those of 15 different investments. The annualized returns of the Standard & Poor's 500 index were 13.4 percent, which crushed the annualized return of 8.6 percent from housing.

I can't justify my recommendation that you seriously consider owning a home if you view home ownership strictly as an investment. Your expected returns from a broadly diversified, periodically rebalanced portfolio of high quality, low-management fee stock and bond funds would likely be superior.

The buy versus rent calculation. You can use this simple calculation to determine if renting or buying is right for you.

Take the asking price of the home you are considering buying and divide it by the amount of rent you would have to pay annually to live in it (or the annual rent of comparable homes). The resulting number is the "housing ratio." The higher the ratio, the more it makes sense to rent. The lower the ratio, the more it makes sense to own. A ratio above 20 means you should consider renting. When the ratio is well below 20, buying becomes a more attractive option. The U.S. national average ratio was 16 for most of the past century, as I wrote in "The Smartest Money Book You'll Ever Read."

Other factors can affect your decision. Rapidly rising or falling home prices, or a change in government policies, may tilt your decision one way or the other.

When considering home ownership, don't overlook expenses like the down payment, closing costs, mortgage interest, insurance, maintenance, association fees and property taxes. Renters do not incur any of these costs.

How much can you spend on a home? As a general rule, you can spend 20 to 25 percent of your total income on housing and utilities. Many homeowners allocate as much as 35 percent of their incomes to housing.

This calculation is complicated by uncertainties about your income. If you obtain a fixed-payment mortgage, your housing costs should diminish as a percentage of your income, assuming your income rises in the future. That's the rub. Relying on increases in income, or even that your job is secure, can be risky. If your financial situation takes a hit, you need to be sure you can still afford to carry the expenses of your home.

Benefits of home ownership. Given all of these issues, you might wonder why you should seriously consider owning a home. Here are some issues to consider:

- You can live in your home. You can't live in an S&P 500 index. Assuming you can afford your home, purchase it with a significant down payment, obtain a fixed mortgage, and consider paying off your mortgage as quickly as possible. Owning a home will give you a sense of security that you cannot find in a rental unit.
- You can customize your home to your individual needs, as opposed to rental units, where your options are more limited.
- You will have a sense of permanence and a feeling of being part of a community when you own your home.

Although a home has historically underperformed investments in stocks, most homes do appreciate over time. In addition, owning a home will reduce your federal and state tax obligations because of the deductibility of interest payments on your mortgage. Remember, though, that there isn't any assurance tax laws will stay the same. If they change, this benefit could be reduced or eliminated.

A home is a vehicle for forced savings. You have probably heard the argument for term life insurance over your whole life: Buy term and invest the difference. The reality is that most people who buy term life insurance spend the difference. Having a mortgage payment due forces you to make payments. Over time, you will find that you have accumulated significant equity in your home.

If you have a fixed-rate mortgage, your mortgage costs will be stable for the entire period of your mortgage, which is commonly 30 years. Rent typically increases yearly. The "real" cost of your mortgage will actually decrease because of the effects of inflation, assuming you have a fixed-rate mortgage.

Part of this decision is emotional and part of it is financial. As a practical matter, I can tell you I have never met a homeowner who lives in a home with no mortgage and regrets it.