Eastwood WEALTH

Buying a Home

Home. It's one of the most sacred places on Earth. It's where we share our lives with the most important people in our lives. It's where we instill values and teach our children. It's where we learn, grow, get better and make memories that last a lifetime. It's the place where we create, design and carve out our own slice of paradise. It's where we enjoy the presents of today and where we plan our tomorrows. It's the place that, no matter what is going on around us, we can just be, quietly and safely, while taking stock of life. Home, such a simple word that connects us with so many feelings.

Buying a home is so much more than a transaction, and it's usually the financial elephant in the room for individuals and families. Let's have a conversation about it.

Buying a home is one of the most exciting experiences anyone will have during life. It is a highly emotional time bringing with it renewed feelings of promise and anticipation, accomplishment, relief and stress just to name a few. Because it's an emotional time and there's so much riding on the outcome, it's important to stay grounded and have a process in place to make wise decisions.

A home is the single largest purchase most people will make during their lifetime. Whether you're wanting to upgrade your current living situation or you're a first-time home buyer, the decisions you make during this process can significantly impact your quality of life and financial position for years to come.

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We have all heard the old adage about real estate: location, location, location. This has not changed. Most homes in big cities, near the water and in destination locations are more expensive than ever and are likely to continue to appreciate at a faster pace than those that are not.

Due to the sheer size of a home purchase, most people obtain a mortgage to finance it. A mortgage means introducing additional costs, most notably interest, into the equation. This is where the financial responsibility to the homeowner starts to grow beyond the initial purchase price.

A mortgage also means that you're leveraging a small amount of money, your monthly payment, against your home's much larger value. When the price of the home increases, it does so exponentially as measured against your monthly payment. This part of a mortgage is attractive.

If you plan on obtaining a mortgage, it is important to understand how the principal and interest formula works before you even start the home buying process. We would encourage you to have a conversation with a qualified mortgage professional that has years of experience. Since this is one of the biggest purchases of your life, everyone involved should be one that you trust completely, has your best interests at heart and can guide you through the entire process start to finish.

The price of the home is just the beginning of the story. It comes with many more costs than just principal and interest. The bigger and more expensive the home, the more expensive it costs to maintain. A homeowner must also figure in: loan closing costs, property taxes, insurance, renovation, repair and maintenance costs, management costs such as homeowner's association (HOA) fees and assessments, weather related costs, legal costs, opportunity costs of a homeowner's time and resources that could be spent pursuing other activities, social costs such buying items to fit into a certain neighborhood, costs to sell the home, illiquidity concerns if you needed to move quickly, etc. It all adds up.

Let's look at two scenarios and how to get on the right side of buying and owning a home.

First, a few assumptions:

This will be the homeowner's primary residence

Home price: $300,000

Down Payment: Let's use a 20% down payment or $60,000.

Putting down 20% provides the luxury of not having to purchase private mortgage insurance also known as PMI. PMI protects the lender from the homeowner not paying their mortgage resulting in the home going into foreclosure. Most homeowners pay their house payment making PMI a waste of hard-earned money. Having a 20% down payment makes the home more affordable in the short and long run and removes the extra cost of PMI from the equation.

PMI has evolved though it continues to be paid monthly in most cases. In the past, it ran around .50% to 1.50% of the original loan amount. Today, the more down payment you have, the lower your PMI. In some cases, if you have a great credit score and your debt to income ratio is low, PMI is not as bad as it used to be. Once 20% equity in the house is established, a homeowner can contact the lender on the steps required to remove PMI thereby reducing the monthly payment.

As part of a down payment, a buyer could include an upfront goodwill gesture to the seller in the form of earnest or due diligence money to show they are serious about the purchase. Earnest money usually buys time to complete a home inspection and appraisal. It is returned if the transaction does not go through.

Due diligence money is often used in hot real estate markets providing the buyer time to make a final decision on whether to move forward with the purchase. Typically, the more due diligence money the buyer provides, the more likely the seller will accept the offer. If the buyer moves forward, the due diligence money is then credited as a down payment or used for closing costs. If the buyer ultimately does not move forward with the home purchase they will lose the due diligence money unless the seller breaches the contract.

Mortgages and Interest Rates: In this example, let's look at two loans. The first is a 15-year mortgage at 2.75% and the latter, a 30-year mortgage at 3.25%. It is less risky for banks to make shorter loans therefore the rates are usually lower. At the same time, the shorter the length of the loan, the higher the payment because the payment period has been reduced.

Additional mortgage options exist between the 15-year and the 30-year loan. For the purposes of our conversation, we use the above-mentioned loans as they tend to be the most commonly used.

The 15-year's monthly principal and interest payment at 2.75% is $1,628. Assuming no extra payments are made to the principal, the homeowner will pay an additional $53,194 in interest over the course of the loan if taken to full term. The price of the home increased, minus any tax savings, from $300,000 to $353,194 or an additional 18% of the purchase price.

The 30-year's monthly principal and interest payment at 3.25% is $1,044. Assuming no extra payments are made to the principal, the homeowner will pay an additional $136,141 in interest over the course of the loan if taken to full term. The price of the home increased, minus any tax savings, from $300,000 to $436,141 or an additional 45% of the purchase price. The 30-year loan is typically the most popular because it offers the lowest payment. It also builds equity the slowest.

The difference between the 15-year loan and 30-year loan, when taken to full term, costs the homeowner an additional $82,947 in interest and 15 additional years of payments!

Buy the home not the payment.

It is also important to remember that a homeowner is making mortgage payments with after tax dollars even though a taxpayer may get to deduct a portion of the interest. When you gross up the total home costs of principal, interest and include taxes, the amount of money a homeowner must earn over time to pay for the home can be multiples of the initial purchase price.

Homeowners today can deduct the interest on the first $750,000 of their mortgage. To take the deduction, the homeowner must file an itemized tax return which doesn't happen as often as in the past due to the increase in the standard deduction in recent years.

In 2021, the standard deduction for single filers is $12,550 and $25,100 for married filers.

Many homeowners will keep a mortgage in place thinking they're receiving a tax break. They do get a break, but they still have to make the payment. For example, if you pay $10,000/year in interest and you pay a total of 25% tax, then you've saved $2,500. Unfortunately, you've paid $10,000 in interest so you're on the wrong side of the benefit by $7,500.

Fortunately, the tax code is set up to reward homeowners upon the sale of their main residence. If you own your home and have lived in it two out of the last five years, prior to the date of sale, a single tax filer may be eligible to exclude up to $250,000 in gains and up to $500,000 for joint filers. To maximize these savings, we would encourage you to keep record of any home improvements you make while owning your home.

Thoughts on Renting

There is nothing wrong with renting in the short-term. In fact, a homeowner can find themselves in worse financial shape buying a home before they're ready rather than renting for a longer period of time.

As we have seen, there is a lot more to owning a home than just the monthly payment. Still, one of the most often used justifications for renters buying is that the rent and mortgage payment are the same or similar. It may make more financial sense to rent for an extended period due to life and career circumstances or the location where you live. Every person's situation is unique and must be treated as such.

Over the longer term, rents are especially sensitive to cost of living increases. As prices rise and properties are bought and sold, rents will increase just to make the numbers work for landlords. The rent keeps going up over time while renters are not building equity. This scenario leaves a long-term renter on the wrong side of the equation as time passes. Renting is something you don't want to do forever, but it certainly has a place in a well thought out financial plan.

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How much home can you afford?

Homes that are typically in the range of affordability are two to two and a half times the prospective homeowner's annual salary. To figure out how much you can afford, you'll need to take into consideration your monthly income, housing expenses, monthly bills, other outstanding debt, the need to save for retirement and plan for a child's education among other items. This is a big decision!

If you can pay cash for your home, we would recommend you do so in most cases. A euphoric sense of freedom occurs in between your ears when you live in a home that is paid for. It is virtually impossible to quantify this feeling, but it is real. It also greatly reduces the exposure to uncertainty in your overall financial situation.

If you plan on obtaining a mortgage, normal lending standards suggest your monthly housing expenses (mortgage principal and interest, real estate taxes, homeowner's insurance, additional costs) should be less than 33% of your gross monthly income. In addition, most mortgages require borrowers to have a debt-to-income ratio that is less than or equal to 45%. This means, you should be spending no more than 45% of your gross monthly income on longer-term debt payments. For example, if you pay $2,150 a month for your mortgage and another $150 a month for an auto loan and $400 a month for the rest of your outstanding debts, your monthly debt payments are $2,700. ($2,150 + $150 + $400 = $2,700.) If your gross monthly income is $6,000, then your debt-to-income ratio is 45%. ($2,700 is 45% of $6,000.)

Over the years, we've witnessed how a few key home buying tweaks can positively impact your financial well-being. This track is designed to get someone in a home they can afford and pursue financial freedom at the same time.

Our preferred path prior to buying a home with a mortgage:

- Be debt free
- Have an Emergency Fund equal to six months of your monthly expenses. If you're in a household where only one spouse works, you're a single parent or a business owner, it would be ideal to have one year's worth of your monthly expenses set aside. Additionally, if you're a business owner, we would also encourage one year's worth of your business expenses in your company's Emergency Fund. These amounts could seem like a daunting task. If so, go back through your monthly budget to find places where you could cut costs and entertain ways to increase your income.

  A properly funded Emergency Fund will help protect against accidents, unforeseen events and could offer additional income assistance during tough economic conditions. Set aside this money for emergencies rather than commingling it with accounts you pay your month-to-month expenses. It's out of sight, out of mind. Please make sure these funds are readily available but earning the most they can possibly earn. The Emergency Fund is looked at as lifestyle insurance rather than an investment.

- Have a down payment of at least 20% to lower your payment, avoid Private Mortgage Insurance (PMI) and begin with the interest formula more in your favor.
- Your monthly payment is 25% or less of your net monthly income.
- Obtain a 15-year mortgage or less. The 15-year loan is the sweet spot where you pay the home off quickly and minimize interest costs while still being able to afford the payment on a monthly basis. It also puts the homeowner in a position to start saving for retirement early. Due to the compounding effect of money, the earlier you start the more your money works for you rather you working for your money. The combination of these factors places the homeowner firmly in a position of financial strength by utilizing the 15-year mortgage.
- Obtain a home inspection by qualified professional.

  An appraisal will be required if you're obtaining a mortgage. If you are a cash buyer, an appraisal is a good thing to have to make sure the asking price is in line with the current real estate market.

  If the appraisal comes back and it is lower than the agreed purchase price, the most readily available options are typically to ask the seller to adjust the price accordingly, make up the difference between the purchase price and the appraisal with out of pocket dollars or walk away from the deal. Remember, if you walk away, you will forfeit your due diligence money if you previously offered this to the seller.

The recipe above is a formula to minimize uncertainty and protect your biggest quality of life and wealth building tool, your income. If it is not doable, it is likely that the home you are purchasing is too expensive for your current financial position.

If you are already in your home and your original mortgage was for 30-years, it is likely that you can simply add additional money to your loan's principal on a monthly basis to pay the house off earlier. This practice is best used as part of broad financial plan, and we would encourage you to meet with a CERTIFIED FINANCIAL PLANNER™ (CFP®) professional.

Compound interest is the eighth wonder of the world. He who understands it, earns it; he who doesn't, pays it. Einstein

Should you use a real estate agent?

Probably so! Find an experienced and knowledgeable real estate agent that can guide you. It will make the process of buying a home much easier and probably save you money in the long run especially for a first-time home buyer.
A real estate agent can:

- Help you determine your housing needs
- Show you properties and neighborhoods in your price range
- Provide insight into neighborhoods and market activity
- Disclose positive and negative aspects of properties you're considering
- Prepare and present an offer to purchase
- Act as an intermediary in negotiations
- Recommend professionals whose services you may need such as lawyers, mortgage and title professionals, home inspectors, etc.

When you enlist the services of an agent, find out how they are being compensated. A flat fee or a percentage based on the sales price arrangement is normal. Many states require the agent to disclose this information up front and in writing. If you're buying the home, you're in luck as the seller usually pays for this cost.

Choosing the right home

Before you begin looking at houses, decide in advance the features that you want to have in your home. Knowing what you want ahead of time will make the search much easier. Here are some things to consider:

- Safety of the area
- Price of home and potential for appreciation
- Location or neighborhood
- Quality of construction, age, and condition of the property
- Style of home and lot size
- Size of the home in comparison to others in the neighborhood
- Number of bedrooms and bathrooms
- Quality of local schools
- Property taxes and insurance costs
- Proximity to schools, work and lifestyle activities
- Renovation, repair and maintenance costs both before and after the purchase

Making the offer

Once you find a home, you'll want to make an offer. Most offers and counteroffers are made through an intermediary, such as your real estate agent. Require all terms and conditions of the offer, no matter how small, to be put in writing to avoid future complications. Typically, your attorney or real estate agent will prepare an offer to purchase for you to sign. You'll also want to include a nominal down payment as earnest money or due diligence money if you're in a competitive situation. If the seller accepts your offer to purchase, he or she will sign the contract, which will then become a binding agreement. For this reason, it's a good idea to have your real estate attorney review any offer to purchase before you sign.

The details

Once the seller has accepted your offer, you, your real estate agent and mortgage professional will get busy completing procedures and documents necessary to finalize the purchase. Typically, you would have made your offer contingent upon the satisfactory completion of a home inspection and appraisal, so now's the time to get these done as well.

The closing

All of your team's hardwork has been building to this day, and you've finally made it! You're ready to close the transaction! When it's over, the house is finally yours!
The closing may require some or all of your team, and the seller's, to be present: the seller and/or the seller's attorney, your attorney, the closing agent (a real estate attorney or the representative of a title company or mortgage lender), and both your real estate agent and the seller's. Depending on what state you live in, all parties may be required to attend the closing at once or the closing can take place at different times. Some closings can be conducted by mail or via the internet using electronic signature.

Items to be on the lookout for during the closing process:

- Closing Disclosure: This lists all of the final terms of the loan you've selected. Your lender is required to send you the Closing Disclosure at least three business days before the actual closing meeting.
- Promissory note: This spells out the amount and repayment terms of your mortgage loan.
- Mortgage: This gives the lender a lien against the property.
- Deed: This transfers legal ownership of the property to you.

There are many intricacies that go into buying a home. In most cases, the advantages significantly outweigh the disadvantages if purchased responsibly. This is a big decision that will most likely have a long-lasting impact on your future quality of life and ability to build wealth. Give it the necessary time, care and attention to detail upfront to make life easier for you and your family in the future. Happy house hunting!

Best,

Tim

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The opinions expressed in this material do not necessarily reflect the views of LPL Financial.
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