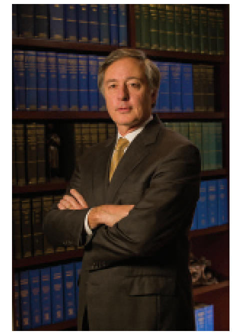
IS "THAT" A GOOD RETURN?



The Bigger Story Behind Home Price Appreciation

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I recently spoke to a friend regarding his parents' house, which was about to be sold. He was ecstatic about the appreciation, telling me "They bought the house in 1972 for $100,000 and are about to sell it for $1.6 million. What a great investment!"

I asked him if he knew the Rule of 72; while he'd heard of it, he couldn't recall its significance. The Rule of 72 is a method of estimating the return of an investment. It says "just divide 72 by the number of years it takes for an investment to double. For example, if something doubled in 3 years, that's a 24% annual return. If it doubled in six years, that's a 12% return." My friend's parents' home doubled four times over forty years, (i.e. once every 10 years) providing about a 7.2% annual return.

He asked "..but that's a good return, right?" So I ask you, is that a good return?

True Cost of Homeownership

Traditionally, seven percent is par for the course when it comes to real estate investments that aren't leveraged.

However, there are considerations when evaluating your home as an investment, including mortgage interest, inflation, taxes, insurance, depreciation, maintenance and renovation costs. Incidentals and market changes could impact the value of your home and how it ultimately benefits you as an investment.

These factors make homeownership far more expensive than it may seem initially since they add to the costs to stay in a home versus other alternatives, such as renting. Let's look at each of these:

Interest. Remember that a home's appreciation of $1.5 million is obscured by the power of compounding interest. The interest rate you've been paying is probably higher than you realize. For a dose of reality, check your mortgage amortization schedule to see how much interest you've paid over the course of 30 or 40 years of owning a home.

To use the original example, if a couple bought a house for $72,000 in 1972 and put 20 percent down, that left a balance of $57,600 to finance. According to federal housing finance agency Freddie Mac, in July of 1972 the average rate on a 30-year mortgage was 7.2 percent. Assuming that mortgage was never refinanced and no pre-payments were made, the total interest paid would be $81,710.

It used to be that homeowners took out a mortgage and paid it off within the term of that mortgage. No longer – with the serial refinancings that have become prevalent during the past 15 years, many homeowners have extended the traditional 30 years of paying off a mortgage into 35 or even 40 years or longer, especially when underwriting standards were more loose and homeowners had the ability to refinance and take additional cash out for other expenses. So a refinancing could have the impact of either increasing or decreasing the total interest paid, depending on when it was done and if there was a cash-out or additional principal borrowed.

Inflation. As with any other investment, inflation takes a bite out of home appreciation. In the case of my friend's parents, their house appreciated at a rate of 7.2 percent during that 40-year period. Inflation over that period easily ate at least 2 to 3 percent a year, so the actual price appreciation is more like 4.2 or 5.2 percent rather than the stated 7.2 percent.

Taxes. Taxes can also eat a chunk of that appreciation. On the Federal level, homeowners selling their primary residence can exclude $250,000 in profits from taxes -- $500,000 if married – if they have live in the home for two years prior to the sale. If you live in a state with state income taxes, state taxes will also be due on any profit exceeding those levels. Property taxes also eat into profits.

Insurance. Homeowner's insurance costs, especially in coastal areas like New Orleans, Villere's homebase, can add up, increasing expenses for homeowners and ultimately reducing the end profit.

Depreciation. Homes age over time and their value doesn't hold, hence the need for repairs, updates and renovations. If homes aren't properly maintained, they won't hold their value, and their eventual value at the time of sale can be much less.

Maintenance. Ongoing maintenance expenses add to the amount it costs to live in a home. In addition, many homeowners embark on renovation projects in the course of 40 years, those costs are more expenses to take into consideration when figuring out exactly how much a home appreciated during the ownership period.

Other issues. When viewed objectively from an investment perspective, homes are illiquid investments – they usually can't be sold quickly and converted into cash. Home price appreciation isn't something that can be counted on, either, as homeowners who bought during the real estate boom of 1999 to 2006 can attest. A significant amount of equity or even owning a home free and clear doesn't guarantee that a home can be sold on demand or for the price it is actually worth.

And even once that home is sold, my friend's parents will have to move somewhere else and spend money to buy or rent that new residence and maintain it just as they have that previous home.

All of this goes to show that owning a home goes far beyond providing shelter. Home ownership, while an investment, has a number of considerations other investments don't.

Diversify Your Investments

We all like to see our investments grow and benefit us in the end. When considering new investments, the Rule of 72 can also be used to calculate how many years are needed for an investment to double.

How does that work? In this case, divide 72 by the annual rate of return to see how many years it will take for the investment to double.

To further enhance the potential for your returns to be attractive, employ a variety of saving vehicles such as qualified retirement plans including IRAs and 401ks, which provide an opportunity for compounding returns over time, but also tax advantages for many people (see our prior posts about IRAs). In fact, a well diversified approach of stocks, bonds and other alternative investments, both inside and outside of retirement accounts, may be a smart way to help your investment portfolio prosper.

Consider, too, that the S&P 500 appreciated nearly 10 percent annually during the time my friend's parents owned their house. Investments in other assets, such as small cap stocks and bonds, help make up a well-diversified portfolio that, over time, could help provide you with the potential to fund retirement, college educations for your children or grandchildren and legacy planning

A Final Word

It's not wise to rely on home price appreciation to fund all – or even part of – your retirement. If your home does appreciate significantly, consider that a welcome surprise.

Just like you'd diversify your portfolio, there should be more to your nest egg than just your nest.

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