Arianne Cohen: Why you shouldn't think of a home as an investment

By Arianne Cohen, Rate.com *on Oct 29, 2020*
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As investments go, the home you live in is likely a bad one.

"From a rate of return standpoint, your primary residence tends to only appreciate a little bit faster than the rate of inflation," says Greg McBride, chief financial analyst for Bankrate.com. Translation: The home you bought for $400,000 in 2010 that is now worth $500,000? Inflation alone would put it at about $480,000. During that same period, the stock market, as measured by the S&P 500, slightly more than doubled.

Yes, yes, there's leverage in real estate. We'll get to that below. But, no, homes don't lead the pack in investment results.

Yet we fawn over real estate because it's visible. We can see it and brag about it and host in it and inherit it and, most importantly, gooseneck at others' homes, with the supposed values conveniently posted on the Internet. This is not the same as stashing money smartly.

This is not what people want to hear about their biggest asset. But there are so many downsides to residential real estate that I'm having difficulty choosing which to expound upon here. And I say this as someone who owns two properties.

First, consider risk. As investments go, residential real estate is dicey. It locks up your money, leaving you at the whims of the market or banks when you want to actually access your cash. And as contractors will tell you, you don't know what you own until you tear into the walls. Just ask my friend who recently spent $80,000 to repair incessant flooding in a 10-year-old house.

Justin Pierce, a Virginia real estate investor and agent, points out that homes are rather complicated structures. "All the trades are involved, and then on the transaction side, it's real estate agents, attorneys, accountants, a home inspector." These people are essential, and they cost money and your time. Annual upkeep typically costs around 1% of the home value (no bond or stock requires an annual deposit) — and much more if you like landscaping or cleanliness or hot tubs.

And your attempts to add value to the property will likely just drain your wallet. The expense of a new kitchen or bathroom is rarely recouped in the sale price.

What about all those people on TV who seem to be flush with cash from real estate deals? They're spending someone else's money. Primary homes are typically profitable in a few scenarios: If someone else (a renter, your parents, etc.) is paying off the mortgage; or if the property is generating a cash flow (Airbnb, roommates, seasonal rental, TV/film set leasing); or, as too many of us assume will happen, if the home's market value appreciates substantially.

In the latter scenario, a mortgage can make wealth seem to magically spring forth. A $200,000 home with a $40,000 down payment (here's the leverage) that rises in value by 20% over three years means you've doubled your initial investment to $80,000, right? But over that time, you've also paid

$25,000 in mortgage costs (including tax deductions), plus selling fees and taxes that will typically cost 8-10% of the home value — meaning that after inflation, you've actually lost money (but had a place to live).

"And it's a disaster when asset prices go down," McBride says. By any measure, this is not a winning investment.

The sweet spot, then, is to purchase the minimum that you need, and invest other money elsewhere. By our math, skipping an extra bedroom can earn you $500,000 over time: https://www.rate.com/research/news/richer-retirement

"It's really dangerous to go looking for a home primarily as an investment," Pierce says. "That can encourage people to overpay and get in trouble in the long run, or buy something that doesn't really fit their family's needs. And then they end up having to move, which creates more cost."

Another cost! Moving is expensive. My recent move cost $1,400, plus new places inevitably need some immediate work, which in my case was a $5,000 interior paint job. (The walls were tapioca yellow. The whole place. Yes.) Plus I spent a pile on essential furniture, and let's be real: Did I work much in the weeks surrounding the move? No. I was too busy applying room labels that turned out to be nonremovable on expensive furniture. The total move cost easily topped $10,000.

A useful rule of thumb: You can likely afford a home that is 3.5 times your annual income(s) with 20% down, and less than that if you pay significant expenses such as tuition or debt payments, says certified financial planner Dana Levit, owner of Paragon Financial Advisors. "That essentially leaves you with enough money to live on." This equation can be challenging in expensive neighborhoods.

Just remember: No one gets filthy rich on a house or two. Lots of people have grown immensely wealthy through seed investing or stock trading (careful) or starting a business — and then they buy real estate when they have money to burn.