Renting vs. Buying: Home Shoppers Should Plan To Stay Put for a Long Time

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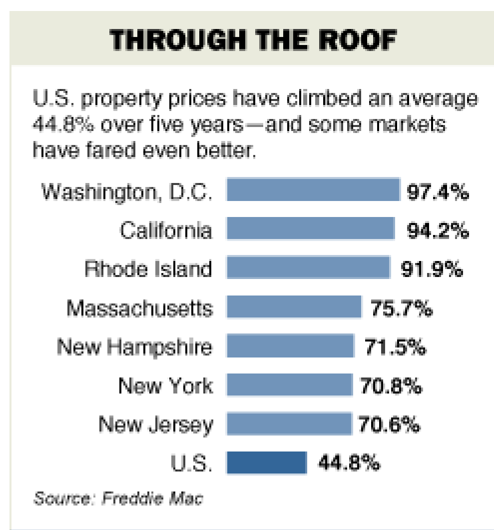
Either way, you are betting the ranch.

Today's home buyers face an unenviable choice. Should they rush to buy because mortgage rates are so low? Or should they continue renting because properties are so pricey?

As you grapple with this tough decision, contemplate these three questions.

What if mortgage rates rise? If you postpone buying because you think property prices will plunge, you could be right about the real-estate market -- and still wind up a loser.

To understand why, call up the "rent vs. buy" calculator at www.dinkytown.net[1], a Web site of financial tools named after a Minneapolis neighborhood. Suppose you were looking to put down $40,000 on a $200,000 home and borrow the other $160,000 using a 30-year fixed-rate mortgage at 6%. Throw in property taxes at 1.5% of the home's value and insurance and maintenance at 2%, and your after-tax monthly outlay would be $1,282, assuming you are in the 25% tax bracket.



But instead of going through with the deal, let's say you held off, because you feared property prices would tumble. Sure enough, prices slide. Trouble is, the slump was caused by rising interest rates and that drives up mortgage rates from 6% to 8%.

In that scenario, to end up with a smaller monthly house payment, you would need home prices to fall 9%. That sort of decline is relatively rare -- but it isn't unheard of. New England property prices, for instance, tumbled almost 12% during the five years through year end 1994, according to data from home-finance corporation Freddie Mac.

How long will you stay put? Despite the risk of higher mortgage rates, let's assume you continue renting.

That means you can invest the money you had earmarked for a house down payment. In addition, renting rather than owning may mean a smaller monthly outlay, and that will give you additional money to sock away.

You would likely stash this cash in conservative investments, so the money will be safe until you get around to buying a house. These conservative investments might give you an after-tax return of 1% or

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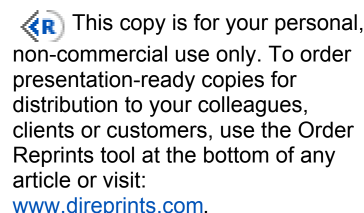

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2%.

If you then head back to the Dinkytown calculator and plug in 1% or 2% as your after-tax investment return, you will get a seemingly bizarre result. The calculator suggests that renting makes sense only if you plan to move again within the next two or three years. Yet the standard advice is that you shouldn't buy a house unless you are confident of staying put for at least five to seven years.

What's going on here? The short break-even period is partly driven by today's rock-bottom mortgage rates. But the real problem is we're making an apples-to-oranges comparison. If you continue renting and stuff your cash in a money-market fund, you will have a low-risk investment with a correspondingly low return.

By contrast, if you borrow a truckload of money to purchase a house, "you're buying an idiosyncratic, incredibly risky investment," argues Chris Mayer, director of the Milstein Center for Real Estate at Columbia University. "There's a lot of risk in one house."

If everything goes right, this risk will be richly rewarded and buying will be far more lucrative than renting. But what if things go wrong? During the past five years, property prices have outpaced inflation by five percentage points a year, compared with a 30-year average of 1.4 percentage points.

That doesn't mean prices are about to crash. But after the recent heady gains, that is clearly a possibility -- which is why the standard advice makes a ton of sense and you probably shouldn't buy unless you plan to stick around for at least five to seven years.

How risky is your local housing market? As you apply this standard advice, take into account the state of your local housing market. To that end, Prof. Mayer suggests categorizing real-estate markets the way investors categorize stocks.

"Think of San Francisco and New York as growth stocks," he says. "And think of Houston as an income stock. In Houston, you get a lot of your return from current consumption and less in appreciation. And in San Francisco and New York, you get less in current consumption and more in appreciation."

As Prof. Mayer sees it, buying in Houston is less risky, partly because prices are less volatile and partly because you get a lot of house for your money, and thus a big part of your return takes the form of "imputed rent." Indeed, in an "income" market -- which is what you typically find once you get away from the big urban areas on the two coasts -- you can buy a house and be fairly confident of coming out ahead, even if your time horizon is just five years.

Meanwhile, if you live in a "growth" market like Boston, Denver, Los Angeles, New York, San Diego, San Francisco or Seattle, you should probably be more cautious, buying only if you intend to stay put for at least seven years and preferably longer. Like low-dividend stocks, home prices in these markets will tend to be more volatile. That means there is a greater risk you will get caught in a real-estate downdraft that temporarily wipes out your home equity.

On the other hand, if you plan to stick around for a long time, buying in a growth market can be a smart move, Prof. Mayer says. His reasoning: Because property prices are expected to climb at a decent clip over the long haul, there is an advantage to buying today and locking in your housing costs.

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