Should You Take Advantage of *Renting* vs. *Homeownership*?

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IS YOUR NEST EGG ROLLING IN REVERSE?

By Fred Dunbar

The word “retirement” conjures up different thoughts and dreams for so many people. Like the title of this publication’s issue, it might be the thought of an endless summer. Unfortunately, sometimes dreams do not become reality; for some, they might actually turn into nightmares. When I hear the term “endless summer,” I think about being able to pursue whatever my passions are, whenever I feel like it.

When we meet with clients to prepare a financial plan focused on retirement cash flows, one of the most common goals is to maintain their standard of living. Next is to travel for a number of years to places they’ve always dreamed of visiting. For many, it might be to provide a legacy for their children or grandchildren. The majority of our clients realize their goals and dreams because they followed the golden rule: They spent less than they earned. The balance was invested so they could meet their goals in style. I believe that you have to live for today but save for tomorrow. I think of this whenever I hear Frank Sinatra sing “My Way.”

A question we are often asked is, “How much money will I need to retire?” That answer is as varied as the weather down the shore. It will depend on your dreams and goals and how much risk you are willing to accept.

Some might not be able to retire in style, or at least in a manner they’ve always dreamed. There are many reasons for this. Perhaps they just didn’t save enough. We had one couple who spent almost every penny they earned and took lavish global vacations annually instead of waiting for retirement. They were sure one of them would not be healthy enough to travel at retirement and wanted to do it right then. At retirement, they didn’t have enough money saved. Perhaps one of them became ill before retirement. Increased medical costs and lack of earnings railroaded their retirement.

Regardless of your net worth, always remember that HEALTH IS THE FIRST WEALTH.

Today I want to focus on those who may reach retirement age with a smaller nest egg than they had hoped but do own their home. When they finally sit down and calculate how much they have saved for retirement, their nightmare begins. Unlike their parents or grandparents, the majority of people today will not have a pension when they retire. Their base income will be Social Security, which certainly will not be enough to fund the retirement of their dreams. The amount of Social Security received will depend on their earnings throughout their lifetime.

Most of us have grown up with our parents and grandparents preaching that you should always own your home. I think that’s a wonderful idea, but sometimes it’s just not practical. I have to believe every one of you reading this article has seen the aging or retired actors become pitchmen for reverse mortgages. There’s Tom Selleck (“Blue Bloods”) or perhaps you remember Fred Thompson, the former Tennessee senator and star of “Law & Order.” They talk about people who need money to live and suggest that a reverse mortgage might be the way to go.

They tell you that a reverse mortgage will allow you to stay in your home and allow you to take out money so you can live. You can take out this money in a lump sum or as monthly income, or leave it there and use it as a line of credit. All of that sounds great.

In reality, the cost of a reverse mortgage might be expensive. They generally have a loan-origination fee capped at $6,000 (2 percent of the initial $200,000 of appraised value and 1 percent on the remaining value). There is the mortgage insurance premium, which is paid to the Federal Housing Administration to provide protection to the lender and the borrower. That cost will depend on the amount you borrow. There's an up-front cost of .50 percent of the appraised value of the home, if your loan is 60 percent or less of the value. If you want more than 60 percent of the value, then the up-front cost will be 2.5 percent. There's also an appraisal fee, which varies but averages out to around $450. The appraisal fees generally are paid in cash while the other fees may be rolled into the loan. One thing to keep in mind: Your home must be structurally sound and comply with all safety regulations and local building codes. If the appraiser finds any defects, they must be fixed by a contractor before you receive the money. There are other closing costs, including title insurance, pest inspection, etc. Interest is charged only on the funds (loan proceeds) received. If you elect the line-of-credit option, it is only on the amount you withdraw. The reverse mortgage is repaid when the property is sold. This is just a thumbnail sketch, and there are certainly more nuances than I can fit in this column today.

A reverse mortgage on a $400,000 home could easily cost over $17,000, if you want 80 percent of the appraised value.

You might be better off selling your home and renting. This is counterintuitive to what we were told all of our lives, but it might make sense. One argument against this is that you have to pay rent for the rest of your life. Home ownership also has annual costs that never go away, including real estate taxes, water and sewer fees, homeowner insurance and heat. Whether you rent or own, you will have certain utilities including electric and cable.

One advantage of renting is that you never have to make any repairs; you simply call the landlord. Another advantage is that you are never stuck with a bad neighbor, since you can move at the end of your lease.

If you decide to rent, you must first sell your home. In this example, the sale price is $400,000 (same as above) and the apartment rent is $1,500 per month. The cost to sell your home might be more than $28,000, including a 6 percent realtor fee ($24,000); a transfer tax, generally 1 percent ($4,000); and some ancillary settlement costs.

Invest $350,000 from the sales proceeds, which might fund your future housing cost. In this example, we had the client keep $22,000 for an emergency fund.

In order to account for inflation, we used 2 percent as the real rate of return. If you earn a 5 percent return on your investment and inflation is 3 percent, then your real (net) rate of return is just 2 percent. This should follow as interest rates and inflation both increase.

Investing $350,000 at 2 percent will provide $1,500 per month (the cost to rent an apartment) for 296 months, or 24 years, 8 months. In reality, you're actually better off renting if your nest egg is small. If you stay in your home, you will still have annual fixed costs including the real estate taxes, utilities, insurance, etc., in addition to any repairs.

If you are unclear on which path to choose, contact your financial adviser or call me.

Now that you have a lifeline and have decided how to fund your future housing costs, grab your chair, book and beverage, and head to the beach to start enjoying your endless summer.

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