In relation to earnings, how much should your house cost?

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(Photo: Provided)

A major way in which many families enjoy the fruits of their labor is by having a nice house. It is usually the largest single life purchase and consumes a great deal of annual income in many ways besides just the cost of the property/structure itself.

How much is too much for a house? Of course, this depends on many factors:

• How much does the house cost in relation to your income?

• How much does the house cost in relation to your savings?

• How much do you spend otherwise?

• How much do you save otherwise?

• In the list of things that you find immensely important to your quality of life, where does the house rank (say, vs. travel, nice clothes, nice cars, etc.)

I'll give you two extremes to illustrate. A young professional newly in practice making $250,000 dollars a year wishes to buy a $1 million home. The family has little savings to date but no other debt. The cost of owning real estate can be estimated at 8 percent of the value of the property per year. This comes from adding up the cost of money (even if you can pay cash, you lose the opportunity cost of making an investment return elsewhere) of 4 percent, property tax and insurance for 2 percent, and general maintenance and repairs (budgeting for roof replacement, A/C replacement, etc.). Add in periodic home improvements and you can easily push up toward 10 percent a year. So, our young family will spend $80,000-$100,000 dollars per year to live in this nice house, only some of which will be pretax (mortgage interest). I'd say that this family will find it very difficult to save for retirement and educational costs for their children with this burden. I'd consider them "house poor."

In comparison, let's move to the case of a financially established family in their sixth decade of life. The primary income earner has a well-funded retirement plan that his/her financial planner states is more than adequate for the family's needs. The primary worker is earning $300,000 dollars per year and saving over 25 percent of this. There are no plans for retirement in the next decade or two. The family lives in a $500,000 home with only a very small mortgage, and has no other debt. They would like to move up to a $1 million dollar home. I'd say "no sweat." They have well-established patterns of savings and have accumulated much in the way of financial security. The new home will not impair this.

The equity in a nice home is not "spent." It remains available if needed in future years by the act of downsizing, home equity loans, refinancing and reverse mortgages. Many homeowners have discovered the really poor returns of residential real estate over the last decade (and longer in many areas). Historically, appreciation of much over 2 percent a year nationwide is a prudent assumption.

So, the amount of house you can afford is relative to all the factors above. Each family is different and you must individualize the answer to fit well.

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