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Rent Ratio Tells You Whether Renting Or Buying Is The Better Deal

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Even with this week's recent bump higher in the benchmark 30-year fixed-rate mortgage, we are still in historically low territory for residential mortgages. That, coupled with home prices that are largely at the bottom of this cycle, has a lot of people wondering if now is the right time to jump into the market and buy a house.

As with most things in life, there's not one "right answer," but there are a few guidelines that anyone can use to figure out if buying a home makes sense, or if renting is a better choice.

Do the Math

When making the decision to rent or buy a home, it's not enough to look at home prices and mortgage rates. You also need to look at rental rates for comparable properties to understand if it makes more economic sense to buy or rent on a long-term basis. One useful tool is the rent ratio, the ratio of the purchase price of a house divided by the annual rent of a similar home.

In a market where a 3-bedroom house costs \$500,000, for example, and the annual rent for a similar home is \$24,000 (\$2,000 per month), then the rent ratio is about 21.

The rent ratio mimics a flipped version of a metric used in evaluating stocks, the dividend yield.

In the case of residential real estate, however, it's the inverse: the stock price (home price) divided by the dividend (rent). The concept in play is that every asset has a fundamental value that equals the present value of its future payoff. For stocks, that payoff is its dividend. For a home, that future payoff is a roof over your head. The proxy used for the value of that is the rent one pays for a similar asset in the same market.

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Experts vary in their opinions as to where the rent ratio tipping point is, but most would agree that it is around 15-20. The higher the ratio, the more you would need a spike in housing prices in the coming years to justify the price you are paying today. So at those levels, it makes sense to consider renting. Conversely, if you have a ratio below 15, it may make sense to consider buying a home rather than renting at least from a purely financial perspective.



Lower home prices and low mortgage rates make buying look good, but compare the payment to what renting gets you.

Take Stock of Your Financial Situation

If you've done the math for the neighborhood of your choice and have determined that now is a good time to consider buying a home based upon the relative prices of renting and owning, the next step is evaluating whether you can handle the immediate financial impact of buying a home.

When estimating your mortgage payment, make sure to use mortgage rates for your specific area, loan amount and credit score, rather than national averages, which may not apply to your situation. In addition to the mortgage, you will need to look at the costs of property taxes, insurance and homeowner's association fees, if applicable.

You will also need to add in the costs of making runs to Home Depot or Lowe's for redecorating or remodeling (usually much greater with homeowners than renters), maintenance and repairs (usually about 1 percent of the home price per year), utilities (which tend to be higher for homes because they are usually larger than rentals) and supplemental insurance.

If you can comfortably pay for these expenses with some financial cushion, then home ownership may be an option for you. If you need every penny of your current cash flow to cover these expenses, then home ownership is probably not feasible at this time. Ask yourself the following questions:

- Will I have to dip into my savings a little or completely exhaust it in order to make the down payment?
- Will I have at least six months' worth of savings to cover unexpected financial demands, such as medical emergencies or job loss?
- Will I be so financially stretched each month that I can't enjoy small luxuries like a family vacation or dinner out at a restaurant?

After looking at the feasibility of homeownership from a "cash flow and cushion" standpoint, think about your longer-term financial needs and goals. Does home ownership allow you to save enough for your future plans? Perhaps you have growing children you want to send to college or aging parents you may need to eventually care for. What about that business you've always wanted to start or that carefree retirement you've been dreaming of? If homeownership will put a damper on your hopes for the future, then perhaps it should not be a part of your plan.

Evaluate Lifestyle Changes

Lastly, when considering whether to rent or buy your home, look for any lifestyle sacrifices that you might have to make. Today, with such high levels of economic uncertainty, many people are not willing to give up the financial flexibility that comes with renting and fear being tied to a long-term mortgage. Some people would like the ability to move where there are jobs available without the burden of selling a home, or simply need to know that their home won't be foreclosed on if they lose their job and can no longer afford the monthly mortgage payment. In addition, many are unwilling to give up the amenities of higher-priced cities for the affordability of the quiet suburbs. They like the shopping, restaurants, nightlife or culture that is often harder to come by in more affordable locations or may enjoy the convenience of a shorter commute to work.

If, after evaluating market conditions, your financial situation and your ideal lifestyle, you find that homeownership is a good fit for you, then jump in and enjoy the ride. But if it doesn't seem to add up, just remember that you can still enjoy the freedom and flexibility that renting has to offer. Even better, you'll be comfortable in the knowledge that you have made a sound decision for both your current lifestyle and your future.