How Much House Can I Afford

[0:00:12.0] ST: Welcome Nation to the Financial Rock Star Show. I'm your host, Scott Alan Turner ready to help you get out of debt, save more money and retire early. In the studio with me is producer Katie who has the best lap for the Ryker the cat, who won't leave her alone.

On the show today we'll be answering your questions about money, business and life, if you have a question you'd like answered on the show visit Goaskscott.com. Last time on the show I shared how you can finally take control of your spending. If you want to be in control instead of your money controlling you or being completely out of control, please listen to that show.

When I was 26, I was talking with one of my coworkers one day. We were in the kitchen at the office and she told me she was buying a house. I said, "Congratulations, that is great!" Later on in the day, I was thinking to myself, "Wait a minute, my salary is more than hers. If she can afford a house, clearly I can afford a house, the thought had never crossed my mind." Now this is perfect logic when deciding on if you should buy house right? "Well they have a house. I guess I can afford one too."

When I started looking at mortgages and mortgage rates, it dawned on me. Yeah, I could afford to buy a house, I told my boss about it and he gave me probably the worst advice I've ever received regarding personal finances. His advice was, "Buy as much house as the bank will let you, your property value will go up and your salary are going to go up over time. So get as much a house as you can."

I started looking around, I had a real estate agent help me out and I fell in love with this house that was way over my initial budget. By "way over" what I really mean is "wayyyy over". It was a two story home, it had an unfinished basement, had a creek in the back yard, backyard was full of pine trees, it was located on the cold sack. It was beautiful.

I put a 5% down payment on it, had a first and second mortgage plus private mortgage insurance. I wiped out nearly every last dollar in my savings account to cover the down payment and closing costs. I had a beautiful new home with a massive monthly mortgage payment and an empty bank account.

The worst part about it was the PMI, which I did not know much about it at the time. I was paying $135 a month in private mortgage insurance because my down payment was less than 20% of the sales price. That's $1,622 a year I had to pay that wasn't going towards the principle or the mortgage interest on this home. I started throwing every spare dollar I could at the second mortgage to get it paid off.

Because the real estate market was hot at that time, the value of my home increased pretty substantially and pretty quickly. After about two or three years, I had my home reappraised. With the equity that I had put in it, I now had more than 20% of the value of the mortgage in equity. That's great news because I didn't have to pay PMI anymore. Now, if I knew then what I know now, I would have waited to save up the 20% to avoid the PMI in the first place, it's just wasted money.

By doing so I would have had a smaller, more manageable mortgage payment, not one so big that it kept me awake at night worrying about, "How am I going to be able to pay this?" You want your new home to be a blessing and not a curse. If you buy a home with nothing or very little down and have a huge mortgage payment with no savings, you're just inviting trouble or at least excessive stress and worry but you don't realize that until after you've signed on the dotted line.

Before you buy a home, make sure you have a three to six month emergency fund and all of your debts are paid off. It will help you a lot with your financial situation. What is the magic number, how much house can I afford if you're looking to purchase any home or get in to one in the future? What is it?

Well in order to avoid that nightmare scenario of getting into a house that's going to break your bank, destroy your relationships, destroy your sleeping habits, keep up at work at night, there are a couple of numbers that are thrown around.

One is called the 36% rule, that is, all of your debt payments should never add up to more than 30% of your gross, that's your pre-tax, income.

For every pre-tax dollar you earn each month, no more than 36 cents should go to paying off mortgages, student loans, car loans, credit card debts and so on. Because most people have their property taxes and their home insurance wrapped up into their mortgage payments, those get rolled into that as well. That's one number that you can look at, it's not a good number though.

Another number I've heard tossed around is 25% of your take home pay, that's after all the taxes are taken out, your 401(k) is deducted, it's like, "What's left over in my paycheck? Let's just take 25% of that and use that as a number for your monthly mortgage." Works sometimes. If you're in a high rent, high housing area like in a dense city, New York City, Boston, San Francisco, some of those places, you're more likely to be paying more in housing. That number doesn't work for everybody.

On top of that when you buy a new home, you should account for 30 to 40% extra for home expenses. So if your mortgage is a thousand dollars a month or you think it might be a thousand dollars a month, you better expect that home is going to cost you $1,300 to $1,400 a month. Your utilities are going to be higher than when you rent. You're going to have upkeep; if you've got a lawn, you got to mow the lawn or pay somebody to mow the lawn.

Lawn mowers, they cost money, brooms, shovels, all these little things. Pest control, lawn fertilization, if you want a green lawn, you don't care about lawn, you live in Arizona where it's erred, you don't have any of that stuff, not a big deal, you got to service the air conditioning systems, get those checked on. On average it's 30 to 40% more of a mortgage for the upkeep of a home. I've been rambling on a little bit, what's the number? "What's the number Turner? Get to it, what is the magic number?"

Here is the magic number, there is no magic number. The financial advice you received, it needs to be given and changed according to what is happening in your own life. Here's where I would start. Write down your spending plan, everything you currently spend money on, if you're thinking about getting a new home. So you write down, "Here's how much we're spending on groceries, spending on going out to eat. Here's what we plan on spending on vacation, here is all of our bills, our car payment, our student loans, here's what we're saving towards investments."

Write all that down then in the separate category you've got your current rent, current utilities. Now those are going to change, so just wipe those off the list and then see what's left over. What's left over each month when I add up everything I'm currently spending money on, I take out my current housing expenditures, what's left over? That's your mortgage payment. That's how much you can afford. Don't forget to factor in that 30, 40% on top of that.

So if you have a thousand dollars left over from all your current expenditures, you have a thousand dollars to spend on a mortgage each month and the upkeep of the house will actually be about $700 just to be in the safe zone. You can pay towards a mortgage. Now, you're going to be a lot better situation if you get some of those debts paid off first. Take care of the credit cards, pay those off, take care of the car loan at least, get out from underneath the car loan.

I understand people who have student loans, they're expecting to pay them for 10 or 15 years. Some people are going to choose to do that, that's a personal decision so you may say, "I'm going to have the student loans but I still want to save for a house anyways because we just want to get into a house." I get that, I can appreciate that. Same situation, add up what you're spending on, what are the student loans going to cost the extra, that's what you have to spend towards your house.

And then look at your long term savings goals. If you're going to save up for a vacation, some day you want a new car someday, you got to factor those in. What you spend each month on a house is really a personal choice. Ryker the cat who is chiming in now he says he owns a cheap $20 little cat condo made out of cotton, he is perfectly susceptible to that. Ryker, please be quiet. This is the home office, this is what we deal with.

But if you're comfortable with spending 50% of whatever's left over on a mortgage and you're happy with that and that fits in your long term goals, you live in an expensive city that works for you then that's what works for you. If you only want to spend

20% and you want to save the rest for above and beyond your retirement, remember, before you get any of these homes, make sure you're paying yourself first towards retirement, save 20% for the long term stuff. Then you start the house savings fund, then you save up for the down payment.

After you add up all your monthly expenses, figuring out what's left over, don't save zero for retirement and put the rest towards a home. Put that 20% in there preferably at least for retirement. Then you use the extra for the home, figure out how much of that extra that you want to apply. You do that, you'll be in a good situation, you'll find a number that works for you depending on where you live, how much you want to spend, what your other goals are, what your current expenditures are, what your current loans are that's a workable number.

Everyone's situation is different. Financial freedom is having a paid for home, if you do all those things, you're going to be in a much better position if something unexpected comes up like a job loss or a medical issue. You get that emergency fund in place before you get in the house, you get your retirement savings in place, that's how you'll get to financial freedom. Now, on to your questions.

Doug writes in:

[0:10:27.6] D: "I've heard that closing credit card accounts that are paid off can actually worsen your credit score. At first it sounded counter intuitive but I read that you're lowering the amount of funds that are accessible to you to the financial institutions consider this a loss in creditworthiness. Do you have any insight in this? Would you recommend opening a no annual fee credit card and not use it just to show you have additional credit available?"

[0:10:50.2] ST: The single most important factor of a credit score is paying your bills on time and the second most is called the credit utilization ratio. Now, the utilization ratio accounts for 30% of your credit score and here's how it works. You add up all the credit limits of all the cards you currently have. So let's say you've got three different cards, MasterCard, Visa, Sears and the total limits of all those cards adds up to $10,000.

Your FICO score, they want to see that credit utilization ratio of 30% or less. So if you carry a balance of $4,000 total across those three cards, that's bad for your score because you're utilizing 40% of your total credit limit, right? 10,000 max, you got a $4,000 balance, 40%. If your balance is $3,000, $2,500, $2,000 less? That's what the FICO people they're looking for. Credit utilization ratio of 30% or less because $3,000 is 30% of your $10,000 max. Simple math.

Now, let's consider if one of those three cards he had had a credit limit of $6,000, you closed it because you never used it so we're closing down the Visa, we like the MasterCard get better perks, whatever. Now your new total credit available on the remaining two cards is $4,000 right? We had 10, we closed down the 6,000 we got four left over. If you had a balance of $4,000 between the other two cards and now your max is $4,000, what is your credit utilization ratio? 100%. 100% is very bad.

So by closing old or unused cards, your available credit goes down which increases your credit utilization ratio. Now, also, opening up a new card, that's going to drop your credit score a little for temporarily. Instead of opening up a new card, you might consider calling your existing credit card companies and request a credit limit increase. By having your credit limit increased, you accomplish the same thing, you're impacting your credit utilization ratio.

If you got your $10,000 max, now your max is $15,000 across those three cards, you can have higher balances and keep your ratio lower. As long as you keep your spending habits the same, that's important, you don't want to increase the max to $15,000 and say, "Ooh I can go out and spend more money!" Terrible idea. That's how you do it, thanks Doug for the question.

Viet from Philadelphia writes in, and I apologize in advance if I butchered your name Viet.

[0:13:37.5] V: "I love the show, your advice has helped me start investing like a financial rockstar. I recently graduated with a doctoral degree and a heavy well-paying job but I have $240,000 in student debt. Interest rates aren't terrible, ranging between three and seven percent. I have a budget of $600 a month and I need to help deciding whether I should one, focus on building my six month emergency fund before I start paying down my debt. Or two, should I split the amount and contribute towards both an emergency fund and paid down in debt at the same time?

It seems reasonable to save $400 a month and use 200 as extra payments towards my loans. Also, is it smart to consider my E-trade investments as part of my emergency fund if I have 10 to 20% of my fund in a liquid savings account?"

[0:14:23.8] ST: In your situation you have to figure it's going to take a long time to knock those student loans out, if you make good money, a fully funded emergency fund is likely to be in the tens of thousands of dollars. Funding it with $400 a month would take three or more years, that's a long time. Now that doesn't factor in any raises or company advancement you might get. But even with those factors, A, it's not enough to fund it quickly and B you're going to be dividing your financial focus.

The loans get knocked out quicker if you throw every spare dollar at them and skip the three to six month emergency fund for now, you'll also save a ton of money on those interest payments. Now, your worst case situation is, you can't work for an extended period. If that happens, your student loans can be put in deferment which can be up to three years or forbearance which can be up to 12 months.

If you've got a good degree, a good paying job, you're probably quite employable so let's not focus on you being out of work. You do want to make sure you have disability coverage though through your employer, that's going to be you weak spot. In the event you become unable to work, you want to make sure there is an income to cover housing and food, your most important expenses.

If you have private student loans, check out getting them refinanced with a company like Sofi.com, see if you can get a lower interest rate. Also you can consider getting your public student loans refinanced. When you do that, you lose the public loan deferment and forbearance benefits if you find yourself out of work.

Now, some of these third party companies that are doing refinancing, some of them have unemployment protection programs, forbearance, in the case you get into some type of hardship in the periods that last up to 12 months. You can look at those as well. Now, regarding your E-trade investments, yeah, any liquid assets you've got, whether it's in a cash savings account or a money market mutual fund, typically held at the brokerage, they can be used as an emergency fund.

Issue with the brokerage account, sometimes it takes a while to get the funds from the brokerage to your bank account if you need it in a hurry. Typically, four to five days. Again, all brokerage firms, they've got some type of cash mutual fund that is, it's just a place holder. You transfer funds in and it sits there until you do something with it such as invest it, do regular type of mutual fund.

It's not like a checking account where you can write a check for the day you need the money or if you need to do a wire transfer fund using western union because the third cousin of a sister in law needs some cash tomorrow or else he's going to get kicked out of his house for missing the rent payment, so you don't have that flexibility there. You have to consider what type of situations might come up, how quickly you'll need that money.

Usually sometimes it depends if you have a bunch of boneheads in the family that are always attracting bad situations or not. 99% of the time, we can get away with waiting four to five days to access our cash. Even if the HVAC goes out on our house, the water heater needs replacing, something like that, service companies are going to do the work first then you pay them when the job's complete. Writing a check within 30 days is usually fine in those type of situations. It's okay, that four to five day wait period. Thanks for the question Viet.

If you have a money related question you would like answered, please visit Goaskscott.com to get in touch with me, that website has my email address, twitter and you can also leave me a voicemail. Please contact me, I am here to help you and this show is all about you. Otherwise I have nothing to talk about so send me questions, come on.

[BREAK]

[0:18:07.4] ST: Alright, today I'm going to share with you another one of my money moron moments, they're kind of limitless, we've got plenty to go from. When I was in college, I signed a two year contract for a gym membership. Now I didn't know anything about gym memberships at that time. Then when the end of the school year was reached, this was my freshman year this happened. I just took off for home and then I left my bank account in that other state to dwindle down to nothing because I didn't know about keeping a balance in there either.

The gym membership auto drafted out of my checking account each month. Well, pretty soon, the bank account was empty and I showed back up the school the next year and they're like, "Hey, you've got an outstanding balance here. You know, you haven't been paying on your membership but you've signed this contract." I'm like, "What? I thought if I just skipped town, the membership would stop," that really was my thinking. You leave town and then the problem or the gym membership just goes away right? I didn't know. What was I? 18 years old?

18 year olds don't know that stuff, you do now if you're listening to me because I'm telling you about it. If you have a gym membership that you've already signed a contract on, you're not using it anymore, you're taking a break, you've got an option to put a freeze on that membership. You can go in there and, "Say hey, I'm not going to be working out for a while, I would like to stop payments on my membership."

It doesn't get you out of the contract but it will give you a buffer so they stop charging you for a period of months. Sometimes you can go up to 90 days which is nice. In the winter time if you don't want to work out, you're going to be traveling a lot, you can put a freeze on that account, pick it up again in the spring or to see if you can cancel that outright and get out of it.

The amazing thing about gym memberships when I think about them, I pay less now for my gym membership than I did when I was in college or high school actually. When I was in high school I was going to a gym there as well. In high school I was paying $30 bucks a month and now I'm paying $10 a month, it's crazy. One thing that has never followed inflation, gym memberships. Now, back to your questions.

JC writes:

[0:20:25.6] JC: "I'm currently employed and consider myself blessed to be so. I have made a lot of money the past two years but I have zero savings to show for, about $350,000 over the past two years. No 401(k), I was severely turned off by 401(k)'s during the last bubble when tons of people lost money. However I realize employment doesn't last forever, I'm only 29, my wife is 28, we've got a kid on the way, she is happy spending money and having no savings. She does not work.

Honestly, I'm not upset about her situation. I have no problem creating income right now. I want to buy a house in cash one day and have no debt and plenty stored up so I can help my family members when needed. I would love to hear about what your thoughts are on someone in my situation?

[0:21:09.3] ST: You have a huge, huge income which is awesome in such a young age. The thing about the bubble and people losing a bunch of money is the people that stayed in it for the long haul made all their money back and then some a few years later. But many investors, they never got the chance to recover their losses from the crash. People got scared, they sold at the bottom or as the market was falling, it's the worst thing you can do.

Market timing which we've talked about many times, it doesn't work. The people who didn't make their money back were the people who didn't know how to invest properly. They were emotional investors, they either sold on the down turn or at the bottom or were heavily loaded in their own company stock and not well diversified.

Buying into company stock, not a good idea on your 401(k). You have so far let your money grow, you should be putting it into a 401(k) and a Roth IRA. You can expect the market to tank many more times until you pull your money out. I'm expecting it too. Ride it out, it's okay, it's expected. Buy when the market is down, buy when it's on the way down, buy when it's on the way up. It's been proven in study after study, you come out ahead in the long run.

For you, just automate your savings. Pull that money out each month so you never even see it and it goes away into your retirement accounts. Don't even tell your wife, just don't tell her. Say, in a year from now you say, "Hey, we saved up all this money, we're going to be having it for retirement." She'll be like, "Yeah, maybe not the best idea but sit down, talk with her, say hey, we're making a bunch of money, let's put a little bit away for retirement."

Spending money, that's fine, enjoy it. Just make sure that you're saving while you're young so that when you hit your 40's, you're not in the situation some of these people are today where they don't have any savings. You could be stocking away a huge nest egg now and then later on not so much. You can live life now or live life later as well. Take the extra later on and like you said, you'll be able to give it away as you see fit and help people which is wonderful thing to do. Thanks JC for the question.

[0:23:28.2] ST: Okay, quick break, back in 30 seconds and I'll be answering more of your questions, you're listening to Scott Alan Turner.

[BREAK]

[0:23:35] ANNOUNCER: Are you tired of scooping the litter box? Sick of throwing away thousands of dollars on cat litter? What about that smell? My friends laughed when I told them I never scoop litter and my cat used a regular toilet until I revealed my training process and they saw the cats using the toilet for themselves. Hi, I'm Katie, expert cat instructor on how to train your cats so you never have to scoop or buy litter again.

Toilet training a cat has many benefits, not in the least is all the money you're going to save by not having to buy litter anymore. The scoop no more system shows you how to do it and best of all, it's completely free. You'll love never scooping or buying litter again. Toilet train your cat and start living a litter free life. Visitscoopnomore.com.

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[0:24:27.7] ST: Welcome back Nation, Matilda writes:

[0:24:31.4] M: "My husband works pretty hard to support the family, we'll be married 10 years next year, we're completely debt free except for the mortgage, I primarily handle the finances in the family. How can I secretly set aside money for a surprise anniversary vacation? I'm planning a trip that will cost about a thousand dollars."

[0:24:47.6] ST: I had a friend in college named Matilda, I always like that name. 10 years for you guys, congratulations on that upcoming milestone. Crafty Matilda secretly wants to buy a new wardrobe but it's covering up under the guise of a vacation, how does she do it? Well first, good for you to decide to save for it instead of reaching for the plastic, that way you're not paying for that vacation over and over again for the next two to three years.

Now, putting a large purchase on a credit card can cause you a lot more but with your paycheck already budgeted for 20 different things, where would you start? You need to embezzle money from yourself. Really? That right? That's what you need to do. First step is by setting a goal, let's begin with an equation, some math. Let's say you want to go to a bed and breakfast for your anniversary trip. It's going to be a weekend getaway and it's five months away.

You think it's going to cost you a thousand dollars after doing some research for gas, lodging, restaurants, something nice for a gift. Now, we want to figure out how we need to save between now and then based on your pay periods. If you get paid twice a month, five months away, you've got 10 paychecks coming in, you're going to need to save a hundred dollars from each paycheck to meet that thousand dollar goal.

If you're getting paid once a month, you're going to need to save $200 out of each pay period. Figure out how much paychecks you're getting in, divide that by time and you'll come up with the amount you need to save for each pay period. If it's a reasonable amount then just go ahead and start stocking away secretly. If that amount is a little ambitious for you for each of your paychecks, you're going to have to look for other ways to find some more cash.

Alternatively you can extend the amount of time that you'd be saving for that goal. Maybe you have that vacation in 10 months, that way you only have to save $50 out of each paycheck rather than $100 if you're getting paid twice a month. Maybe that would be more manageable for you. But if you want to still stick to your five month goal, then we need to find other ways to save money.

You need to look at your overall spending plan, see for ways that you can trim and cut without being too obvious, groceries and budget are a couple of areas. If you have some personal spending for each of you, maybe you want to save some of your own money so maybe you don't buy as much in your clothing allowance this month for example, maybe don't buy the kids as many toys, take that money out. There's different ways that you can do it. Maybe sell a few things on the side slyly to save up for it.

Little things that you can do here and there. Taking your lunch to work each day will save you a ton of money and you'd be able to save up for that trip. Once you figure out how much you need to sock away, you need to put it somewhere. If you're talking a thousand dollars for vacation, probably your husband is not going to notice that money hanging around your checking account.

If you're on the cash budget, it's easy, you just skim it off the top like I said, you're embezzling for yourself, putting that away, hide it in a sock in your drawer, if you're cutting your grocery and entertainment by a hundred bucks a month, take it out of the cash envelope at the beginning of the month, go hide it, be sneaky. No matter how you do it, it's important to create a savings plan that is going to work to get you to your goal.

[BREAK]

[0:28:38.8] ST: If you made it this far, I'm certain of one thing, even though we may have never met, shook hands or exchanged an email or tweet, you're not giving up. Committing to that 20 plus minutes, you just did, getting this far, you're in it to win it so I applaud you. Silent though, I'm not going to clap my hands right now and blow up your ears in the microphone. I congratulate you on not giving up. Getting out of debt, saving, being responsible, it's hard work. It is hard work, and it's easy to give up. If you want to give up on something, give up on giving up. Those are the words.

If you can do me one favor, please take 30 seconds right now, text three of your friends the link Getfr.com, tell them to check out the show. I appreciate you guys listening, I love it if you could help me out and spread the word. Super simple, just text them Getfr.com, tell them how awesome my cats are and the advice is okay too.

Next time on the show, if you're struggling to get ahead, I'll tell you how you can make more money. That's it for this episode, I'm your host Scott Alan Turner, Rock star Katie is my producer, all the links mentioned in the show are available in the show notes on Scottalanturner.com. Today's episode is powered by Ben and Jerry's ice cream. Thanks for listening.

[0:30:25] ANNOUNCER: Okay nation, for your free copy of the guide, "How to save $1,000 in one week", simply subscribe to the podcast right now on iTunes and text the word "saving" to the number 33444 to prove that you did it. Subscribe now to get out of debt, save more money and retire early. See you next time.

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