PART 2:
MANAGING YOUR MONEY

Chapter 8

The Home and Automobile Decision

Learning Objectives

- Make good buying decisions.
- Choose a vehicle that suits your needs and budget.
- Choose housing that meets your needs.
- Decide whether to rent or buy housing.
- Calculate the costs of buying a home.
- Get the most out of your mortgage.

Smart Buying

Step 1: Differentiate Want From Need

- Smart buying requires separating wants from needs.
- “Want” purchases require a trade-off.
- Before buying a “want,” determine whether the purchase will interfere with your ability to pay for your future needs.

Smart Buying

Step 2: Do Your Homework

- After deciding to make a purchase, comparison shop.
- Start your research with publications that provide unbiased ratings and recommendations such as:
  - *Consumer Reports* at www.consumerreports.org
  - *Consumer's Resource Handbook* from the U.S. Office of Consumer Affairs at www.pueblo.gsa.gov

Smart Buying

Step 3: Make Your Purchase

- Getting the best price might involve negotiations.
- Conduct research before haggling.
- Know what the product's mark-up is.
  - This is the price dealers add on above what they paid for the product.
- Consider what fits your monthly budget.

Smart Buying

Step 4: Maintain Your Purchase

- Maintain your purchase after the deal is complete.
  - Resolve complaints or issues.
  - First contact the seller, then the company headquarters that made or sold the product.
  - Work with the Better Business Bureau and other local, state, and federal organizations.

Smart Buying

Checklist 8.1 Before You Buy

- Decide in advance what you need and can afford.
- Take advantage of sales but compare prices.
- Be aware of extra charges that increase the total price.
- Ask about refund or exchange policy.
- Read and understand the contract before signing.
- Learn about your cancellation rights.
- Don’t succumb to high pressure tactics or do business over the phone with unknown companies.
- Get everything in writing.

Smart Buying

Checklist 8.2 Making a Complaint

- Keep a record of your efforts to resolve the problem.
- Contact the seller, then go to the manufacturer.
- Type letters, keep copies, and send letters with return receipt requested.
- Allow time for the company to resolve the problem, then file a complaint with your local consumer protection office or Better Business Bureau.
- Don’t give up until you are satisfied.

Smart Buying in Action: Buying a Vehicle

- Vehicles are your largest purchase, next to buying a house.
- Choices to consider:
  - Buy new
  - Buy used
  - Lease the vehicle
    - Leasing is renting for an extended period with a small down payment and low monthly rates.

Smart Buying in Action: Buying a Vehicle

Step 1: Differentiate Want From Need

- Determine which features you need.
- Make a list of the features you want.
- Consider your employment, family, lifestyle.

Smart Buying in Action: Buying a Vehicle

Step 2: Do Your Homework

- How much can you afford?
  - Typical family spends 4-6 months of annual income on a new car.
  - Determine size of down payment.
  - Determine an affordable monthly payment.
- Which vehicle is right for you?
  - Comparison shop, looking at choices and trade-offs.
  - Consider operating and insurance costs, and warranty.

Smart Buying in Action: Buying a Vehicle

Step 3: Make Your Purchase

- Be sure to get a fair price.
  - Know the dealer cost or invoice price.
  - Research using *Edmund's Car Buying Guide* at www.edmund.com at www.edmund.com or AutoSite at their web site www.autosite.com/content/home.
  - Most car dealers receive a "holdback," amounting to 2-3% of the price, when selling a car.

Smart Buying in Action: Buying a Vehicle

Step 3: Make Your Purchase

- Financing Alternatives:
  - Cheapest way to buy a car is with cash, but investigate all financing options before buying.
  - Keep financing out of the negotiations.
  - The shorter the term, the higher the monthly payments.

Smart Buying in Action: Buying a Vehicle

Step 3: Make Your Purchase

- Leasing:
  - Appeals to those who are financially stable, like a new car every few years, drive less than 15,000 miles annually, and don’t want hassle of trading in car.
  - Popular with those with good credit but not enough up-front money to buy.
  - 1/3 of all new vehicles are leased.

Smart Buying in Action: Buying a Vehicle

Step 4: Maintain Your Purchase

- Keep vehicle in best running condition.
  - Read owner's manual and follow regular maintenance.
- Don't ignore signs of trouble.
  - Listen for unusual sounds, drips, or warning lights.
- Your first line of protection is the warranty.
- Know your rights under the *Lemon laws*.

Smart Buying in Action: Housing

- Many people equate home ownership with financial success.
- Housing costs can take up over 25% of after-tax income.
- Home ownership is also an investment – likely the biggest investment you will ever make.
- Consider lifestyle, wants and needs, and budget constraints when making choices.

Your Housing Options

- A House:
  - Popular choice for most individuals.
  - Offers space and privacy.
  - Offers greater control over style decoration and home improvement.
  - Requires more work than the other choices, including maintenance, repair, and renovations.
  - Most potential for capital appreciation.

Your Housing Options

- A Cooperative (Co-op) is a building owned by a corporation in which residents are stockholders.
- Residents buy stock, giving them the right to occupy a unit in the building.
- The larger the space and the more desirable the location, the more shares you have to buy.
- Difficult to get a mortgage.
- Pay monthly homeowner’s fee for taxes and maintenance.

Your Housing Options

- A Condominium (Condo) is an apartment complex that allows individual ownership of the unit and joint ownership of land, common areas, and facilities.
- Allows direct ownership of the unit with a proportionate ownership in land and common areas.
- Pay monthly fee for interest, taxes, utilities, and groundskeeping.

Your Housing Options

- Apartments and other rental housing offer:
  - Affordability
  - Low maintenance situations
  - Little financial commitment
- Chosen by young, single people.
- May be a lifestyle decision.
  - Limited upkeep and no long-term commitment.
- Offers lack of choice regarding pets or remodeling.

Smart Buying in Action: Housing

Step 1: Differentiate Want From Need

- Determine what you need versus what you want.
- Decide what is important to you:
  - Consider location – country, suburbs, or city
  - Consider the neighborhood – safety, convenience, schools

Smart Buying in Action: Housing

Step 2: Do Your Homework

- Investigate the potential home and all that goes along with it:
  - Neighborhood, community lifestyle, satisfy needs.
  - www.homes.com/Content/NeighborhoodSearchMain.cfm
  - www.homefair.com
- Understand how much you can afford to pay.

Smart Buying in Action: Housing

One-time Costs

- Down payment
- Closing/settlement costs
  - Points
  - Loan origination fee
  - Application fee
  - Appraisal fee
  - Title search

Recurring Costs

- Mortgage payments
- PITI includes principal, interest, taxes, insurance

Maintenance and Operating Costs

- Repairs and maintenance items

Renting Versus Buying

Buying

- Many up-front and one-time costs
- Beneficial for those who itemize their deductions
- Mortgage payments are a form of forced savings

Renting

- No large up-front costs other than a security deposit
- Beneficial if staying only for the short-term

Determining What You Can Afford

- Before house hunting, ask yourself:
  - What is the maximum amount the bank will lend me?
  - Should I borrow up to this maximum?
  - How big a down payment can I afford?

What is the Maximum Amount the Bank Will Lend Me?

- Lenders look at:
  - Your financial history – steadiness of income, credit report, and FICO score
  - Your ability to pay – lenders use ratio of a maximum 28% PITI: monthly gross income
  - Appraised value of home – limit mortgage loan to 80%.

How Much Should You Borrow?

- A mortgage is a large financial commitment of future earnings.
- Look at your overall financial plan before deciding on how much to borrow.
- Prequalifying – lender confirms the loan size based on ability to pay and down payment.

Financing the Purchase: The Mortgage

- Sources of mortgages:
  - S&Ls and commercial banks are the primary sources of mortgage loans.
  - Mortgage bankers originate loans, sell them to banks or pension funds, have fixed rate mortgages.
  - Mortgage brokers are middlemen who place loans with lenders for a fee but do not originate those loans. They do the comparison shopping.

Conventional and Government-Backed Mortgages

- Conventional loans - from a bank or S&L and secured by the property.
- If default - lender seizes property, sells it to recover funds owed.

Conventional and Government-Backed Mortgages

- Government-backed loans – lender makes loan and government insures it. VA and FHA account for 25% of all mortgage loans.
- Advantages:
  - Lower interest rate
  - Smaller down payment
  - Less strict financial requirements
- Disadvantages:
  - Increased paperwork
  - Higher closing costs
  - Limits amount borrowed

Fixed-Rate Mortgages

- Monthly payment doesn’t change regardless of changes in market interest rates.
- If rates are low, a fixed rate mortgage locks in the low rates for the life of the loan.
- An assumable loan can be transferred to a new buyer.
- Prepayment privilege allows early cash payments to be applied to principal.

Adjustable-Rate Mortgages

- With an ARM, the interest rate fluctuates based on current market interest rates within limits at specified intervals.
- Borrowers are better off with an ARM if interest rates drop.
- Initial Rate - “teaser rate” can be deceptively low and available for only a short time period.

Adjustable-Rate Mortgages

- Interest Rate Index – rates on ARMs are tied to an index not controlled by the lender, such as 6- or 12-month U.S. Treasuries.
- Margin – the amount over the index rate that the ARM is set.
- Adjustment Interval – how frequently the rate can be reset.

Adjustable-Rate Mortgages

- Payment Cap – sets dollar limit on how much the monthly payment can increase during any adjustment period.
  - If interest rates go up, the monthly payment may be too small to cover the interest due.
  - This results in negative amortization. The unpaid interest is added to the unpaid loan balance, increasing its size.

Adjustable-Rate Mortgages

- ARM Innovations:
  - Convertible ARM – convert traditional ARM to a fixed rate loan during 2nd – 5th years.
  - Reduction-option ARM – one-time optional interest rate adjustment to market interest during 2nd – 6th years.
  - Two-step ARM – interest rate is adjusted at end of 7th year, then constant for life.
  - Price level adjusted mortgage – low initial rate, payments and interest change with inflation.

Other Mortgage Loan Options

- Balloon Payment Loan – small monthly payments for 5-7 years, then entire loan due.
- Graduated Payment Mortgage – payments set in advance, rising for 5-10 years, then level off.
- Growing Equity Mortgage – designed to let homebuyer pay off mortgage early.

Other Mortgage Loan Options

- Shared Appreciation Mortgage – borrower receives below-market interest rate and lender receives a portion of future appreciation.
- Interest Only Mortgage – combination of interest only payment at beginning, then pay both interest and principal for remainder of loan.

Adjustable-Rate Versus Fixed-Rate Mortgages

Adjustable-Rate

- Primary benefit to homeowner is low initial interest rate.
- Rate gap between 1-2%.
- Qualify for larger loan because PITI is lower.

Fixed-Rate

- Usually a better choice over adjustable.
- Know your payments never change.
- Allows for control and planning.