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# Wake Up, America—
# Houses Don't Make You Money!

*This essay was originally published in* Muhlenkamp Memorandum, *Issue 1, July 1987.*
*In the 1970s (when inflation rates were higher than mortgage rates), one of the best investment strategies was to borrow money. The easy way for people to borrow money was on real estate. It worked in housing, in farmland, and in commercial real estate (which was also an effective tax shelter). People continued to believe in the strategy through the 1980s, even though the economic climate had reversed in roughly 1981. Ron wrote "Wake Up, America—Houses Don't Make You Money!" to point out that change.*

America is slowly awakening from the dream of benefiting financially from owning a house. We all know houses that sold for $40,000 in the mid-1960s that are worth $120,000 today. It is obvious that anyone who owns such a house has made $80,000. It's obvious, but it's also wrong.

Prices throughout the economy have tripled since 1965. Therefore, housing prices had to triple to maintain their value. Anyone who bought a house for cash in 1965 and sold it today would get just enough money to buy (before commissions and fees) the identical house next door. Some may call that a profit, but the buyer hasn't improved his financial position.

Nevertheless, in the past 20 years, many people have improved their position dramatically through house ownership. But they didn't make money on the house; they made it on the mortgage.

During the decade of the 1970s, interest rates were below the rate of inflation in housing prices. Borrowing at 8% tax deductible, to buy a house appreciating at 10%, made money for people throughout the 1970s. Today, interest rates are well above inflation; if you borrow money, it costs you money.

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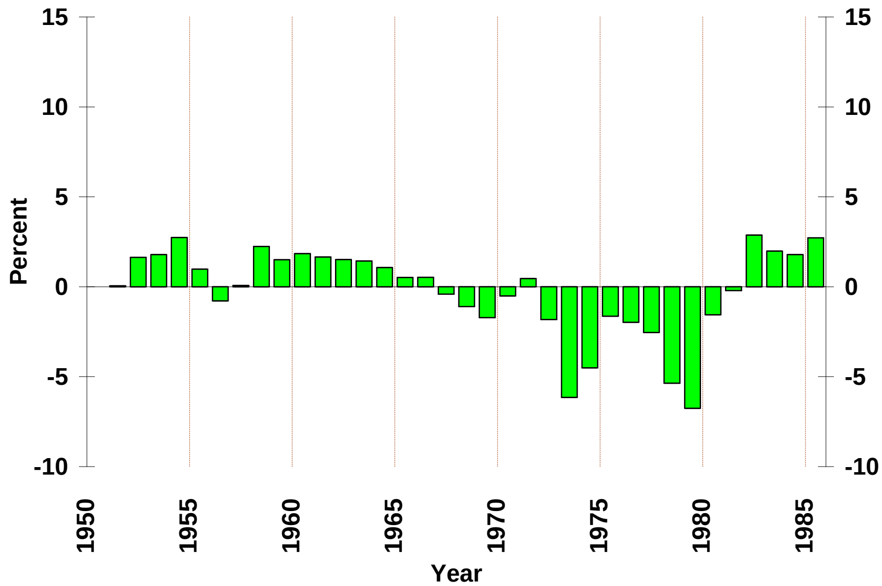
Figure 5.1 represents annual mortgage rates for the last thirty-five years, adjusted for taxes at the (then) maximum rate, and for inflation (at the annual change in the Consumer Price Index). For much of the period 1968 to 1980, after-tax interest rates on mortgages were less than the inflation rate. In fact, mortgage rates were 8% or less as long as savers were willing to accept 5% on their passbook savings. This allowed borrowing at 8% to buy houses appreciating at 10%. When borrowing money at 8% (4% after taxes) to finance a house appreciating with inflation at 10%, purchasing power increases by a net 6% of the amount borrowed. You get paid to borrow money! As the chart shows, from 1968 to 1980, this net gain averaged 4% per year, or $4,000 on a $100,000 mortgage. So the key to getting ahead between 1968 and 1980 was to buy a big house with a big mortgage.

**Figure 5.1 Real After-Tax Mortgage Rate, 1952-86**




The dream ended in 1981, and the awakening is just now occurring. As the chart shows, it now costs money to borrow money (real after-tax mortgage rates have turned positive). By shopping around, savers learned they could do better than a passbook with CDs or money market funds. This caused mortgage rates to rise at the same time inflation in housing prices was coming down.

In 1986, mortgage rates of 10% (5% after taxes) exceeded the inflation rate of 2% by 3%, and led to a $3,000 real cost on that same $100,000, a considerable change from the gain of $4,000 experienced from 1965 to 1980. In addition, the after-tax cost of borrowing is increasing as a result of the new tax bill.

Today, many people continue to buy big houses with big mortgages, stretching and adding incomes to meet the 10% or 12% interest payment on a house that appreciates only 3% or 4% per year. They don't realize that the house will not appreciate enough to earn a profit; they will awaken too late to the real cost of borrowing in the 1980s.

## 2007 Update

Today, 30-year fixed-rate mortgages are approximately 6%. With a top income tax bracket of 35%, the after-tax cost of borrowing is 4%. We judge inflation to be 2% (house prices have been increasing faster, but we find no reason to expect that to continue). So the real (after inflation) after-tax cost of carrying a mortgage is 2%, which is close to the historic norm.

## Editor's Note

*The interesting thing is that 20 years after this essay was written, many people are again talking about making money on houses, but this time the reason is different. Normally, house prices track with inflation. For the past few years, house prices have well exceeded inflation and, in some cases, exceeded the cost of the mortgage because as mortgage rates fell, people could pay more for housing. (The limit on what you can pay for a house is the amount of the monthly mortgage payment.) Since mortgage rates have now reached "normal" levels, Ron does not expect house prices to continue to rise faster than inflation.*