The 106 Common Mistakes Homebuyers Make (and How to Avoid Them)

FOURTH EDITION

GARY W. ELDRED, PhD

WILEY

John Wiley & Sons, Inc.

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Preface to the Fourth Edition

Successful sales for the three previous editions of *106 Mistakes* proved that this unique guide to mistake-free homebuying will give you the heads-up knowledge you need. Indeed, I greatly appreciate the positive comments that readers have sent me (via e-mail: gary@garyeldred.com) as well as favorable media reviews (a special thanks to Robert Bruss). In addition, *106 Mistakes* has been condensed by *Reader's Digest* and cited in many leading publications such as *Business Week, Money Magazine, Your Money, Bottom Line,* and *Kiplinger's Personal Finance.*

Now, this new fourth edition keeps everything that past readers have found helpful, but it also presents the latest developments in the fields of homebuying and mortgage lending. Plus, we've added examples and information that show you how to:

1. Identify homes that will appreciate the fastest.
2. Qualify and secure lower cost financing.
3. Work profitably with your real estate agent and loan broker.
4. Understand the ins and outs of credit-scoring.
5. Write and negotiate your purchase offers.
6. Gain valuable information from the Internet.

Because failing to buy remains the number-one mistake of renters, this fourth edition includes an expanded Chapter 11, "How to Afford the Home You Want." This chapter leads you through the mortgage qualifying process and shows you how to shape up your finances and strengthen your borrower profile. Because many homebuyers still mistakenly accept without question the so-called standard purchase contract form, Chapter 12, "Writing Your Offer," explains the pitfalls of such contracts and tells how to rewrite them to achieve a win-win agreement.

For homebuyers who wish to use the web, I've included within each chapter various web sites where you can research topics such as home values and sales prices, neighborhood data, mortgage loans and costs, financial calculators, consumer information, environmental hazards, bargain-priced properties, credit scores, credit records, and school rankings. For your convenience, I've also listed these web sites in an Internet Appendix. You'll find a comprehensive homebuyer checklist that integrates with the topics covered in this new edition at the web site, www.stoprentingnow.com.

I've written this fourth edition of *106 Mistakes* to guide you through a satisfying and profitable homebuying adventure. I wish you the best as you move toward your cherished goal of home ownership.

Special Note for Investors

Although I originally wrote *106 Mistakes* to guide homebuyers, investors (both new and experienced) have told me that the examples in this book have helped them avoid buying the wrong property. Condo investors especially appreciate the tips on how to read markets and forecast price increases.[1] So, whether you buy a home or an investment property, *106 Mistakes* will guide you to a better choice. Indeed, when you follow this advice, your home will almost certainly prove to be your best investment.

Acknowledgments

For their valuable help in preparing this fourth edition, I thank my secretary Barbara Smerage and assistant Mohsen Mofid.

[1]See also, Gary W. Eldred, *Make Money with Condominiums and Townhouses,* 2004 (Wiley).

Contents

CHAPTER 1

Profit from the Mistakes of Others

Thinking about buying a home? Good for you. You're about to make one of the best personal and financial decisions of your life—if you do it right. And that's just what this book will help you do.

As you read through the eye-opening stories—sometimes funny, sometimes sad—you will see how to steer clear of potential pitfalls. Even better, you will learn to profit from the opportunities that you discover (or create) along the way. You will gain not only from the knowledge I've accumulated from dozens of my own property transactions, but also from the experiences of hundreds of homebuyers, real estate agents, mortgage loan officers, and home inspectors.

Here are some of the fears, mistakes, and pitfalls you'll learn how to handle:

1. Getting turned down for a mortgage
2. Paying too much for mortgage interest, fees, and costs
3. Overpaying for your house
4. Discovering that a house or neighborhood comes with hidden and unwelcome surprises
5. Being taken advantage of by a real estate agent, loan officer, or lawyer
6. Buying too little, too much, or the wrong kind of insurance
7. Suffering discrimination

8. Buying a house whose value doesn't appreciate much
9. Running into problems at (or on the way to) closing
10. Buying a house that doesn't meet your needs, wants, or budget

Unlike other books on homebuying, the discussions here don't merely present general principles, simplistic questions, or a "homebuying process." Instead, *106 Mistakes* illustrates what you need to know through dozens of real-life examples. Through these examples, you'll see how to conquer your confusion, become more confident, and make the right homebuying decision.

The Origin of This Book

Throughout the past 20 years I've taught graduate and undergraduate college courses in real estate; professional education programs for Realtors®, home builders, and mortgage loan officers; and STOP RENTING NOW!™ seminars that are directed especially toward first-time homebuyers. In these courses, one of the most favored classroom topics has been "How to prevent mistakes in homebuying."

Although just about everyone knows that real estate, particularly home ownership, stands out as one of the best ways to build personal wealth, a growing number of people also realize that successful homebuying doesn't occur easily. It requires education. Shopping for a home, negotiating, arranging financing, and qualifying to buy have become much more complex. There are many ways to get bamboozled. Naturally, then, learning about the mistakes of others has proved to be a good prescription for a happy and profitable homebuying experience.

When I first began to discuss mistakes in homebuying with my classes, I relied on many of my own experiences (and mistakes). Over time, though, students were eager to broaden their knowledge and learn firsthand about the mishaps, misfortunes, and mistakes suffered by others. As a result, I incorporated "interview papers" into class assignments. To carry out these assignments, students interviewed Realtors, home builders, loan officers, recent homebuyers, and other people involved in homebuying and financing.

The students asked their interviewees to describe in concrete detail the homebuying mistakes that the interviewees had made themselves or had seen others make. Next, the students wrote up their conversations and we scheduled a class session or two to discuss what they had learned.

These classroom discussions became quite popular. As a result, many students suggested that they would like to see the most common (and costly) mistakes I've collected brought together in a book. Fortunately, John Wiley & Sons, Inc., and senior editor Michael Hamilton agreed. In this book we've aimed to help you benefit from the experiences of hundreds of people who have been involved in homebuying. Read through these stories and apply the lessons to your own situation. You'll enjoy a more profitable and more satisfying homebuying adventure.

[1]To protect the privacy of individuals, in many instances I've changed names and specific identifying facts. But all told, these experiences are real.

CHAPTER 2

Explore Possibilities, Set Priorities

As you search for a home, you'll run up against many choices, confusions, and contradictions. You may face discouragement. In fact, some potential homebuyers give up on the challenges they encounter. They then make the biggest mistake of all: They needlessly continue to rent.

As you go through this chapter you will see that, regardless of your present situation, the power of knowledge, motivation, and goals can move you into the home you want.

You also will see why you can profit when you explore various neighborhoods, price ranges, types of homes, and home features. Even if you think you can describe (and afford) the perfect home, the mistakes in this chapter show you why you should still broaden your knowledge of the market. Greater knowledge will encourage you to rethink your priorities and discover better alternatives for you at this stage of your life.

MISTAKE # **1**

We want to own, but we pay less to rent.

LESSON: Over time, you will pay far more to rent than to own. Plus, homeowners gain the wealth-building power of home equity.

Do you believe that you'll pay more to own than to rent? If so, you're experiencing the same confusion that troubles many of the renters who attend my STOP RENTING NOW!™ seminars. They want to own, but they hesitate because they think owning costs too much. Undoubtedly, the recent increase in home prices has made this myth even more prevalent.

But here are the facts you need to know: After you weigh in income tax deductions, personal freedom, long-term rent increases, and the accumulation of wealth through growing home equity, you will see why it actually costs much more to rent. In addition, renters stand to lose tens (and often hundreds) of thousands in net worth.

Benefit from Tax Deductions

As a homeowner, you can deduct most of your monthly mortgage payments from your taxable income. As a result, your actual out-of-pocket home costs may fall—depending on your combined federal, state, and local marginal income tax rate (MTR)—to 20 to 40 percent less than the actual check you write each month to your mortgage lender.

Say your house payment (principal, interest, property taxes, and insurance) will cost $1,000 a month. Chances are, after counting the tax benefits of owning, that $1,000 may cost you only $700. A $2,000-per-month mortgage payment may cost you around $1,400 a month. Or to look at it in terms of rent, if you're paying your landlord $600 a month, you may be able to afford $750 to $800 a month for your own home. If you're now paying $1,800 per month in rent, you might be able to go up to $2,500 a month for your mortgage payment. To get a general idea of your potential savings, see Table 2.1.

Your personal rent-versus-own cost figures will differ from those listed. But this point is true: Don't assume that monthly mortgage payments will

Table 2.1 **Rent-Equivalent Mortgage Payments after Benefit of Tax Deduction**

	Marginal Tax Bracket (After-Tax Costs)			
Monthly Rent($)	*.15 (MTR)*	*.25 (MTR)*	*.33 (MTR)*	*.40 (MTR)*
450	530	600	672	750
600	706	800	896	1,000
750	882	1,000	1,119	1,250
900	1,058	1,200	1,343	1,500
1,200	1,412	1,600	1,791	2,000
1,500	1,765	2,000	2,239	2,500
2,000	2,667	3,200	2,985	3,333

cost more than renting. Talk with a loan representative and tax advisor. Run through specific figures. In today's world of home finance, lenders offer multiple ways to obtain lower monthly payments. Quite likely, you'll be pleasantly surprised to learn how advantageous it is to own.

Escape from Renter's Jail

After buying her own home, Yolanda Jones told me, "I can't believe it. Not only am I saving money each month and building equity, but I feel like I've escaped from renter's jail." When I asked her what she meant by "renter's jail," Yolanda explained, "For the first time in my life I feel free. No more landlords to tell me how I can decorate, who I can have over, or whether I can get a dog. This is my home now. I'm free to do with it what I want. Even if it costs me more it'd be worth it."

Yolanda brings out a point many renters overlook. When you own, you don't just buy a home, you gain freedom. You escape from renter's jail. If you're like Yolanda, the personal benefits of owning will far surpass those of renting. When figuring your rent-versus-own cost comparisons, keep in mind those great feelings of freedom and security that owning will bring you.

Think Long Term: Rents Will Go Up

We've all heard dozens of times how America's corporate management focuses on the short term instead of the long term. Renters commit a similar error. In some high-cost areas of the country even after allowing for tax deductions and owner benefits, your monthly mortgage costs still may look higher than the costs of renting. If that's your situation, think long term. In fact, no matter where you live, the most important reason to buy a home is not to save money today. It's to save hundreds of thousands of dollars over the rest of your life.

Say you pay $1,000 a month to rent. Assume that after tax deductions, owning will cost you $1,500 a month out-of-pocket. Renting sure looks cheaper. But wait—don't fall into this trap. Think: If you've got a fixed-rate mortgage, your monthly mortgage payments won't go up—and if at some later date you can refinance at lower interest rates, your monthly costs of owning actually will go down.

In stark contrast, over the longer term, you can only expect your rent to increase. Even at relatively modest rates of inflation, rent levels will head up to the stratosphere. Table 2.2 provides several examples of how rents will increase at rates of four, six, and eight percent a year.

Some of those future rent figures look absurdly large. But consider the rent levels of the 1940s and 1950s. In most parts of the country, you could rent a nice house for $25 to $75 a month. Average house payments were $40 to $60 a month. Today's rent and mortgage payments often run 20 to 40 times higher than the amounts of those earlier years. Likewise, you can safely bet that over the next 20 or 30 years, people in the future will be talking about the ridiculously low rents of the early 2000s.

Fortunately, today's homebuyers will still enjoy mortgage payments at those "ridiculously" low early 2000s prices (and interest rates) decades into the twenty-first century. Those who didn't buy will be paying (if they can afford them) rents 3 to 10 times higher. And if we get years of double-digit inflation similar to previous years, rents could even shoot past the figures in Table 2.2. Over time, owning costs far less than renting—and the benefits are far greater.

When it comes to buying a home, think long term. Pay no attention to how high home prices are today compared to where they sat 5, 10, or 20 years ago. Instead, think how *low* today's prices are compared to where they'll be perched 5, 10, or 20 years from now.

Table 2.2 **Escalating Rents**

Future Monthly Rents with Annual Increases of 4%

Today's Monthly Rent	Years: *10*	*20*	*30*	*40*
$500	$740	$1,095	$1,620	$2,400
750	1,100	1,642	2,430	3,600
1,000	1,480	2,190	3,240	4,800
2,000	2,960	4,382	6,487	9,602

Future Monthly Rents with Annual Increases of 6%

Today's Monthly Rent	Years: *10*	*20*	*30*	*40*
$500	$895	$1,600	$2,891	$ 5,140
750	1,342	2,400	4,308	7,715
1,000	1,790	3,200	5,743	10,285
2,000	3,582	6,414	11,487	20,571

Future Monthly Rents with Annual Increases of 8%

Today's Monthly Rent	Years: *10*	*20*	*30*	*40*
$500	$1,075	$2,330	$ 5,000	$10,862
750	1,612	3,495	7,500	16,293
1,000	2,150	4,666	10,000	21,725
2,000	4,318	9,322	20,125	43,449

Homeowners Build Wealth

We will talk more about the investment benefits of home ownership in Chapter 3. For now, notice the great wealth-building power of home ownership—even in periods of relatively low inflation. True, throughout our country's 200-year history, home prices have proved cyclical: sometimes fast appreciation, sometimes slow; sometimes recession, sometimes depression. Yet, over time, homeowners have always built more wealth than renters.

As you make your monthly mortgage payments, your outstanding loan balance steadily falls—slowly at first, then more rapidly. Even if your home doesn't appreciate much (which is unlikely), at the end of your mortgage term (15, 20, 25, 30, or 40 years) you will own a valuable property free and clear. But at rates of appreciation of say three, five, or seven percent, your home equity will grow to hundreds of thousands of dollars (see Figure 2.1).

As renters become poorer through rising rents, you will become richer through growing home equity. Without a doubt (and in more ways than one), continuing to rent will cost you dearly.

MISTAKE # 2

We want to own, but we don't have enough for a down payment.

LESSON: You don't need much savings for a down payment. You may not even need a down payment.

I was listening to a talk-radio show recently. The subject discussed was "no-money-down" home financing. Just as I tuned in I heard an agent angrily say, "I've been selling real estate for 25 years, and I've never seen a nothing-down deal." This agent went on to complain about the "hucksters" pushing nothing-down seminars, books, and tapes who had gotten rich deceiving the public. "People who attend these seminars and watch too much late-night television just waste my time," this sales agent said. "I tell 'em when they call me, 'If you don't have the money to buy, go bother someone else.' "

Work with Agents or Lenders Who Understand Possibility Analysis

Now contrast this agent's attitude to that of Realtor Joan Evans. "Anytime someone comes into our office seeking a rental," Joan says, "the first thing I do is ask them, 'Do you really want to rent? Or would you rather own?' More often than not, they say, 'Sure, we would like to own, but we don't have enough for a down payment.' When I hear that, that's when I go to work. One of the best parts of my job is to take renters who think that they don't have enough money to own and then figure out ways to turn them into homeowners. Granted, it's not a piece of cake; sometimes it takes six months or more. But I've found many of these

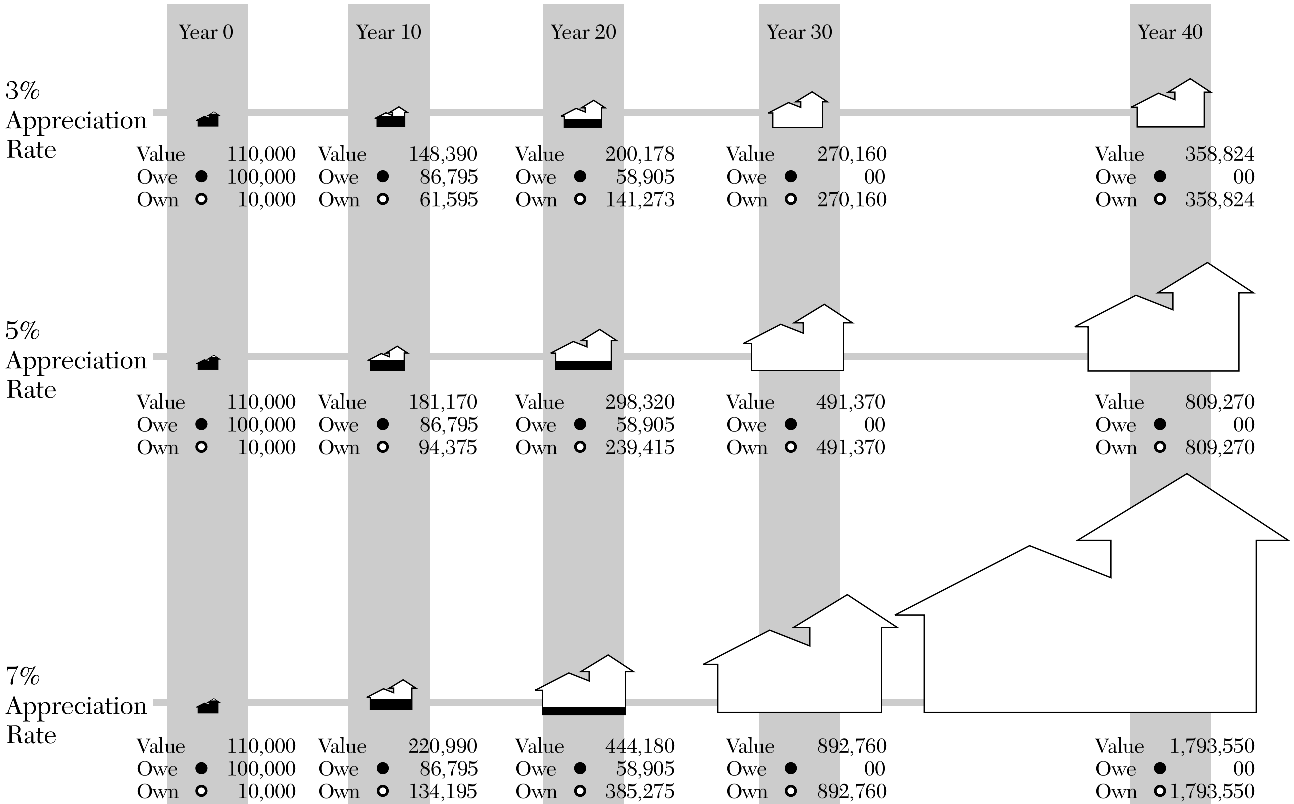

Figure 2.1 Building Home Equity. (To calculate your future equity with a higher-priced home, multiply the figures shown above by a factors of 2, 3, 4, or other multipliers that might apply to your purchase relative to the modest $110,000 in this example.)

buyers become my most loyal clients and a great source of referrals and repeat business."

If you are short on cash, look for a Realtor like Joan Evans. Quickly drop run-of-the-mill agents who show a don't-bother-me attitude to anyone with less than a five-figure bank account.

For the past several years, mortgage lenders, homebuilders, not-for-profit housing groups, and government agencies have been reaching out to cash-short renters who would like to become homeowners. You now have dozens of little- or nothing-down home finance plans to choose from:

- FHA (Federal Housing Administration) 203(b)
- FHA 203(k)
- FHA assumables
- HUD (Department of Housing and Urban Development) foreclosed homes
- Fannie 97
- Freddie Mac Discover the Gold
- Neighborhood Housing Services
- Central city mortgages
- Community Reinvestment Act programs
- Rural Economic Development Programs (formerly Farmers Home Administration)
- Lease-options
- Lease-purchase
- Sweat equity
- State mortgage bond programs
- Land contracts
- Seller "trust deeds"
- Seller seconds
- VA (Department of Veterans Affairs) mortgages
- VA assumables
- State VA programs
- Habitat for Humanity homes
- New home builder grants
- Economic opportunity programs

- Private mortgage insurance
- Pledged collateral
- Gift letters
- Family loans
- Fannie Mae rehab loans
- Fannie Mae and Freddie Mac zero down
- Wrap arounds
- Self-contracting
- Shared equity
- City down payment assistance
- County down payment assistance
- Co-ownership
- Create value/fixers
- Not-for-profit grants
- Employer assistance
- Government grants
- Neighborhood Advantage Mortgage
- Community Homebuyer Programs
- First-time buyer programs
- Coborrowers
- Cosigners
- Blanket mortgages
- REOs (real estate owned by lenders after it's gone through foreclosure)
- Manufactured home financing

We'll look at little- or nothing-down financing in more depth in Chapter 8. For more home-financing possibilities, read my book *106 Mortgage Secrets All Homebuyers Must Learn—But Lenders Don't Tell,* 2003 (Wiley).

To discover ways to buy cash-short in your area, closely read the real estate sections and real estate ads in your local newspapers. Over the course of a month or two, you're likely to see many properties or finance plans that are available with little or no money down.

Buying when you're cash poor may not prove easy. But loan reps and real estate pros who know all the homebuying possibilities will be able to help you locate, develop, and qualify for the financing you need to become a homeowner.

MISTAKE # 3

We can't afford to buy; the monthly payments are too high.

LESSON: If you can afford to rent, you can afford to own.

Before you convince yourself you can't afford to buy, make sure you compare your rent and mortgage payments on an *after-tax* basis (see Mistake #1). But if monthly payments still look too high, don't give up. There are many ways to get over the "unaffordable" monthly payment hurdle. Here's how Doreen Bierbrier did it.

At the time she bought her first home, Doreen says, "I was earning a modest salary (by Washington, D.C., standards) as a government worker…. The only way I could buy a house in a good neighborhood was to find one large enough to accommodate a couple of housemates who paid rent. If everything worked out, the rental income would cover more than half my house payment and two-thirds of the utilities. Adding in tax advantages and appreciation, I figured I would actually make money. Further, when the loan on the house was paid off, I would own a valuable asset free and clear."

As time has proven, Doreen had the right idea. While many moderately paid singles and couples have mistakenly pleaded "not enough income" to buy (see also Mistake #5), others like Doreen have acted creatively and figured out ways to bridge the gap between their current earnings and affordability. Other than taking in housemates, you might also:

- Create an accessory apartment in your home (sometimes called a mother-in-law suite) by converting a garage, attic, or den.
- Reduce your monthly payments with an adjustable-rate mortgage.
- Reduce your monthly payments with a graduated-payment mortgage.

- Reduce your monthly payments by using a balloon mortgage.
- Buy a duplex, triplex, or other type of home that's already producing income that will help cover the monthly mortgage payments.
- See if your area offers a mortgage credit certificate (MCC) program. Through MCCs, the federal government gives you a mortgage subsidy of up to $2,000 a year.
- Take up a part-time job.
- Ask your employer for a raise or housing assistance.
- Buy with someone else.
- Secure an interest rate buy down (discussed in Chapter 8).
- Assume a low-interest FHA or VA loan.
- Assume a low-equity adjustable-rate mortgage.

Generally, these techniques either reduce your monthly payments or increase your available income. But to really boost your borrowing/buying power, prioritize your spending (and savings!).

Match Your Spending to Your Goals

Whenever renters say they can't afford to own, I ask them to list all of their typical monthly expenses. Nine times out of 10, their list reveals spending patterns that wildly deviate from these renters' professed priorities. In other words, they nearly all say that they value home ownership highly. Yet, they spend much of their money on such things as upscale rentals, new cars, boats, jet skis, travel, entertainment, furniture, vacations, electronics, eating out, and many other fleeting pleasures.

Before you complain about affordability, fill in the blanks below. Find out where your money really goes each month:

Rent	$_____
Electricity	$_____
Gas	$_____
Cable TV	$_____
Internet charges	$_____
Online charges	$_____
Telephone(s)	$_____