Don’t build your own prison and call it a home

Krauser PUA | 20 November, 2013 | by krauserpua

“Annual income twenty pounds, annual expenditure nineteen [pounds] nineteen [shillings] and six [pence], result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.” Charles Dickens, David Copperfield.

The essence of a bachelor’s life is that he maintains control of his time and his freedom to maneouver. This is how you feel in control of your life and avoid the sense of being harried, put-upon and trapped. We are quite aware that getting married-up (the old “ball & chain”) and having children are the two major ways in which a man can surrender his time and freedom to maneouver.Â If that’s what you want in life, by all means go for it. This post is written for bachelors who have chosen to remain free of such entanglements for the foreseeable future. The two key principles are:

1. Get a secure high top-line income, preferably scaleable
2. Get a low fixed cost base. Convert fixed costs to variable costs.

This is talk from business financial planning so I ought to unpack it a little for non-bankers, beginning with considering a man who has it all wrong per Dickens. Imagine a caricatured cubicle-jockey who works full-time 48 weeks a year on a permanent-employee contract. He owns a suburban three-bedroomed house and both he and his wife have a lease car each, perhaps a couple of years old. They have a sky sports / entertainment subscription, 24-month 4G mobile phone contracts for both adults and both children. The mortgage has ten years paid and fifteen years remaining plus there are a few unsecured loans to cover big ticket expenses like the recent kitchen remodelling. What is the risk profile of this man’s finances?

- Income is not scaleable – He is already working at his full capacity of 48 weeks a year of full-time working weeks.
- Income is all from one source, his salaried employment.
- Expenses are all high, fixed amounts with long duration. There is significant debt which is subject to (probably) floating interest rates.

What this means is the man has a very narrow margin of error. When expenses rise he had few options to absorb the change – does he try to get overtime at work or does he trade-off another expense? If his income drops (his hours are cut, he is fired) he has a huge monthly payment to meet and no means to do so. Not only that but by having equity in his home he has alot to lose in a home repossession. The man has no time and no freedom to maneouver.Â **This is why bachelors should be very wary of owning a home**. The things you own end up owning you.

One thing investment managers quickly adopt is the idea of asset classes. Everything is an investment and allocating funds to one asset class (e.g. equity) means less funds for another asset class (e.g. bonds). This is simple opportunity cost. Investment managers will take a strategic view on the likely performance of different asset classes and make their bets accordingly. You should be doing the same.

Property is not an emotion. It’s not a symbol of success. It’s not a part of your identity as a man. *It’s just an asset class*. Depending on your life situation and the economy it’s wise to be either long or short property. Usually it’s better to be short (i.e. renting not buying), here’s why.

Freedom

Buying a house locks you into one place and a high monthly fixed expense. For no reason other than that it is usually smart for the bachelor to avoid buying a house. When you tell your boss you have a mortgage you are telling him “I can’t walk away from this job so please fuck me over with limitless demands, pressure and shitty projects. I’ll take it all while wearing a shit-eating grin because I know I don’t have the option to walk away”.

A man with a huge income-expense margin can accumulate a large pile of fuck-you money in his savings account. He can take time off work. A man on a six-month rental apartment can very easily trade down to a cheaper place if money is tight, trade up when he’s flush or just go move to another country/city to follow a good job opportunity. As Robert De Niro advises in Heat: “Don’t let yourself get attached to anything you are not willing to walk out on in 30 seconds flat if you feel the heat around the corner…. Now, if you’re on me and you gotta move when I move, how do you expect to keep a… a marriage?”

On the lam

Taxation

The golden rule of taxation is that the burden falls heaviest on those least able to avoid it. The poor don’t pay tax because they have little income to tax and little to lose by refusing to work. The rich don’t pay tax because they can restructure their affairs to minimise it. Tax falls disproportionately upon the middle class for three simple reasons:

1. They earn high enough incomes to make their life significantly more comfortable from working than not working.
2. They have assets (housing, savings, pensions) that can be plundered and are too large to comfortably walk away from.
3. They own property. It is fixed in one location and cannot be moved offshore. Nor can they.

Buying a house positions yourself squarely into the cross-hairs of a thieving government whether overtly (property taxes, stamp duty, rates) or covertly (you are locked into place for all the personal taxes)

Asset bubbles

Property is just an asset class. Nobody buys a house outright in cash. Under periods of stable banking families will typically provide a 20% cash deposit and borrow the remaining 80% which any investment manager will tell you is 4x leverage. You have Â£4 of debt for every Â£1 of equity but still control (carry risk and rewards of) 100% of the investment. Let’s consider a contrived example to clarify the maths:

> Your capital: Â£20k. Your mortagage: Â£80k. Your house price Â£100k.
>
> **Scenario 1:** House prices rise 10%. Your house is worth Â£110k. You now have Â£30k in equity (the debt didn’t increase) This is Â£10k profit on an investment of Â£20k = 50% return.
>
> **Scenario 2:** House prices fall 10%. Your house is worth Â£90k. You now have Â£10k in equity. This is Â£10k loss on an investment of Â£20k = 50% loss.

The key characteristic of leverage is it magnifies the impact of asset price movements. A change of just 10% in house prices creates a 50% change in your wealth. We are so used to hearing risk-takers extoll the virtues of leverage in rising markets that we can forget ***leverage also works on the way down***. As many a leveraged hedge fund found out to their cost. The main point for the bachelor to process is this:

Buying a house is a highly leveraged bet on the direction of the housing market.

You are not reducing risk by buying a house. You are increasing it. This is before taking into account another factor: housing is a depreciating asset. Houses fall apart and become delapidated without regular maintenance and repairs. This truth is hidden in fast-rising markets because the net amount of house price rise minus maintenance costs will be positive.Â Thus accepting that buying a house is an ***investment*** decision, and in particular a speculative investment decision, we must understand how a house is valued. If your natural thought is "look in the estate agent's window for similar houses" you are a moron. There are three ways to price a house over the long term – all are ways to determine if the housing market in a given area is over- or under-valued at the time you are considering purchase.

1. Median house price to median salary ratio

It's an obvious truism that if the average person cannot afford the average home then house prices are going to drop. You can find long-term historical data (for example Case-Schiller) that gives a clear pattern for any region. Generally speaking in the US house prices will cost 3 times the salary of whoever lives in it. Pull up the graphs. Any time prices deviate there is a bubble or crash and eventual reversion to the mean. It's simple (effective) supply and (effective) demand. What can't happen won't and therefore when median house prices outstrip the median earner's capacity to pay **they don't pay**. There'll be a period of market breakdown as delusional sellers refuse to drop prices (the first sign of a house price crash is sharply reduced transaction volume – buyers and sellers can't agree a price) but then as the 3Ds come into effect (divorce, death, reDundancy) the forced sales pull the market down.

Find this for your region

2. Median salary to median mortage payment ratio

People have a comfort zone for how much of their monthly income they are willing to allocate to housing. Long term statistics show that to be about 33% of take-home pay. The rest goes on food, entertainment, clothes, car whatever. Banks consider this ratio in making loans because as the % rises the borrower's wiggle room to deal with external shocks reduces as does their willingness to meet payments in times of duress. When you read stories of young couples paying 60% of take-home pay to meet mortgage payments then its a sure sign the market is overpriced and headed down.

3. Bank optimism

There are long-accepted rules in the banking industry and long-accepted ratios in determining loans. Put simply your banker assesses you on the three Cs

- **Collateral** – How much of a deposit or how valuable is the asset the loan is secured on. This is why they require a cash deposit. If you pay 20% deposit then the house value can drop 20% before the bank takes a loss. Your skin in the game is 20% and thus you are far less likely to walk away from your loan. Reduce that to 5% and the game has changed.
- **Cover** – How many times over can your take home pay cover your mortgage payment? If that number is low you will struggle when interest rates rise or your income takes a knock. You are fragile.
- **Credit** – What is your historical creditworthiness? Do you have a history of repaying your debts or welching on them?

House prices are determined by the availability of credit because it's the size of the mortgage the bank will give you that determines your effective demand to bid on a house. Thus when lending standards are lax (i.e. banks are optimistic) borrowers can get larger loans and thus bid up prices. When banks are aggressively marketing loans with 5% deposits or ALT-A interest-only repayment schedules, or the central bank is forcing down interest rates it is all pointing in one direction: houses are overpriced. Lax lending leads to high rates of bad debts and an inevitable banking contraction. Lending standards over-correct to the strict side and suddenly borrowers can no longer bid so high. House prices drop.

This is what a banking crisis looks like

There are many additional factors that impact house prices that I won't go into. For example consider how these sociological changes affect prices:

– Expansion of public sector jobs in a particular region: Wages rise in that region leading to increased ability to bid-up house prices. When government contracts and fires those workers prices come back down.

– Mass immigration: Large numbers of wealth-destroying third world immigrants flood a country. For their housing demand to become "effective demand" (backed by the ability to pay) they must receive government housing benefit. This can only be funded by taxation (national debt is merely deferred taxation) which means the increase in effective demand by the colonists is offset by the decreased effective demand of the wealth-creators (when taxes rise, median salaries and interest cover falls – see above ratios).

– Debasement of the currency: Prolonged periods of quantitative easing artificially suppress interest rates which has the effect of (i) reducing monthly payments for borrowers on floating rates (ii) destroying yield on investments for savers. It's a direct transfer of wealth from savers to borrowers. Effective demand is transfered from one group to another but not increased overall. When currency is debased house prices have the illusion of increasing because they are measured in a unit that loses it's real-world value. For example in the UK the pound was devalued 25% in 2008-09 but house prices remained flat. The economic effect is house prices dropped 25%.

These are complex factors but I raise them to solidify the key point: Property is just an asset class and it's a leveraged investment. It's not an emotional decision or a rite of passage to becoming an adult.Â For most bachelors most of the time buying a house is suicide. It takes away your time and freedom to maneouvre. It will also very likely lose you money if you buy now.

** Anyone retarded enough to say "rent is just throwing your money away" will be sent to the spam queue.*
