CALAMOS
WEALTH
MANAGEMENT

FAMILY MATTERS

Insights on key topics—
through a multi-generational lens.

TOPIC:

REAL ESTATE

Wealth management considerations for:

STARTING OUT | MIDDLE AGED | RETIREMENT

Buy or rent? Pay off the mortgage? Transfer title to a trust?

Questions about real estate are important at every lifestage. This *Family Matters* insight article gathers input from Calamos Wealth Management experts on key considerations for people in three categories: just starting out; middle aged; and retired.

We created the *Family Matters* insight series to spark ideas and spur conversation among family members on a wide range of important financial topics. They're purposely written as a primer for more in-depth discussions with your Calamos Wealth Management advisor on how the matters presented will apply to you and your family's unique situation. We hope you find that the multi-generational lens by which topics are presented promotes pass-along readership to multiple family members. Your Calamos Wealth Management advisor is available to all members of your family to provide guidance on matters you care about most.

STARTING OUT

Abigail Hollenbeck-Pratt, 26, has had a BIG year. She got married last fall, is wrapping up a master's in healthcare administration at Temple University, and just landed a job with a hospital operator in Jacksonville, Florida. Husband Marc works remotely for a software development company, so relocating from their Philadelphia apartment is not an issue.

Abby took out loans for grad school, but hasn't touched the $85,000 her parents handed her and Marc at their modest wedding. Now they're wondering if it's time to buy a house.

Rent vs. Buy

For lots of 20-somethings, "rent vs. buy?" is their first experience with a complex financial decision. And in recent decades it seemed like a no-brainer: the popular wisdom was buy as soon—and as big—as you can. All that changed, however, in 2008/2009, when many Americans learned that home values go down as well as up.

Subsequent years saw big increases in renting, but that drove rent prices up and in late 2016 the Census Bureau reported that, for the first time in more than a decade, the number of renters declined in the U.S.

The bottom line is that housing prices, like stocks and bonds, are volatile. How well a given household will fare by buying instead of renting depends on factors that are impossible to predict. There are, however, a couple of important things to consider:

Are your expectations realistic? Viewed purely as a financial investment, houses are mediocre. "If you look at the history of the housing market, it hasn't been a good provider of capital gains," said Yale economist Robert Shiller, noting that from 1890 to 1990, inflation-adjusted home prices were virtually unchanged. Of course, a house is more than an investment, it's a place to live. But studies have shown that over long periods, renting and investing the savings elsewhere sometimes works out better.

How long do you plan to stick around? The upfront fees that come with financing a home purchase are steep, so buying probably isn't a good choice if you expect to relocate within five years.

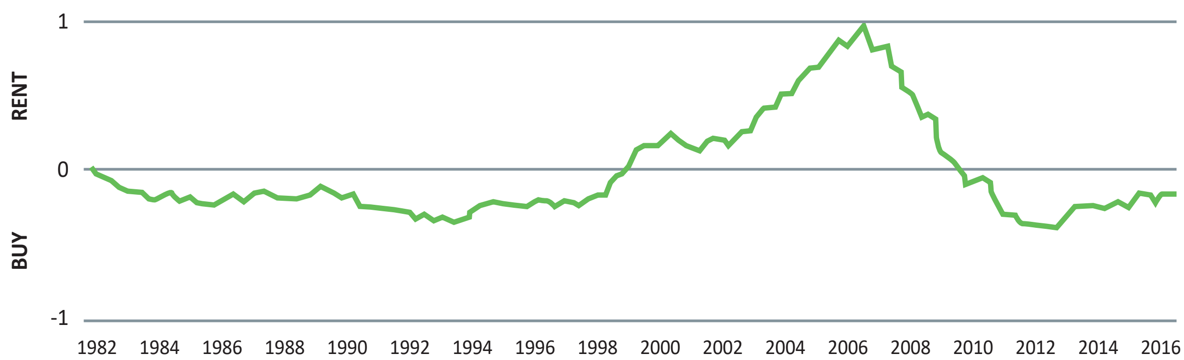
What kind of saver are you? When academics study the buy/rent decision, they assume a renter will invest all the cash they save by not buying in a portfolio of stocks and bonds. But if you're the type who is more likely to invest it in, say, an island vacation and a new flat-screen TV, the forced discipline of saving up for a down payment and then building equity through monthly mortgage payments may be just what you need to build wealth.

What's the market doing? Conditions related to the supply and demand of housing can impact the relative attractiveness of renting versus buying over time. Professors at Florida Atlantic University have created an index[1] that suggests when it's a better time to buy or rent in the United States as a whole and in 23 metro areas (see the chart on the next page).

What about taxes? Probably one reason many Americans take it on face value that buying is better than renting is that home owners have historically been able to deduct mortgage interest from their income taxes. But don't just assume this is an advantage in your specific circumstance. For many young people, taking the "standard deduction"—rather than itemizing deductions, including interest on a mortgage—turns out to be a better move.

[1] https://business.fau.edu/departments/finance/real-estate-initiative/bhj-buy-vs-rent-index/

Beracha, Hardin & Johnson Buy vs. Rent Index: United States



Buying Basics

Back to Abby and Marc. Let's say they weigh the pros and cons and decide they may be ready to buy a starter home. Here are some basic considerations:

What kind of mortgage? Nearly two in three U.S. mortgages are "conventional loans" designed to conform to guidelines from Fannie Mae and Freddie Mac. Because there's a limit on the size of conventional loans—$424,100 in most U.S. cities, slightly more in pricier markets—they're even more prevalent with buyers of starter homes. Conventional loans have great terms because they're supported in several ways by the federal government. They are available in terms ranging from 10 to 30 years, with fixed or adjustable interest rates. With adjustable rate mortgages, the rate resets after a specified number of years based on prevailing interest rates at the time of the reset. There's a risk that the new rate may be higher, but adjustables can be a solid choice if you plan to sell within a few years of the adjustment date because the rate you will have been paying in the initial period is lower than that of a fixed-rate loan.

How much can you afford? The limiting factor for most borrowers under the conforming loan rules often is the debt-to-income ratio (DTI). DTI is calculated by dividing total recurring monthly debt by gross monthly income, and is expressed as a percentage. Generally, the maximum DTI for a conventional loan is 43%. Exceptions can be made for DTIs as high as 50% when the buyer has stellar credit and/or lots of cash reserves. It's important to understand, though, that the guidelines may say you qualify for a house much more expensive than is prudent.

How much to put down? Many buyers target a down payment of at least 20%. One reason: if you don't have 20% or more of the purchase price available in cash, you'll have to pay private mortgage insurance (PMI), which may cost up to 1.5% of the original loan amount each year. PMI payments will end eventually as you build equity, but they can be harder to get rid of than you assume, especially if real estate prices are flat or down. It's usually smarter to put 20% or more down.

What are points and should you pay them? Points (or discount points) are a way to pre-pay some of the interest on a mortgage. One point amounts to 1% of the total loan, so, for a $300,000 mortgage, one point costs $3,000. Paying a point or two upfront can lower your interest rate significantly, thus reducing your monthly payment. It's easy to go online and find calculators that show the breakeven point—in other words, how many months of lower payments it will take to offset the initial outlay for points. If you plan to be in the house past the breakeven point, consider paying up for a point or two.

MIDDLE AGED

The Pratts of Blue Bell, Pennsylvania already are long real estate, but they'd like to get longer. Few things make 51-year-old Nick, head of the chemistry department at a private college, happier than riding. He's dreamed of moving further out in Bucks County to a bigger house with proper stables and access to riding lanes.

Annalise, 49, a pharma sales rep, likes riding, but she likes golf even more and wonders if it's time to consider a vacation home somewhere warmer—especially now that their eldest daughter Abby is taking a job down in Florida.

Moving Upscale

Is a larger house the right move? It's certainly a costlier one. Setting aside the obvious—bigger house, bigger mortgage (most likely a non-conforming "jumbo" mortgage with a higher rate)—there are some less obvious costs. InvestmentZen estimated that for every additional 500 square feet, the average homeowner can count on the following extra costs over the term of a 30-year mortgage:

- **$1,470** in closing costs
- **$8,400** in furnishing
- **$24,148** in mortgage interest
- **$16,506** in property taxes
- **$15,450** in energy costs
- **$12,600** in maintenance

And these cost figures are for the average home. A horse farm in the country? Longer commutes, outbuildings to maintain, well water and a septic system? Nick better be sure his ponies are worth it!

Second Homes

What about staying put in Blue Bell, but buying a condo near the beach (and Annelise's new favorite golf course!) outside of Savannah, Georgia? She and Nick aren't sure they're ready or what the implications are for their financial plan.

What are the big-picture questions? There's plenty to think about even before finances come into play:

- Do you view the second home primarily as an investment property or a place to spend your vacations? The answer will inform many of the decisions, from location to property management to tax planning.
- Will you grow tired of the "Ye Olde Shoppes" or lobster rolls or [insert whatever quaint thing it is that draws you to the location]? In case you're thinking you'll just sell in a couple of years if you get bored, think again. Not only will you incur real estate transaction costs, but experts say you should plan on owning a home for at least seven or eight years to ride out potential downturns in the real estate market.
- Is it accessible? According to the National Association of Realtors, the median U.S. vacation home is 200 miles away. Much further than that, and you're likely looking at flights. Sure, that fishing cabin in Montana is spectacular, but how often will you use it if it takes nine hours to get there (and that's IF you spring for the seaplane charter)?
- Will you retire there? There can be tax benefits (explored below) to buying a retirement dream home early and using it for vacations in the interim. But be extra careful choosing a location for the long haul: before long, proximity to a medical center may be just as important as proximity to the lake.
- Who will look after it when you're away, and who will deal with tenants if you plan to rent it out? Rental property managers can charge up to 40% of rent for their services.

» Local restrictions? If you were planning to rent the place out, be aware that homeowners associations may cap the total number of rental days, forbid guest access to amenities like the swimming pool and tennis court or enact restrictions—on everything from pets to children to motorcycles—that reduce the pool of potential renters.

How is rental income on a second home taxed?
Short answer: It's complicated and you definitely should consult with an expert.

Longer answer: If you rent out your place for fewer than 15 days per year, the tax treatment for a second home is straightforward. You're not required to report the income to the IRS and can generally deduct mortgage interest and property taxes (subject to IRS rules on such deductions for second homes).

But if, like many people, you rent out the property for more than a fortnight every year, taxes get trickier. The treatment then depends on how much time your family (and not just your nuclear family) uses the place. If it's more than 14 days, the property is still treated as a personal residence. But if you spend fewer than 14 days vacationing there per year, it's considered a rental property and can qualify for a host of deductions and depreciation.

RETIRED

Even when nobody else is there, if he listens closely, Walter Pratt still hears the clatter of skis in the boot room, or his wife calling out "Uno" (she always won), or the squeals of Abigail, Audrey and Nick, Jr. up way too early on Christmas morning.

Walt, 77, feels he has done a good job getting his affairs in order. When he became a widower six years ago, he sold his house in town and updated his will. He amended it again to make his son, Nicholas, executor when his eldest daughter moved out west in 2015. He is still bothered, however, about what will become of the cottage in the Poconos. More than anything, Walt wants to make sure that a place full of cherished family memories doesn't become a source of acrimony between the kids when he is gone. Importantly, he already sounded them out and they said—though with different degrees of enthusiasm, he noted—that they would like to keep the place in the family, at least for now. But some of Walt's kids are more well-off than their siblings, and he wants to make sure the cottage isn't an immediate burden and that there is a framework for equitably liquidating if it should ever become one. Is putting it into a trust the solution?

When to create a trust for real estate?

Homes often are the single most valuable asset in an estate and they can also be the most contentious. Different heirs may have very different financial imperatives, as well as varying degrees of emotional attachment to the home that can—lead to conflicts over whether and when to sell—and at what price.

The most common approach for passing down real property is through a will. You simply specify which children or family members you wish to leave the property to and your estate transfers the deed to your heirs who own it in equal portion. Wills can work fine when the heirs are on good terms and in similar fiscal circumstances. However, putting a home in your will means putting it into probate. That can take time and money—typically around 5% to 10% of the estate goes to pay legal fees—and puts strain on the heirs who must fly in from all points for probate. It also means the property may not be available to the heirs for a period of time.

Putting real property into a trust avoids many of those problems and it can be an especially good strategy for family vacation homes when the owner wishes for it to remain a source for cementing family bonds. By putting the property into a trust, it stays out of probate and you cover most legal costs (usually about $2,000-$3,000) when you set the trust up.

With a trust, a single trustee is appointed to make most day-to-day decisions concerning the property and mediate disputes, and is typically designated as a beneficiary along with the other heirs. The beneficiaries' rights can be specified in the terms of the trust: When can they use the place? Can they rent it out to third parties for all or part of their allotted time? What about holidays?

The trust can also include funds set aside to cover upkeep on the property and insurance for a period of time.

Circumstances change, so the trust might also include language providing for a sale of the property when the majority of the beneficiaries want to liquidate or when the upkeep funds are depleted, with a right of first refusal for one or more beneficiaries to buy out their counterparts pro rata at the appraised market value.

Whether contemplating the first real estate purchase or saddled with disposition of multiple homes, the best advice is to move carefully. The decisions you make can have lifelong consequence, and not just financial in nature. There's the toil of sweat equity, emotional ties of memories created and responsibilities of maintenance.

Before making a major decision regarding real estate, reach out to your Calamos Wealth Management advisor for a discussion on how the matters of real estate can be a positive influence on your family's future.

SECTION SUMMARY

1/ Key Questions for Starting Out in Real Estate

- ☑ Are you viewing your purchase as an investment or as contributing to your lifestyle?
- ☑ How long do you plan to stay in the property? What type of loan makes sense for that corresponding period of time?
- ☑ How is your local real estate market behaving in the current economy? What is the forecast for the future?

2/ Key Questions for the Middle Age Real Estate Owner

- ☑ If moving to a bigger home, have you considered the true cost that comes with increased square footage? Utilities? Tax? Maintenance? Furnishing?
- ☑ If purchasing a second home, how many weeks a year will you be occupying it?
- ☑ What is the distance to the second home, and who will look after it when you are not there?

3/ Key Questions When Owning or Disposing Real Estate in Retirement

- ☑ Do you plan to leave the physical property to your heirs? Or, only its value?
- ☑ Have you stipulated the disposition of the real estate as part of your will?
- ☑ Are your heirs emotionally prepared to share and/or dispose of the real estate as equal beneficiaries?

FAMILY MATTERS

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