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Getting Going / *By Jonathan Clements*

How to Stop Relatives From Bragging About Their Big Profits in Real Estate

TODAY'S BUDDING property magnates haven't yet suffered. But they're already insufferable.

Take your brother-in-law Bob. During the late 1990s, he was forever boasting about his stock-market successes. Amazon.com, JDS Uniphase, Yahoo, he owned them all—and, unfortunately, still owned them at the market bottom.

But Bob no longer bothers to mention his stock-picking prowess, in part because he is too busy touting his real-estate smarts. How do you get the man to shut up? Here are a few questions to toss Bob's way.

How much did you pay for your home?

This is an unfair question, because it pretty much begs Bob to wallow in self-delusion. If he is completely out of touch with reality, he will tell you how much he put down rather than how much he actually paid.

Let's say Bob made a $50,000 down payment in 1999. Five years later, the place is worth $360,000. As Bob notes with smug satisfaction, that is a 620% profit.

But how much did you really pay?

When pressed, Bob admits that he actually paid $250,000, putting down $50,000 and borrowing the other $200,000.

Nonetheless, his home's value has climbed 44%, giving Bob a $110,000 gain on his $50,000 down payment. Meanwhile, as he points out, investors in the Standard & Poor's 500-stock index lost a cumulative 2.8% over the five years through year-end 2003.

True enough, you concede. But because you are a little cruel, you note that the 44% is no great shakes. That is barely better than the average gain during the past five years for a single-family home, as calculated by home-finance corporation Freddie Mac.

What about borrowing costs?

Now that Bob has mentioned his mortgage, you quiz him about that. He relates that, when he bought his house, he took out a 30-year fixed-rate mortgage at 7.5%. That was the average rate in 1999, according to Keith Gumbinger, a vice president at HSH Associates, a mortgage-information provider in Pompton Plains, N.J.

Run the numbers, and you find Bob laid out $84,000 in mortgage payments during the past five years. To be sure, $11,000 of that sum went toward paying down the $200,000 initially borrowed, so Bob's loan balance is now $189,000.

But the other $73,000 was interest. Many homeowners get little or no tax benefit from their mortgage interest, because they don't itemize their deductions or their itemized deductions are curtailed because of their high income.

But let's assume Bob can deduct his mortgage interest at his 25% federal income-tax rate, thus reducing his cost to $54,750. Tack on the $2,750 that Bob paid in closing costs, and his five-year borrowing tab would amount to $57,500.

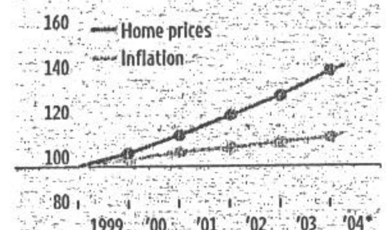
As Mr. Gumbinger notes, Bob probably would have refinanced last year, when mortgage rates dropped below 6%, thereby trimming his monthly payment. At this point, however, that might not have lowered his total five-year tab, because refinancing would have meant coughing up another round of closing costs.

What annual expenses have you incurred?

Bob looks puzzled. Annual expenses? You explain that you are referring to stuff like maintenance, property taxes and homeowner's insurance.

Building Wealth

Home prices, which usually track inflation closely, have sprinted ahead in recent years.



Note: Year-end 1998=100 *First quarter
Sources: Freddie Mac; U.S. Labor Department

Chris Mayer, director of Columbia University's Milstein Center for Real Estate, says such expenses might run 3.5% a year of a property's value, and these costs will likely climb as a property's value rises.

At that rate, Bob would have forked over some $45,500 during the past five years. (This assumes property taxes account for 1.5 percentage points of the 3.5%, and that Bob can deduct them at his 25% tax rate.)

In truth, this $45,500 estimate is probably too low, for two reasons. First, a lot of homeowners do a fair amount of maintenance themselves and yet they never put a dollar value on their sweat equity.

Second, there is a decent chance Bob undertook one or two major home improvements, and we aren't counting those. When homeowners sell, they almost never recoup the money involved, because potential buyers usually don't put a high value on the current owners' home improvements.

"For many improvements, I would guess the return is 50 cents on the dollar if you sell soon after making the improvements," Prof. Mayer says.

Have you figured in selling costs?

You take Bob's $360,000 home value and subtract the $45,500 annual expenses, $57,500 borrowing costs, $50,000 down payment and $189,000 loan balance. Result: Bob is left with just $18,000—and $11,000 of that came from loan repayments.

Bob is looking a little miffed. But before he gets whiny, you go for the kill. What if he sold the place and paid a 5% real-estate broker's commission? Knock off the resulting $18,000 commission, and suddenly Bob's brilliant home purchase doesn't look so brilliant.

At this juncture, Bob storms off to the kitchen, where he pours himself a stiff drink. That is a shame, because you never got around to telling Bob that his house was indeed a decent investment. After all, he got to live there for five years without paying any rent.

But Bob probably wouldn't have been interested. Buying a home so you have a place to live? In today's overheated real-estate market, that's way too radical a concept.