



Sense for Your Financial Future?

BY GLENN AYRTON - CLU, CHFC, CFP

The Issue:

Has the time finally come in Vancouver where investing in real estate is no longer as attractive an option? Canada's housing market bears have been predicting for a few years now that a crash indeed looms ahead.

On the other hand, we have projected what the returns would be on the S&P500 index with the following assumptions:

Most Vancouverites would argue that buying their first home is an important life achievement that they want to check off their list as soon as possible. Not only does it feel good to pay down your own mortgage instead of someone else's, but it gives you the peace of mind that there is useful equity in your home. We also tend to value real estate above most other things as both a financial and an emotional investment because it's tangible.

But what about buying a piece of real estate as an investment? Is it still a good idea given the fact that the future of Vancouver real estate seems to be under constant scrutiny? What if instead of investing in an investment property, you invested in to an equity portfolio? We have seen recently that the markets can change drastically within days (both up and down), and investors need to be prepared to ride these times out if they want to see their long term goals come to fruition.

The truth of the matter is that we can't predict what will happen in any future market, although we do know the long term trends are always positive. Let's look back over time and see how a globally diversified portfolio of equities compares to how the performance of investing in Vancouver real estate over the past 20 years. Data is a better judge than human speculation, and we can use it to understand how markets behave in the future in order to determine the best investment strategy now.

The Facts:

We've done a comparison of returns on a real estate investment versus returns on an investment portfolio using historical data from the past 20 years. From that data, we can infer for the next 20 years about what the outcome will likely be for returns on real estate and portfolios.



Purchase price	\$500,000
Downpayment	\$200,000
Mortgage (25 year term)	\$300,000
Mortgage rate	4.9%
Purchase tax (once upon purchase of property) ²	\$8000
Average property tax per year ³	\$3840
Average rental income per year ⁴	\$37,655
Average rate of return ⁵	6.4%
Strata fees (per year) ⁶	\$3600
Average operating costs per year (0.5% of strata fees per year plus average rate of inflation (2.5%))	\$2300

On one hand we have projected what the returns would be on a new, 2 bedroom, 1200 square foot apartment near downtown Vancouver purchased in 1995. We calculated the outcome based on the following assumptions:

¹Sturgeon, Jamie. As Sturdy as a House of Cards? A Look at Canada's Property Boom". Global News. March 3, 2015.

<http://globalnews.ca/news/1860605/sturdy-as-a-house-of-cards-a-look-at-canadas-property-boom/>

² Formula: 1% on the first \$200,000.00, and 2% on the remaining value.

³Formula: Annual tax rate multiplied by every \$1000 of the property's value (in this scenario: $3.54 \times (\$500,000/\$1000) = \$1770$)

⁴Housing Price Survey. Royal LePage. Reports and Surveys. Historical data 1995 – 2014. <http://www.royallepage.ca/realestate/info-and-advice/market-reports-and-surveys/>

⁵"Long-Run Rate of Return for Canadian Home Prices". Special Report: TD Economic. March 11, 2013.

<http://www.td.com/document/PDF/economics/special/LongRunRateOfReturnForCanadianHomePrices.pdf>

⁶Schliwinsky, Frank. "Condo Maintenance Fees by Size and Age of Unit". Strategics Vancouver Condo Report. REW.ca.

<http://www.rew.ca/news/condo-maintenance-fees-by-size-and-age-of-unit-1.1342315>

Initial Investment	\$500,000
Investor's Equity	\$200,000
Loan	\$300,000
Loan interest rate (loan interest repaid from investment account)	4.9%
Average Rate of return ⁷	8.51%

Results:

So what did we find? Both investments performed well, with the portfolio performing slightly better in the long run:

Comparison of Real Estate Investment Return vs. S&P500 (Net equity before tax, after expenses)

	1995	2014	Annualized Return
Real Estate Equity	\$500,000	\$1,510,637	10.28%
S&P500	\$500,000	\$1,635,980	10.72%

The table above shows that over 20 years, the portfolio performs slightly better than the real estate investment. It captures all of the assumptions listed above and allows us to see in simple terms what we might be able to expect in a real life scenario.

After 20 years, the Physician who purchased the \$500K investment property would have an annualized return of 10.25%. They would still have a small mortgage but would have increased their initial investment by almost 3 times as the value in 2014 would be just over \$1.5 million.

For that same time period, the Physician who invested his \$500K in a portfolio would have had an annualized return of 10.72% and would have increased their initial investment by more than 2 times.

What the table does not show are the unquantifiable variables involved such as time and energy spent on managing the investment property. We have also assumed that the property is generating rental income every single month, however, it is likely that there were periods of time when the property was vacant and did not generate income. Quantifiable operating costs are also incurred differently for each investment: while the portfolio cost is paid by the investment itself, the operating costs of the property need to be paid directly so additional planning would be necessary to ensure those funds were available.

The unquantifiable variables associated with the portfolio is market volatility. Although volatility is normal and should be expected, it is still unsettling to some investors when the market drops. We cannot predict year by year what the variance will be or what the rate of return will be, but we can use historical data to identify patterns that help us make educated estimates. We use a globally diversified target asset allocation approach to minimize the risk and maximize the return. If you are averse to risk, your asset allocation must be allocated accordingly to provide you with more peace of mind – your team of experts should be there to ensure your plan is a good fit with your goals and with your own personal investment philosophy.

Conclusion:

Investing in anything should be based on an overall financial plan that is built specifically for you by a team of experts. The cardinal rule of investing is: never let your emotions drive your investment decisions. By running a quick analysis the numbers show an outcome most Vancouverites may not have expected – that a portfolio would out-perform real estate. Especially in Vancouver, real estate investors tend to lead with their hearts versus their heads because they have been inundated with media coverage that depicts the real estate market as the golden ticket to high returns. They are breaking the number one rule of investing and letting their emotions guide them.

Over the past 20 years, Vancouver real estate has seen an unprecedented rise. Will this continue? No one knows. What we do know, however, is that the average working Vancouverite can no longer afford to purchase a home anywhere near the downtown core. Vancouver, although it is a very desirable place to live, is very expensive when compared to other metropolitan areas around the world. Interest rates are very near as low as they can get, and should those begin to rise there will be a significant dampening effect on real estate values going forward. We also know that at the time of this writing, the S&P 500 is trading below its historical price earnings ratio which makes it an attractive alternative to investment real estate.

As a Physician, the thing you lack the most is time. So if you can accomplish the same or better outcome by investing in a portfolio which involves less of your time commitment, why wouldn't you?