

# Sound choices for potential and existing homeowners.



## There's perception and then there's reality

- Making sound money choices is all about closing the gap between perception and reality.
- As a potential new homeowner or an existing homeowner looking to trade up, it's a good idea to evaluate any real estate decision through the lenses of: **perspective**, **prudence** and **balance**.
- Think of real estate, as primarily for meeting lifestyle needs – not investment goals.

### 1) Gain perspective – price performance

**Real estate's poor price performance:** Over the last 40 years, Canadian residential real estate has only produced an average annual return of 0.2% after inflation. This compares to the Canadian stock market with a very respectable 4.4% after inflation<sup>1</sup>.

REAL ESTATE (after inflation)	S&P/TSX TR (after inflation)	DIFFERENCE in Returns
0.2%	4.4%	4.2%

\* S&P/TSX Total Return Index.

### 2) Emphasize prudence – minimize your risks

**Real estate's ups and downs:** Since price performance can vary widely from decade to decade depending on the rise or fall in housing demand, deciding when you enter the real estate market can elevate or diminish your risks.

**Weakening demand for housing:** 1) Pent-up housing demand from first-time homeowners has been mostly absorbed, reinforcing the likelihood we've passed an important peak in short-term demand; and 2) over the next five to ten years, it's forecasted there will be weakened housing demand related to the slowing of the overall population growth. This effect will be somewhat offset by continuing immigration into Canada, especially the larger urban centres like Toronto and Vancouver<sup>2</sup>.

**Beware of interest rates:** Today we have historically low mortgage rates, but when your mortgage comes up for renewal several years from now, interest rates will more than likely be higher. This can have a big impact on your monthly mortgage payments, especially if you have a high-ratio mortgage (less than 25% down).

### 3) Stress balance – real estate and your other assets

**Balance your assets:** Think of real estate as an asset. In order for you to get a better picture of the balance of your assets, ensure that your real estate holdings are included in your overall asset allocation plan.

**30% rule:** Generally, as a good rule of thumb, the value of your real estate minus your mortgage should make up no more than 30% of your total assets<sup>2</sup>.

**Asset diversification:** Real estate offers an additional level of diversification in any portfolio – however, be careful not to overdo it.

<sup>1</sup> AGF Funds Inc., Bank of Canada, 2004 Clayton Research based on data from Statistics Canada CMCH.

<sup>2</sup> 2004 Clayton Research based on data from Statistics Canada.



## Make a real estate decision tailored to you

Any prudent decision involving real estate needs to be right for you. Below are some simple exercises to help guide you towards making sound choices on real estate decisions.

### A) Ensure your assets are balanced

The large amount of money required to purchase a house means that real estate is part of your overall wealth. It should be balanced against other asset classes – stocks, bonds and cash – to ensure steady, even gains in your portfolio. As a guideline, the average Canadian household has approximately 28% of its net worth in real estate in 2003<sup>1</sup>.

	YOUR CURRENT ASSET MIX		YOUR PROJECTED ASSET MIX	
	ACTUAL \$	%	ACTUAL \$	%
<b>VALUE OF REAL ESTATE MINUS YOUR MORTGAGE</b>	_____	_____	_____	_____
CASH/GICs	_____	_____	_____	_____
BONDS AND FIXED INCOME MUTUAL FUNDS	_____	_____	_____	_____
STOCKS AND EQUITY MUTUAL FUNDS	_____	_____	_____	_____
OTHER TANGIBLE ASSETS	_____	_____	_____	_____
<b>TOTAL ASSETS</b>	_____	_____	_____	_____
<b>RATIO OF NET VALUE OF REAL ESTATE / TOTAL ASSETS</b>	<div style="background-color: #d9ead3; width: 100px; height: 20px; margin: 0 auto;"></div> RULE OF THUMB: 30%		<div style="background-color: #d9ead3; width: 100px; height: 20px; margin: 0 auto;"></div> RULE OF THUMB: 30%	

### B) Ensure your mortgage payments are easy to meet

The ability to consistently cover your mortgage payments with a reasonable safety margin is paramount. Below is a simple way to assess your household's sensitivity to interest rate changes.

MORTGAGE INTEREST RATE CHANGE	REMAINING MORTGAGE DEBT	MORTGAGE MULTIPLIER	EXTRA PAYMENT REQUIRED PER MONTH
1% CHANGE	\$ _____	X .00059	= _____
2% CHANGE	\$ _____	X .00122	= _____
3% CHANGE	\$ _____	X .00187	= _____

Note: Mortgage calculations based on an original 25-year mortgage with a 5% mortgage rate and payments made monthly

### C) Ensure your income can service the debt

Most lenders prefer a homebuyer to not exceed a certain threshold of debt. The Total Debt Service Ratio is the measure of total household debt expenses (existing debt expenses and mortgage payments) and heating costs to total income, and should be no more than 37%.

<b>YOUR HOUSEHOLD INCOME</b>	_____
SUBTRACT: – EXISTING DEBT PAYMENTS/EXPENSES	_____
– HEATING COSTS	_____
– PROPOSED PRIMARY RESIDENCE MORTGAGE PAYMENTS	_____
<b>= YOUR TOTAL DEBT PAYMENTS</b>	_____
<b>RATIO OF YOUR DEBT PAYMENTS/YOUR HOUSEHOLD INCOME:</b>	<div style="background-color: #d9ead3; width: 100px; height: 20px; margin: 0 auto;"></div> RULE OF THUMB: 37%

<sup>1</sup>2004 Clayton Research based on data from Statistics Canada.

