Money Matters

Investing in your home provides psychological benefits

By BRIAN SLESSOR

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Dollars and Sense

So often these days, when people learn that I am an Investment Executive, I am asked to prove why investing in stocks is more profitable than investing in real estate. I find this a difficult task because a house deposit has reaped massive returns in the Toronto Housing market over the past few years. However, let me try and make things a little clearer.

Firstly, I think an investment in your own house is one of the best investments you can make. You generally only require a deposit of 25 per cent of the house value and in some cases even less. This gives you the power of leverage. If you buy a house for $300,000 for 25 per cent down and the value of the house increases by a conservative five per cent a year, you are making a 20 per cent return on your down payment. This is a reasonable return by anyone's standards. On top of that, you get a tax exemption when you sell it, boosting your overall return to an enviable level.

Secondly, I think that people normally spend a lot of time choosing their houses. People rarely buy based on a rumour that the price is going up or a newspaper report that a particular house has become "hot". No wonder people make money in the real estate market and lose money in the stock market. They spend months choosing their homes, and minutes choosing their stocks.

However, this is a time when people start to get carried away with their superior investment performance in real estate. They start telling me that "I've made so much money in real estate, you can't show me a comparable investment in the stock market," or "I'll never invest in anything but real estate." These people then go out and buy a property with their life's savings. They buy another $300,000 house and put $75,000 down. The price goes up five per cent and they make a 20 per cent return on investment. However, now they have the added problems of finding tenants to rent their new investment (not to mention managing those tenants). Also, if it is a house they would not dream of living in themselves, they probably have not spent as much time as they should researching their investment. On top of that, when they sell it, they are faced with a capital gains tax liability (albeit subject of a lifetime $100,000 exemption) and a possible capital cost allowance recapture (ask your accountant about this). There may be additional problems of cumulative net investment losses. All these factors, and more, add up to the fact that real estate investments outside your own home can become messy and are often more sophisticated than you think. I will not even touch upon the problems associated with commercial real estate investments.

There is also one other factor which should be made clear. The power of leverage works both ways. If you have four to one leverage factor on the way up, then you also have a similar leverage factor on the way down. That is, if the value of the house falls by five per cent, your initial investment of $75,000 suddenly becomes $60,000, i.e. a 20 per cent loss on your own down payment. Compared with stocks, it is also much harder to sell on the way down. Put real estate on the market during a decline in prices and you may be carrying it for a long time before the next "maverick" real estate investor turns up to bail you out. In other words, liquidity in the market place is very important, especially during bad times.

Let my try and reinforce these points with some simple historical facts. Firstly, investing in stocks is undeniably more profitable than investing in bonds. In fact, since 1927 common stocks have recorded gains of 10 per cent a year on average as compared to five per cent for corporate bonds, 4.4 per cent for government bonds and 3.5 per cent for Treasury Bills. The long-term inflation rate, as measured by the Consumer Price Index, (CPI), is three per cent which gives common stock a real return of seven per cent; corporate bonds two per cent; government bonds 1.4 per cent and Treasury Bills 0.5 per cent.

If, in 1927, you invested $20,000 in the stock market, you would have $1,200,000 in 1989. This is in spite of the Great Stock Market Crash (1929), World War II, Pearl Harbor, the Korean War, Bay of Pigs, Cuban Missile Crisis, Assassination of President Kennedy, Six-day Middle East War, Vietnam War, resignation of President Nixon, Collapse of Oil Prices and, of course, the much remembered Stock Market Crash of 1987.

Unfortunately, there are few statistics giving the average return on real estate investments *over the same period. This is* mainly because real estate investing is primarily a regional selection and it is difficult to gather this partial information into a representative whole. However, the Canadian Real Estate Association does supply an average Canadian residential house prices and it appears that the average yearly increase from 1956 to 1989 is 8.1 per cent. If we assume that this average holds for the period 1927 to 1989, then a $20,000 investment in 1927 would now be worth $375,000 (adjusted to inflation).

In conclusion, what I am trying to say is that real estate investments are not always as profitable as stock market investments for a number of reasons. Since the stock market has evolved in such a way as to actually help the process of investment through methods such as liquid markets, daily price quotes, accessible research, etc., it is easy for me to say that the stock market is a better investment than real estate. However, having said that, I must also add that you should invest in your own house before contemplating an investment in stocks. This is a recommendation which has more to do with psychology than with economics or investment research.

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