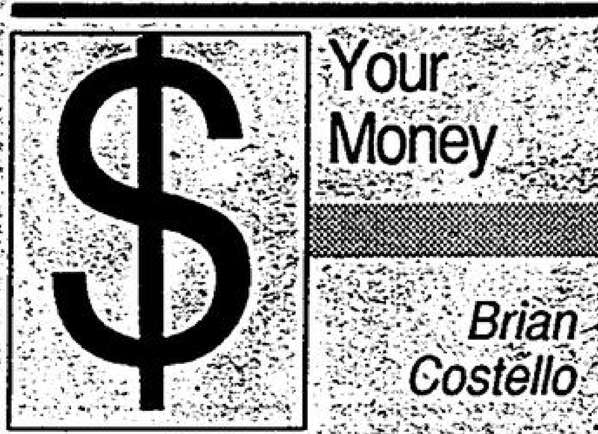
House and growth funds aren't mutually exclusive



While a record number of Canadians have purchased a record amount of mutual funds so far this year millions of Canadians continue to shy away from mutual funds and stocks because they fear they will eventually lose their money.

It's a natural fear especially in Canada where we are generally considered to be a very cautious lot. But, it's the wrong one.

If you've ever owned a house you should also consider stocks and mutual funds. They are all assets. Historically, good quality assets rise in value given enough time. How much is anybody's guess but based on past performance you can expect to make a reasonable rate of return when you own real estate stocks and mutual funds.

The term "reasonable" is important as interest bearing investments don't offer the rates of return we've become used to throughout the 1980s.

The house is a key comparison. Even with a decline in house prices thanks to the recession few people have lost money on their house purchase. And, if you live in it you get an extra advantage. When the value rises, which it almost always does, over a reasonable period of time, you can say that you lived there for nothing. In fact, you made a tax free profit. Everybody, I mean everybody, should own a principal residence. They rise in value, and they do it tax free.

With rental real estate we no longer enjoy tax free capital gains.

However, it's still a popular choice as prices normally rise and you enjoy regular cash flow from rents and tax relief from operating expenses.

The key point though is that we buy real estate because we feel comfortable that we won't lose our money.

For example, let's turn the clock back to 1967, our Centennial year. An average house purchased in Toronto at that time for $24,078 is today worth $214,971 based on the Multiple Listing Service numbers. That's an increase of 792.81 per cent.

Remember, also, that this is tax free if it's a principal residence and much of the gains earned prior to February 1992 would be tax free if this was a rental property. Obviously, real estate as an asset pays off.

As a comparison though, it's important that we consider what inflation has done to the value of our money.

If your $24,078 in 1967 has not escalated to at least $115,475.74 in today's dollars you have lost purchasing power.

That's correct, we've lived through almost 380 per cent inflation from 1967 until now. And, don't forget that taxes will also play a roll here. You need $115,475.74 after tax to match inflation.

One alternative might have been a term deposit or guaranteed investment certificate. According to the Bank of Canada Review a five year GIC purchased in 1967 for $24,078 would today be worth $250,259.31.

That's a gain of more than 939 per cent in the last twenty-five years. Remember though, that interest is fully taxable. The return of the original investment is tax free but the remaining $226,000 is taxable. Just to match inflation you need $115,475.74 so your real profit is not going to be large.

Initially, it looked like the GIC was going to outperform real estate. But, after taxes are considered it's obvious that owning the asset paid off.

Now, let's consider a mutual fund. While there are 700 or so in Canada I'll use Templeton Growth Fund. It has a long and highly visible track record. $24,078 invested in Templeton Growth in 1967 is now worth $1,279,832.76. That's a gain of 5215 per cent over the past quarter century. While you still have to consider inflation you do get some tax breaks with mutual funds. They often pay some interest which would be fully taxable.

However, the bulk of the income from quality mutual funds comes from dividends and capital gains. Dividends qualify for the dividend tax credit that reduces the tax obligation substantially. And, capital gains from stocks and mutual funds still qualify for the $100,000 tax free capital gains deduction.

Many of the capital gains earned in earlier years would have been taxed when capital gains were taxed at 50 per cent of our normal tax rates. Regardless, the numbers are overwhelmingly in favor of the mutual fund.

Here's the part I have trouble with. Many people say they don't want to buy stocks and mutual funds because they aren't guaranteed.

They might lose their money. Yet, they'll buy a house. In this example the mutual fund is now worth five times more than the house.

The mistake is looking short term. Yes, stock markets will go up and down from time to time. But, in the long term assets will outperform interest bearing investments. The trick is looking long term and spreading your risk around.

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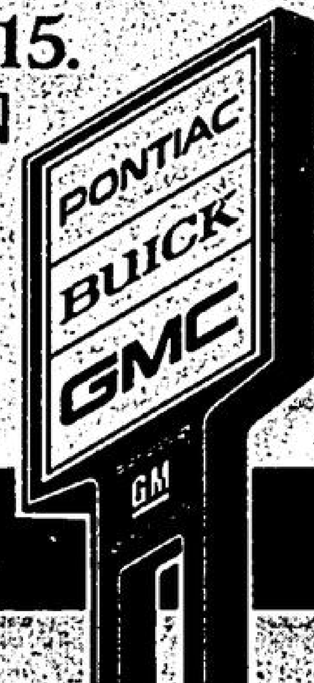

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