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Is Buying a House a Good Investment?

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Intended Audience

Individuals looking to purchase a home for personal use or as an investment. As well, looking into conventional wisdom's statement that buying a house is one of the best investments someone can make.

Summary Points to Take Away

- Why a House is good investment: (1) Forced Savings Plan (2) Leverage (3) Inflation Resistant (4) Tax Free Capital Gain (5) Control over Asset.
- Points against a House as an investment: (1) Lack of Diversification (2) Maintenance Costs (3) Historically lower returns than equities (4) Unavailable to take advantage of other opportunities (5) Limited Scope.
- Additional points to consider if planning on purchasing property for personal use: (1) Doesn't provide any cash flow (2) No tax shelter from interest expense (3) Can get personal joy out of investment.

Analysis

Conventional wisdom states that buying a house is one of the smartest and best investments an individual can make. This article is geared towards challenging this conclusion to see whether this statement rears any truth to it.

Why a House is a Good Investment

Forced Savings Plan

Most individuals claim that the purchase of their personal home was the best investment they've ever made, which is true in most cases because it is the only investment they've ever made. The general public struggles with saving for retirement; thus, purchasing a house assists in that problem as it forces individuals to continuously pay down the mortgage (or lose the house in a foreclosure to the bank); therefore, allows the storing of equity for the owners. This built up equity (i.e. market value of home minus remaining mortgage) can be borrowed against during their retirement years or they can downgrad into a less expensive house in order to provide some retirement funds to the owner. If individuals take a disciplined approach to saving, then the benefit of being forced to save in order to pay for a house diminishes.

Leverage

Typical real estate purchase require only a 5% deposit, while the remaining amount can be borrowed through bank debt. Few alternative investments outside of real estate can the acquirer obtain such significant leverage, which can enhance investment returns.

Example, suppose that you purchased a home for \$200k, for which you made a 5% deposit down (\$10k). During the next few years the house appreciates in value and you sell it for \$220k (10% higher than the level you purchased it). Though the return on the house is only 10%, the return to the investor based on invested funds sunk into the home (\$10k) is **200%** (\$20k earned over \$10k investment) - that is the power of leverage. On the negative side, more debt means higher fixed monthly mortgage payments; thus, higher risk of being able to make the monthly mortgage payments. As long as cash flow is not a concern and the mortgage payments can be met – investments should be leveraged to maximize returns to the investor. Could you imagine walking into a bank and asking for \$100k to invest in equities while only putting 5% down – likely to never happen, this is a major benefit of real estate ownership.

Inflation Resistant

Real estate holds its value during inflationary periods; thus, acts as a hedge against the investors other assets that aren't protective against inflation (ex. Currency). The asset will continue to hold its buying power (store of value), which is difficult to get outside of investing in precious metals. The reason real estate holds its value is there is the same number of houses that the increased monetary supply of dollars are chasing; thus, it'll take more dollars to purchase the houses as the supply of houses stays stagnate while the demand rises (due to the increase in the number of dollars in everyone's hands). This can become critical given the current economic times and numerous expansions of monetary supply across many nations, which will have the aftermath affect of higher inflation.

Capital Gain is Tax Free

In Canada, every home owner is provided with a capital gain exemption on amounts earned in excess of cost for their principal residence. Only one piece of real estate can be claimed as the principal residence per individual. For example, if you owned a home and a cottage, only one of those houses upon selling could take advantage of the principal residence exemption. No other asset class has such advantageous tax reduction characteristics. Unfortunately this is a onetime event; thus, those holding numerous pieces of real estate can only apply it to one property.

Allows for Control over the Asset

Real estate is typically an investment an individual has control over (assuming you're the majority owner – which is typically the case) by the means of the owner has the ability to increase the value of the asset, which may not be the case in most other investment opportunities. When purchasing real estate, owners can make capital improvements to the home (ex. Finished basement, new porch, etc.), which will increase the value of the property (capital appreciation) as compared to purchasing stocks or mutual funds as assets where the owner can't take action to increase the value of those assets (unless they're a significant owner, greater than 20% - which is typically unlikely). The ability to control an asset adds value to the owner through what is known as a control premium, as a real estate asset may be more valuable in the hands of some individuals over others.

Why a House is a Bad Investment

Lack of Diversification

Average individual thinks the stock market is very risky while investing in real estate is more of a certainty. Purchasing equities allows the owner to conveniently hedge their risk amongst various companies in numerous industries, countries, etc. The purchase of real estate doesn't provide the ability to diversify risk away as easily unless an investor plans on owning numerous pieces of different types of properties (ex. residential, commercial, resorts, etc) across various markets (North America, Europe, etc) – which is probably very unlikely for the average investor. Purchasing real estate prevents the diversification of risk because it's dependent on the economic, migration, and regulation trends of the local area.

For example, assume you purchased a home in Oshawa, Ontario – which is a town extremely reliant on the large manufacturing facility of General Motors (GM). Should GM cut back on production or move their facility housing prices would fall sharply as it is the biggest employer in the area; thus, demand from individuals will decline as unemployment rises and real incomes fall. With a decline in demand and supply staying stagnate (as you typically can't "un-build" a house once it's constructed) the price will have to shift towards in order to align demand with supply.

Real estate doesn't allow the investor to diversify away the specific risks in the local area as compared to purchasing equities, which allows the investor to spread risk amongst investments that perform differently during different points along the business cycle. Most individuals when purchasing real estate have all their eggs in one basket.

Maintenance Costs

Transaction and maintenance costs are significantly higher for real estate investments than stocks, mutual funds, etc. When purchasing stocks costs are typically broker commissions (\$20 per transaction if using an online discount broker), while when purchasing a home it is typically 2% commission on the transaction value, significantly higher than purchasing equities.

Once you purchase shares, no further cash is required from the investor unlike real estate, which requires constant annual expenditures that continue to increase the investors cash committed towards the property, such as property taxes, insurance, utilities, maintenance and repairs of the asset, etc. These are costs that real estate investors or

home purchasers don't factor into their expected return, but play a significant role as the payment of property taxes (etc.) doesn't contribute to the value of the property for eventual sale in the hopes of capital appreciation.

Historical Lower Returns Compared to Equities

During any 20 year period throughout history, no other asset class has outperformed equities, which includes real estate. This is from the perspective of asset vs. asset without consideration of leverage and how that may enhance returns (as discussed earlier). While it is true that over the long run real estate prices go up in value, this is typically due to inflation incurred. Recent spikes in housing prices seen in the past 10 to 15 years has been due to changing demographics, specifically the baby boomer generation (who makes up largest segment of the population in North America) go through life stages at the same time (same goes for starting a family and purchasing a home and real estate investment property). The result was a large influx in demand without a corresponding increase in supply as construction requires lead time; thus, leading to rising real estate prices.

Will this high demand continue? That's where the argument lies. Likely there will be softness felt in overall real estate demand as baby boomers already have their homes and they're likely to either stay put, move to retirement homes or downgrade into a smaller place in order to obtain some retirement income. Immigration will continue into North America that will prop up demand, but likely not the extent to fulfill the whole in demand left by the baby boomer generation; therefore, the future appreciation in real estate properties is likely to flatten out.

Can't Take Advantage of Available Opportunities

The purchase of a home or real estate property requires the individual to tie up a significant portion of their net worth into the property (in a lot of cases, all of it). Having all your net worth in real estate is a risky strategy as you'll be severely impacted by movements in real estate prices as compared to having your cash tied up into several asset classes; thus, less vulnerable to swings in any one asset class. Similar to the discussion had under the "diversification" section of this article.

With the majority of an investor's net worth tied up in a real estate property, there isn't available cash to take advantage of other opportunities that come along; thus, significant opportunity costs are involved in venturing into real estate. This should be considered before purchasing an expensive personal home or making a real estate investment.

Limited Scope

Real estate is a local good, unlike gold for example – which can be bought and sold throughout the year for the same market price. An individual looking to buy a personal home or make a real estate investment doesn't have access to all available properties as there are physical limitations to contend with. It comes down to wanting to live where you grew up or currently work or not wanting to buy a rental property far from your home in order to reduce logistical issues. For example, if you live in Toronto, Ontario and are looking to make an investment in a rental property, you're unlikely to consider properties in Paris, France though the opportunities may be better than those surrounding Toronto due to language and logistic issues. Equities (and etc.) are globally traded and available; thus, users can take advantage of opportunities around the world; thus, their scope is not limited to the local area of their current surroundings like real estate is.

Additional Points to consider if you're purchasing a Home for Personal Use.

Doesn't Provide Any Cash Flow

An asset typically provides you with cash flow, i.e. puts cash in your pocket. When purchasing a home, cash only flows out (property taxes, repairs, etc.); some would argue that if it appreciates in value then it is an asset. In this instance it is only an asset when converted into cash and if that is the case, where will you live? Likely end up buying a new house, which has also gone up in value similar to your house. This makes it difficult to realize the value of your personal home appreciation, which acts more like a liability than an asset since it takes cash out of your pocket instead of putting some in there.

Tax Deductibility of Interest

Interest expense paid due to bank loans taken to finance investment properties is deductible against income because the investor is pursuing income and tax legislation allows deduction of any expenses incurred in the pursuit of income. This is not the case for a mortgage taken out to purchase a house for personal use as the individual is not in the pursuit of income; thus, interest expense is paid with after tax dollars, with no tax shelter provided. If those funds had been borrowed to invest in equities or mutual funds, the interest would be deductible because again that would count towards the theme of pursuing income.

Can Get Personal Joy Out of It

Unlike equities and other alternative investments, the investor can't personally use or get joy out of it as compared to purchasing a home, which the individual can live in and enjoy during the investment process. An investor who purchases shares in General Motors (GM) can't exactly borrow and test drive cars whenever they please simply because they're a part owner. This is a qualitative benefit that is difficult to quantify, but should be considered.

Where to go from here?

The main reason to purchase a house is to have somewhere to live and enjoy their life, don't think of it as an investment. Buying a home isn't a bad decision; it is the investor's perception that may be tainted because it is important to realize that there are many arguments against a home as an investment to be considered. Don't buy real estate property with the mindset that an individual can't lose and that there is no better investment opportunity than to purchase a home, etc. Beware of conventional wisdom that states there is no better investment than purchasing a house.

Would love to hear your feedback – contact thatstockguy.NET@gmail.com .

Thanks,

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