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How Much Real Estate is Too Much?

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This is a topic that I have waited to write about – if you have followed my writings for a while you know I regularly write about real estate planning and your financial plan. For most Canadians, this is the largest purchase you will make in a lifetime, often tied to a mortgage which may be the largest debt of your lifetime. With real estate as the centerpiece of your financial plan and a very big ticket asset within your net worth, it is shocking how few financial advisors talk about real estate in their planning with you. Well, we do – and it is this comprehensiveness and integrated planning that continues to set our practice apart in Canada. From buying your first home at 30 to upsizing at 45, downsizing at 65 and selling a home in an estate when you are gone at 105, real estate is central to most Canadians' financial planning. Some of you own several pieces of real estate. Some of you want to own more. Some for personal use. Some for business purposes. Real estate is a topic of discussion with almost all of our clients – all starting with your goals – your financial goals, over your lifetime.

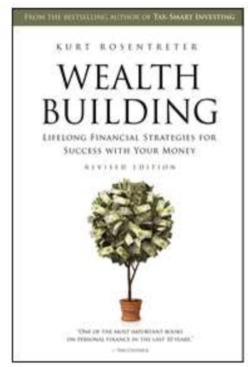
This edition of my newsletter is very important. I hope you will pass this copy to everyone you know that cares about real estate and their finances. The goal is to stimulate discussion and a focus on your goals (you have your financial goals written down right? You should!) as we walk through a partial list of real estate issues to consider. The list of considerations (legal, tax, financial, emotional and practical) are beyond one newsletter. If we hit a note with you, feel free to contact us for a consultation on your real estate and broader financial plan.

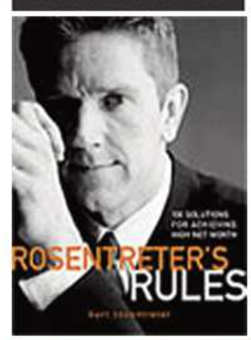
Owners Have Done Well

As real estate ownership boomed in Canada over the last ten years, the rising tide of higher and higher home prices lifted everyone's boat , meaning your home, as it became worth more and more in record time. Perhaps due to buying fueled by population growth. Perhaps and more likely buying fueled by the lowest interest rates in decades and easy access to credit. Whatever the reason, residential new builds, condominiums, existing home renovations and anything tied to home ownership has seen a record growth boom over the last ten years. Homeowners of all kinds, coast to coast have benefitted from an increase of wealth not matched in recent years.

"Kurt, my best investment has been my home" is an easy statement for all long time home owners in Canada to make right about now – we have seen record rises in home values across the nation, in some cases seeing your home value double or more. "Beats investing in the stock market" has been an easy and correct claim to make as the TSX Index has a negative return over the last five years (as of February 28, 2013) while real estate, almost any real estate in Canada, has gone straight up. It has caused some to become "drunk" with real estate – leveraging the equity in one property to buy another and another. Flipping properties briefly renovated with Ikea furniture for hundreds of thousands of new profit in three months. Record commission levels for real estate agents working hard to help transition home owners. Investors from the other side of the world buying entire floors of condo towers sight unseen. Young professionals

Kurt's National Best Selling Books





committing hundreds of thousands of borrowed money to buy a condo in three years that is a hole in the ground today. More cranes in Toronto building new condo towers than in Los Angeles or Mexico City, cities four times bigger.
As we stand here in March 2013, your real estate sits valued likely at the highest price ever.
This edition of my newsletter is about your next move with this real estate.

What are your Goals?

The preparation of a financial plan always starts with your goals – short term, medium term and long term. I'm always flabbergasted when I hear from Canadians that their broker, insurance agent, financial advisor (etc.) has never asked them what their goals are. Aren't we hiring these advisors to reach your goals? All planning starts with a definition of your financial goals (what the goal is, dollar value and time line) with a regular progress checkup to see how progress towards the goal is coming.

Real estate transactions are often tied to some of our biggest and most important goals as humans and Canadians: the purchase of a first home for a young couple about to have a baby; perhaps they will buy a bigger home in fifteen years as well when they need more space; the purchase of a rental property by a middle aged executive seeking to diversify investments beyond stocks and bonds; a widow seeking a simpler life in her 60's by moving to a condo and selling her bungalow; an elderly couple leaving the family cottage to their adult children equally in their Will – real estate of many types is tied to the fabric of who we are as Canadians. So many of us have real estate as part of our goals. So again, I reflect on the timing of now: March 2013. As you look forward from this point, what are your real estate goals for the rest of your life? What about in the next 20 years? How about the next five years? If you have a spouse do you agree on these goals? Have you written down these goals to focus on them and create accountability? Have you priced them out? Have you talked about these goals with your financial planner (us)? Do you know if these goals are possible? How will you know if you don't have a plan?

Life is About Trade-Offs

Let's now dive into some of the thinking on this.

The title of this newsletter is "How Much Real Estate is Too Much?". That is the question – in a country where people now own a lot of high priced real estate, carry huge mortgages, have bought cottages, investment condos, REITs and private mortgages tied to real estate - how will all this real estate contribute to your main financial goals? In all the good that has happened to your real estate investments so far, how will you play your next card? And, as I wish to discuss in this newsletter, let's start with focusing on the rest of your financial goals that you wish to achieve over the rest of your life to help answer this question.

If your home or other real estate may now form 60%, 80% or even 100% of your net worth (net worth is assets less liabilities), how will this real estate need to adapt over time (the rest of your life) to achieve your goals?

Let's look at the two major goals that many Canadians share: raising a family and paying the child's costs to adulthood and second, retirement from somewhere around age 60 and lasting to as late as age 100 for up to two spouses.

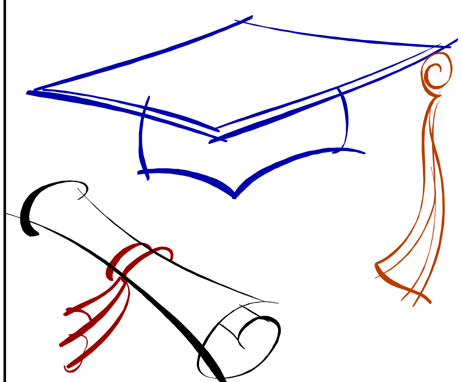
Raising Children…or not.

One of the major goals in many of our lives is to have a family, raise the children to adults and give them a helping hand on their way out of your nest. Often the timing of your first home purchase, the type of home, numbers of bedrooms, location for schools and more has goals related to children weaved into your thinking. As children age and need their own bathroom you may buy a bigger home or renovate. And as children move out for good you may reduce the size of your home or sell a cottage or property in Florida that will no longer be used as much. And when you die you may leave your home, a cottage or a rental property to your children heirs.

Along the way, as you age, many of your real estate decisions are affected by these family matters. And, if you never have children, clearly the decisions for real estate are not impacted by these emotional variables. This is equally important as you will decide to allocate capital in different ways.

From my perspective as a financial planner, while children are a major factor around real estate decisions, I would suggest they are not the driving factor – in the end, it is your choice, your emotions, your finances and your overall goals may override how your real estate will evolve with the growth of children. For example, if you would like a vacation home to spend summers with the kids on a lake, you will not make this purchase if you cannot afford the cost of the second home. Financial logic trumps emotional goals in this case. Not always though – children are a powerful emotional force and adults can often make significant financial investments (e.g. private school) that have significant financial tradeoff consequences.

And, looking at children's financial goals specifically as one of the major goal sets of the lives of many Canadians, I would also conclude from my experiences that the children's goals will not be sacrificed if something else can be – children may go to private school costing $30,000 / year even if that money could have paid off the home mortgage ten years sooner; and the children's post secondary education cost of tuition may end up on your line of credit because your children deserve an education even if your own retirement will have to wait. Perhaps it is as simple as timelines – their goal came before yours does so you pay for the first one first. Or perhaps in the end, you will sacrifice yourself and your own future because you love your family and you put their goals first. I particularly notice this with Canadian immigrant families that will put everything into their children's futures even if it means they will have to work to age 75. This doesn't stop with school costs when then are age 18-25. Often parents will find money to pay for a wedding or two and chip in savings to help with the down payment on their children's first home purchase. We do a lot for our kids – in many cases it results in some trade off you are prepared to make on your own finances. That's fine, but have you quantified that impact and how far your own tradeoff will have to go? Playing this day by day is reckless. None of us are a bottomless pit of money – when will you finally kick adult kids out of the house? How long do you fund the eternal student that is 28 and still not employed and independent? Can you afford $10,000 or $100,000 to help the kids with a home deposit – all three of them? In what are heavily emotion laden decisions that can even have spouses turn against each other, the objectivity of a neutral financial planner to sort through the factors and pull it all together alongside you can be critical to getting through this. This is where planners add value to your finances – picking mutual funds or stocks pales in comparison to the importance of getting decisions like this right. Sometime putting the psychology of financial decision making in perspective and in sequence is more important that the stock market – or even real estate, the topic of this newsletter.



So let's ask a big question: do you have all the financial means to achieve all your real estate goals (e.g. buy a home and pay it off in 25 years or less, buy more real estate, renovate, etc.) and achieve your children's goals at the same time (pay for post secondary school costs, weddings, home deposits) and raise a family of several children for the first 18-25 years? I am not asking if you can afford to have kids – I have no right to ask that question – I am asking if your financial math is adequate to achieve all of these personal goals in two key areas of your overall financial plan: family planning and real estate. The home purchase could cost you $500,000 today – plus the mortgage interest could cost you another $200,000 by the time you are done. Raising a child to age 18 will cost you tens of thousands of dollars – hundreds of thousands if the kids go to private school. The cost of an out of town university is now approaching $100,000 in 2012 dollars. If the cost of three kids and paying for a house is over a million dollars of after-tax earnings, can you afford all this in a twenty year window and if not, what will you give up? The answer is less important than the process to find the answer – the process is math, analytics, conservative assumptions and forecasting – you need an accountant hardwired with these skills not a stock broker that can't add and calls a standardized sale document, spit out by a software program, a financial plan! Financial planning and reaching your goals has little to do with investing and investment products in the end – but the investment industry doesn't want to hear me say that because they are ill-equipped to help you actually sort out the real planning guidance you actually need. They just want to sell you something. Bad idea.

To digress for a moment, let me define all the areas of everyone's financial plan: retirement, children and family, career finances, taxes, estate, insurance and risk management, debt, investing and real estate. All bound together by your evolving goals and cash flow. Together this is one plan for your finances: a financial plan – and it is all integrated.

Answering my big question how much real estate is too much is done at least partially through equations, forecasts and math: what are your incoming resources from pay cheques or investments over decades, what are the taxes you pay on earnings yearly, what are the goals you have (in this case, helping children well into adulthood vs. real estate ownership) and what are your annual spending levels. Some of the challenges we are seeing families deal with in this area today are:

- Large mortgages attached to homes in major cities that are leaving young families short of money for full RESP contributions for all of their children each year - money that would go towards post secondary education in the child's future. Big mortgage debt sucking the life out of families cash flows today and for years to come – is this the price we pay to own a home today? No money for any other goals?
- Parents unwilling to downsize their home or sell the cottage or rental property to pay for a child's wedding, pay for an MBA for the child, or to keep the 20 something child out of student debt. While this point may surprise you (few parents are selling their home to pay a kid's debts), perhaps this outside the box thinking is overdue – again the title of this newsletter is "how much real estate is too much?" If a significant part of your net worth is tied up in one big, expensive asset, and it is tax free, how important are your children to you – that is the focus of this point – and perhaps repositioning real estate at the highest value you have ever seen is an opportunity to accomplish more of your other goals away from real estate. Food for thought. Let's move on.

Retirement

Perhaps the single goal that most of us have in common is the desire to one day cease our day to day careers, kick back, relax, perhaps travel and live off pensions and savings for the final one third of our lives. In the olden days , mom and dad retired on Dad's indexed defined benefit pension of $22,000/year from the factory where he was employed 35 years and they spent the last fifteen years of their life fitting their lives into that $22,000/year. Their home (an actual home on the ground) was paid off long ago and generally they died in their home. They had one car. Vacations were camping. They died with all their savings untouched, spending little of it in retirement. They made life work from the one pension, CPP and some OAS.

Let's fast forward to today and compare notes:

- Today's white collar Canadian 50 year old couple or individual:
  - Is lucky if they have been employed with the same company ten years.
  - Has no pension.
  - Has no indexed retirement benefits of any kind.
  - Lives a free-spending, higher-end lifestyle compared to past generations – and has no plans to cut back just because they get older.
  - Is far from debt free after signing up for the biggest mortgages in history.
  - Those interest rates on the mortgage can only go up – making payments bigger and bigger and pushing their debt free date farther and farther out.
  - Two, three or four kids are living at home longer and post secondary education is easily costing $100,000 for four years of a major university out of town.
  - Has at least two vehicles - but we pay the insurance for our kid's cars too.
  - One vacation can cost as much as a small car used to.
  - Our retirement will be easily 15 years longer because we are living longer as a society.
  - And last but not least….we have our home…..our big, expensive real estate that has gone up so much lately.

My point is that it is a different world today – we all know that – but perhaps I have laid it out in such vivid contrast that you got a chill up your spine – thinking that retirement on our terms (key words) may now have just become…..unaffordable all together. Is the word "retirement" a thing of the past for many?

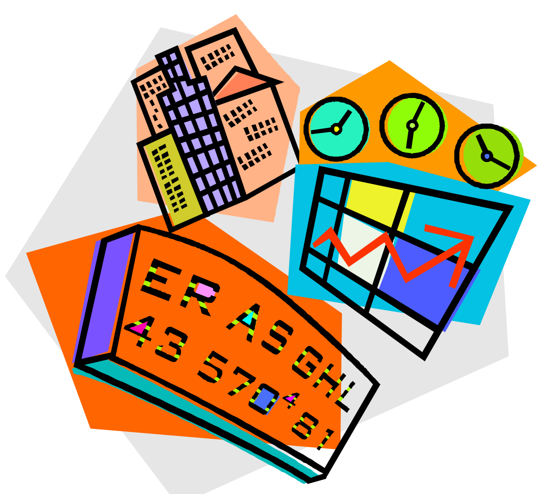
But then there is your big, expensive home – the point of this article. What do you do with the huge amount of value in the home? And when is too much tied up in one asset?

Let's answer this question from a risk perspective first – 80% of your net worth is tied up in one asset – worse, you may also owe hundreds of thousands in debt, and interest, related to this one asset. A lot of your earnings have also perhaps gone into renovations – you have bet the farm on this real estate and wonderfully it has paid off. But from a risk perspective where common financial theory says not to concentrate your eggs in one basket you are now in this position – the question is, what are you going to do about it? 99% of Canadians will do nothing – I need to live in my home they will say – nothing is safer than real estate, I'm not changing anything. I expect this answer – it is often hard to change one's thinking when all you see is rainbows under the current plan.   But we all at least need to acknowledge that we do carry an inherent risk of concentrating our wealth into one asset class that could theoretically bankrupt young families who may not be able to carry their mortgages at 8% interest rates in ten years or materially affect the quality of retirement for today's middle aged Canadians counting on this asset to be their pension of the future.

That brings us back to this goal of retirement that we are discussing in this section – reflect back on my points about discussing how different your finances are from Dad's or Grandpa's. For many Canadian families today in their 40's and 50's, their real estate is all they have – you cannot retire today on $200,000 or even $400,000 of retirement savings and hope to have a quality of life anything close to what you have during your working years – you need a bigger asset base to live off of if you don't have a big defined benefit pension as your base. And 75% of Canadians no longer have that safety net. You are on your own. The meager savings plan at work will never add up to enough.

So here is where the rubber hits the road.
Your home is worth the most money in history. So is your cottage and your investment condo. Where do you go from here?

Your retirement RRSP accounts are lagging – perhaps because of the stock market (TSX is still negative on five years as of February 28, 2013, bond and GIC yields are barely 2%/year) and partially because you haven't been saving the 20% of your gross income per year that you need to save in order to generate the base of savings to provide for the retirement you want (note that everyone can afford to retire at 60 – but I keep saying "on your terms" because I doubt as your planner you want me to tell you that retirement will work if you move to rural Canada, drive one car, only have 10 cable channels, camp for vacations and live in a small house for the rest of your life – we are not our parent's children. We are boomers with high expectations forever!)



In Canada today I see a tremendous imbalance among middle aged Canadians. We are real estate top heavy due to the success with real estate – and we are light on assets that can generate an income for retirement. With most Canadians preferring to keep their primary residence indefinitely and keep the cottage forever, the old adage of downsizing real estate at retirement is a myth. And if there is any downsizing happening it is immaterial – folks are selling their $600,000 home to buy a $500,000 condo. Pointless. So little is freed up to add to retirement savings that you may as well stay put. This situation is called "asset rich, cash poor", meaning that most of your wealth is tied up in assets that may be good assets but they don't produce an income in most cases – we cannot buy food with your eaves trough.

Knowing this, how will you proceed to plan your retirement?

If you don't save enough for retirement, you have two choices: i) plan to work to age 70 or so – and pray you don't have a health issue that forces retirement before you are ready. This will hopefully give you all the money you want well into the healthy phase of retirement (generally ends around age 80) and pushing awkward financial decisions well into the future; or ii) be forced into downsizing the real estate at some point and hope we time it right (top of the market again, like it is right now possibly) – the question of how far the downsizing will need to go depends on how much the property is worth, what savings you do have and how much cash flow you want to convert this into during your retirement years. Again, it is back to math, analytics, goals and time – we will all have different answers to these questions. This is nothing more than a healthy discussion of some of the issues (note I say some). The important message of this newsletter is a reflection on retirement, where are you at in funding it, what will it cost and what role will the real estate you own play in your retirement finances. Do you want to be forced into real estate liquidation at some point to buy food or do you want to control your financial future separate from real estate? Where are you at with all of this? Your real estate is likely your most valuable asset today – how will it fit into your retirement when it may have a bigger role to play than your RRSP does?

Our American Friends

I think it is important that we reflect on what happened with residences in other countries in the last five years. We have all watched as the US real estate market, a market that is ten times the size of Canada's, was crushed and fell more than 50% in value starting in 2008. News reports are only now saying that the US real estate market has finally bottomed five years later. Thousands of people lost their homes. Many more hold mortgages far larger than their real estate values.

While I doubt that such a deep correction would happen again (it was enhanced by inappropriate lending practices), it is prudent to ask yourself how your life (financial life) would change if you experienced a 20% drop in value of your home or other real estate next year – any financial plan starts with risk management upfront and this is one element of risk management. If you can say there would be no impact, then carry on, all is good perhaps, you'll be fine. But if a 20% drop could affect your goals – affect your ability to retire, affect your ability to make a mortgage payment or more, I ask that you reflect on that point and take steps today to reduce this risk. Defense before offense when it comes to the strength of your financial core – and your real estate is a big part of your financial core. Canada is a little country on the global scene – we dodged a bullet with our real estate in 2008 but a direct hit to our small market could be deeply felt by homeowners. Many call our real estate market overheated for the moment and it is prudent to reflect on perhaps your most valuable asset, your goals, priorities and the milestones you may be facing in the short term future (e.g. retirement).

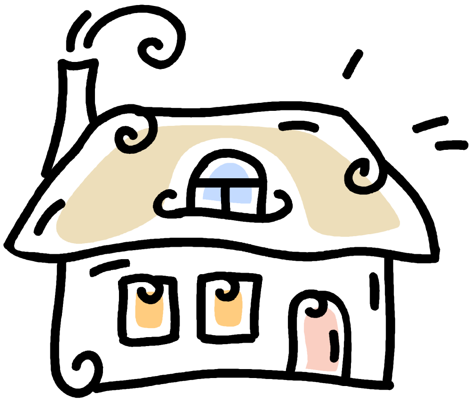
Other "Thinking Points" When Contemplating Real Estate Investments

Have we reached a point in major Canadian cities where real estate is now too expensive for the average Canadian (blue collar and white collar) to purchase ever? Have we caught up to London or New York where people rent for life? While Canadians view home ownership as a birth right, drowning in debt for 30 years and compromising all your other goals is no life at all. We don't seem to get this yet – I see it every day though – families that haven't taken a vacation in five years because there is no money. Old cars. No savings. Just big, big mortgage payments. While I do think home ownership is an important element of net worth, there also needs to be balance across all of your financial plan. Having 60% go towards debt financing is way too much. So is 40% of net pay. How much of your net pay goes to mortgages and lines of credit? What happens if interest rates double in five years?

Ok, don't like that idea – what about renting throughout retirement instead of home ownership? Besides the simplicity of letting someone else deal with ownership issues, it should generally be cheaper to rent than to own. If your goal is more cash flow for travel and leisure, then renting could enhance cash flow. Sure you give up the potential for tax free capital gains if a home you own rises in value but so what? You might be 70 years old now and how are you going to benefit from that? Your estate and heirs will perhaps – but are you prepared to live with less while you are alive to leave your kids more money when you are gone? I guess this can be a goal but I'd really prefer to see you enjoy life more now.

Considering a purchase of US real estate? Be careful – get professional tax and legal advice before you consider a purchase for personal use – U.S. estate taxes for example have approached 55% in the past and they apply to US real estate assets even if they are owned by a Canadian citizen. Are you planning to rent out your US real estate for the hope of profit? You may need to file a US tax return yearly and you may need a corporation- the cost of this legal and tax work annually may exceed your profits so talk to specialists in cross border planning before you buy anything.

Do you own a rental property in Canada and are you producing a loss because of a big mortgage interest costs? Note that CRA changed the rules on how they look at rentals with losses a few years back – they now expect to see your business plan showing how you will make money on this investment. Gone are the days of just writing off losses indefinitely. You can't do this anymore and if you still are, you risk getting reassessed for multiple years in the past.



Thinking about giving your cottage to the kids now? Don't do it. Any gains on the cottage market value are taxable at the time of the gift to your adult children. You would owe the full taxes on the property gains next April. Plus it can be a dangerous idea if your son or daughter gets divorced later in life.

Thinking about leaving the cottage to the kids when you die? Think again. Joint ownership of real estate between families with different goals and financial means is a powder keg for family destruction. Either use a family trust with specific buy/sell rules for death, disability and the other reasons or force-sell the cottage on your death.

Thinking about giving private mortgages to friends, family or strangers? If you do this, get it all properly drawn up by a lawyer and never, ever agree to a second mortgage position. Even if it is your children – if a child gets divorced you may need official legal documents to have the debt stick.

Thinking about investing in a private mortgage pooled fund that has paid out 8% a year for what seems like forever? Be careful – these products look good when real estate times are great and that's all we've had for a while. But danger when times turn tough – remember, they can afford to pay you 8% because they are lending your money to people who cannot get normal financing – people without credit records, have past payment issues or organizations taking risks. With private mortgages you have no protection, poor liquidity, little transparency and in some cases no audited financial statements to even look at.

What makes your home tax free when you sell or die? It's a rule in the Income Tax Act called the "principal residence exemption" that permits one residence to be tax free if it is where you ordinarily inhabit. Weekends at the cottage would not pass this test and if you have a bigger capital gain on the cottage than you do on your city home then I advise you to talk to a tax professional about how to understand the PRE rules clearly. These tax free rules have changed a lot in 40 years and if you have owned real estate that long you need to hear how these rules work before you sell or prepare a Will.

Are you a young couple thinking about using the Home Buyer's Plan to come up with money for a deposit on your first home purchase? I'd rather you not. Actually I'd prefer if the HBP didn't exist. Taking money from one goal (retirement) to fuel a more immediate goal (home purchase) is a tradeoff that I don't think is wise. Your retirement savings need the money just as much as you want to buy a home. Depleting the RRSPs for as much as 15 years will likely set back your retirement. All this program does is effectively let you 100% finance your home purchase – welcome to America and too much debt – there is no way this can be a good idea.

Thinking about buying a rental property to supplement your retirement nest egg? I like this idea – rental income can be steady, like a pension for your retirement. Rents can be raised, offsetting inflation, another good thing. The tenant pays your mortgage and I feel this can be prudent use of leverage. But I don't like rental properties if you are not the handy type (property managers take up too much of your revenue), if your cash yield after expenses isn't at least 5%/year (because you could just buy a real estate investment trust (REIT) and get this without you having to clean bathrooms), and if you are over 55 and cannot pay cash for the entire property (no point buying a rental to provide cash flow to your retirement if the mortgage for the next 20 years will eat up all your cash flow).

If you have real estate, perhaps a few different pieces (home, cottage, vacation property, business property, etc.) I hope you are very carefully preparing your Will to include advanced tax planning considerations. When you die, each of these properties will have very different tax consequences and the tax impact on your estate can be huge. If you hold any of this through a corporation or a family trust, (or perhaps you should) then this adds to the complexity. If you have substantial real estate holdings it takes estate planning to a whole new level of complexity: legal, probate, income tax, estate taxes, emotion, attitude, boom! You cannot just leave assets to the kids and your spouse or second husband and hope it turns out well.

Conclusion

Real estate – land, buildings – they are some of the most expensive assets you will own.
My only goal in this edition of my newsletter was to demonstrate the complexity to which real estate is part of our entire financial plan.
There are layers of discussions related to real estate planning – make a list of all the facts, alongside a list of your financial goals. They may change ten times before you die, reflecting on the need to update your plan regularly as well. Give us a call – let's start the planning discussions together now.

We hope you found this information useful as a learning tool. We are committed to transparency, education about finance and goal based planning. If you have any questions about this document or about our practice in general, please contact us at your convenience.

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