HOW HOME EQUITY CAN BE A KEY PART OF YOUR AND your family's *financial future*

***by* PETER KINCH**

DOES REAL ESTATE PLAY A ROLE IN CANADIANS' financial plan and/or should it play a more important role? As we grapple with ongoing concerns about taking on more debt, there are a few other realities that cannot be ignored:

1. Canadians are sitting on an unprecedented amount of home equity
2. Although many may be "house rich," they have growing concerns about their financial future and that of their children.

Can your home equity be part of the solution?

Let me share the story of a client of mine – we'll call him Dave.

Dave is in his early 40s with a house and young family, works in a great industry with a well paying job, but like many Canadians he has concerns over long-term job security along with his long-term pension needs. He has allocated some savings to his RSP and other investments, but has decided that buying one or two rental properties would be a great way to supplement his current pension.

Of course, a big question was affordability. Since Dave lives in a suburb of Vancouver, a greater concern was the inability to find a positive cash-flowing investment property, given the high cost of housing where he lives. I suggested that he review his family budget. We looked at how much money he could afford to invest on a monthly basis over and above what the family was currently spending. His answer was between $300 and $400. How can anyone afford to buy a property with only $300 or $400 a month?, you may ask.

Let's consider the following:

Let's assume we chose a conservative long-term investment vehicle – a bond, GIC, mutual fund, stock investment – whichever you prefer. It would likely look something like this over a 20-year period:

- $300 cash (out of pocket/part of your family budget), every month for the next 20 years
- Total cash out of pocket invested over 20 years = $72,000
- Value of the $72,000 invested over 20 years = Depends on the average annual rate of return, but if you were lucky enough to earn an annual average of eight per cent, you would have between roughly $164,000 and $178,000 to add to your pension

Remember, these calculations were based on the fact that:

a. Dave feels the need to supplement his current pension with an investment, and
b. He is willing to invest at least $300 a month for the next 20 years out of the family budget

Now let's take a different approach to looking at real estate as an alternative option.

Dave, his wife and I sat down and analyzed the following:

- Dave currently has a home valued at $600,000
- The mortgage is $290,000
- Dave will qualify to refinance the home to 80 per cent of its value = $480,000
- Potential new mortgage – existing mortgage = potential accessible equity. In Dave's case, this is $190,000
- I don't want Dave or his wife to feel that they are over-leveraged, so we'll only use $100,000 of the accessible equity
- We set up a new mortgage/line of credit on their home based on 65 per cent of their house value, an amount both Dave and his wife are comfortable with
- This structure provides Dave with $100,000 of "investable capital" from his home equity
- Dave can use the $90,000 as a down payment on a $400,000 rental property and keep $10,000 from the LOC to place in a contingency fund

You may be saying that this is going to cost a lot more than $300 a month. Just the interest alone on the down payment of $100,000 is more than $300 a month. The answer to this is Yes and No. When buying an investment property, the down payment is typically considered the main expense. However, Dave and I analyzed the true out-of-pocket expense of making this purchase.

The first thing you have to realize is the fact that real estate, unlike many other investments, has the potential to create revenue. The amount of monthly rent you can get for a $400,000 purchase will vary greatly depending on the city, so we'll try to be conservative with the numbers we use.

Remember, Dave was willing to invest between $300 and $400 per month additional money out of the family budget. So let's break this investment down to see what the true monthly cost is.

CONTINUED ON PAGE 62...

Let's assume a monthly rental income of $2,000 (which is very possible in many parts of Canada)

- We would access $100,000 from a line of credit on the principal residence
- We would take $10,000 of that and set it aside in a "contingency fund." This is equal to roughly five month's rent.
- We would have a new first mortgage on the rental property for $310,000

Monthly Expenses:

- Interest on the line of credit taken out on the home = $334 (based on rate of four per cent)
- Interest on new first mortgage on rental property = $1,390 (based on a five-year rate @ 3.5 per cent with a 30-year amortization)
- Property taxes = $140
- Property insurance = $100
- Property management (eight per cent of rent) = $160
- Condo/strata fees (if applicable) = $200

$2,324

Assuming Dave's first purchase had the above scenario, he would find himself subsidizing this rental property by about $324 a month. Conventional thinking would say that Dave is "losing" $324 a month on this investment – but I would like to challenge that thought process. Again, assuming the above scenario, the only amount of money that would actually be coming out of Dave's family budget in order to make this investment purchase part of his long-term financial goal is $324 a month. Remember, the key here is to realize that even though Dave and his family are making a down payment of $90,000 to buy this property, the only actual money that is being spent out of their family budget is the difference between his total monthly expenses and the amount of revenue the property is generating every month.

Based on the above assumptions, the purchase of a $400,000 investment property that has a shortfall of less than $400 a month, fits into Dave's investment, long-term planning and budget criteria.

It may seem counter-intuitive to suggest that an investment that loses money every month is a good thing, but let's take a closer look:

- Assuming that the property has to be subsidized by $300 a month every month for the next 20 years.
- $300 x 12 months x 20 years = $72,000. This is the same amount of total invested money that we discussed in our earlier example.

Now, let's see what the end result could be if Dave keeps this property for the next 20 years and pays off the mortgage:

- I'm going to be very conservative and suggest that the value of his property is the exact same in 20 years = $400,000
- Dave and his wife would have a $400,000 asset
- Let's assume that the rent stays the same in 20 years (that's not realistic, so we'll keep the expenses the same for argument's sake)
- Rental income = $2,000
- Non-mortgage expenses = $1,000 (I've allocated some extra to pay off the remaining LOC on the principal residence which was used for the down payment)
- Net income = $1,000 a month

The simple comparison is quite startling:

- You have an alternative investment of $300 a month at an eight-per-cent annual rate of return over 20 years, which = roughly $178,000 with potentially no cash flow or income

OR

- You have the exact same investment of $300 a month for 20 years in an investment property valued at $400,000, which equals a $400,000 asset with $1,000 per month net revenue

Many would-be investors have been scared off from purchasing real estate in major centres such as Vancouver and Toronto out of fear or concern that the investment would have a monthly shortfall. What if we re-labelled the term "negative cash-flow" and instead saw the monthly shortfall as your long term "investment capital"? All you need to do in order to make a sound investment is to determine the maximum amount of "investment capital" that your budget could afford each month and that would act as a filter when shopping for the right property to fit your needs. Keep in mind that in many parts of Canada, a $400,000 investment would actually create a "positive cash flow," which makes the potential returns virtually infinite.

The purpose of this article is not to convince you to buy investment real estate, but to at least think about it. Too many Canadians are passively handing their savings over to investment advisors in hopes that their financial goals will be met. When it comes to wealth management in this country, real estate can and should play a bigger role.

Dave and his wife realized this potential and made a choice that will positively impact their financial future.

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