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LONG LIVE YOUR MONEY

The Case for Renting

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ABSTRACT

This paper explores Canada's culture of home ownership, and offers financial analysis to support renting a place to live as a viable alternative for building long-term wealth. Choosing where we live and how we pay for housing is an extremely important decision; it is often influenced by the perception that renting is a waste of money. Renting has benefits over owning which must be considered. The people promoting home ownership as the only smart decision may not be doing so based on logic. In a side-by-side comparison of a renter and an owner, using a reasonable set of assumptions, we see that a comparable financial outcome can be achieved. All things considered, renting your housing is not a waste of money, and it can even result in a greater accumulation of wealth over the long-term compared to owning.

This report was written Benjamin Felix, PWL Capital Inc. The ideas, opinions, and recommendations contained in this document are those of the authors and do not necessarily represent the views of PWL Capital Inc.

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1 Overview

There is a common discourse in Canada that owning real estate is a bulletproof investment, and renting is a waste of money. This idea is promoted by the real estate industry, the media, the government, and the many Canadians who believe that owning real estate has been their best investment. This paper explores the basis of home ownership's reputation in Canada, and offers financial analysis to support renting as a viable alternative for building long-term wealth.

2 What Drives the Housing Decision?

There are a handful of key factors that determine where we want to live, where we are able to live, and how we pay for our housing.

- **Cost** – Renting is generally less expensive. In every major Canadian city, the average rental cost tends to be lower than the average monthly mortgage payment[1].
- **Location** – Whether you rent or buy, your location relative to your place of work, schools, social networks, and amenities is very important. Due to the lower cost of renting, you may be able to rent in a more desirable location without breaking the bank.
- **Flexibility** – If you know that you will need to move or change your living arrangements for any reason (a new job, a growing family), buying and selling multiple homes in a short time frame can be costly and risky.
- **Psychology** – The desire for perceived security, pressure from friends and relatives, and doing what everyone else is doing can all play a major role in determining where you choose to live, and whether you choose to rent or buy.

There is a financial aspect to each of these factors, and it is that aspect of the housing decision that is not generally well understood.

3 Financial Benefits of Renting

Buying a home is generally accepted as a solid financial decision, but the financial benefits of renting make it an attractive alternative.

Less commitment – It is normal to change housing multiple times through the course of life. This may happen due to the need for more space, relocations for work, or changing family dynamics. The costs of changing housing are extremely low for a renter, while an owner might pay as much as 10%[2] of the value of their home in total transaction costs.

[1] Designed Rental Market Reports - Major Centres. (2016). Retrieved June 20, 2017, from https://www03.cmhc-schl.gc.ca/catalog/productList.cfm?cat=79&lang=en&sid=MyulcTl8y4nkDyo48hoHHUJ4rLXO5ZqCYgFp9hH2iRatfp5lP2zpby4Xqz4JdKr1&fr=1497960975485

[2] Estimate based on real estate agent commissions, legal fees, moving costs, etc.

Predictable cost – When you sign a lease for a rental, you know exactly how much you will be spending on housing. Home owners can usually tell you their mortgage payment, property taxes, and insurance costs, but those numbers are obvious and explicit. Home owners also have to cover maintenance costs to keep their dwelling in good shape, transaction costs when they buy or sell, and the opportunity cost of tying their capital up in a home.

Lower risk – A renter need not worry about the risk of fluctuating real estate prices, problems with the home, or the evolution of neighbourhoods. The cost of maintaining a rental property is usually the financial responsibility of the landlord. If the renter no longer enjoys their home for any reason, they can easily leave at the end of their lease.

No investment illusion – Owners tend to renovate beyond what is necessary for maintenance on the basis that the improvements are an investment in the future value of the home. While this seems logical, it is not. Alex Avery, a real estate analyst and author of *The Wealthy Renter* explains that "The Golden Rule of investing in real estate is that buildings never go up in value. Ever. Period. Only land can go up in value.[3]" Renters will never suffer from the illusion that their housing is an investment.

While these benefits are significant, most people cannot get their heads around the phrase "Why pay someone else's mortgage, when you can pay your own?" There is more to this argument than most people take the time to evaluate.

4 Renting Is Not Throwing Your Money Away

Any time that you exchange your money for the use of something with no residual value, you are paying rent. Some rent is explicit – like when you sign a lease – and some rent is less obvious. The less obvious rent is implicit when you have capital tied up in a home, and is often ignored entirely when evaluating housing options.

4.1 Explicit rent

When you sign a lease for a rental, you are renting a place to live. When you take a mortgage from the bank, you are renting money. Property taxes and maintenance costs are other forms of rent that increase the cost of owning a home. All of these items are easy to track or calculate, and both renters and owners will usually have a good understanding of their explicit housing costs.

4.2 Implicit rent

One of the most common arguments of happy home owners is that when they pay off their mortgage, they can live rent free. It is not that simple. When the mortgage is gone, you are still renting money; you are renting it from yourself in the form of an opportunity cost. If you own a $500,000 home outright, that is $500,000 of equity that could be used elsewhere. Assuming that you sell your house and keep 95% of the

[3] Avery, A. (2016). The wealthy renter: how to choose housing that will make you rich. Toronto: Dundurn.

value after transaction costs, you would have $475,000 to invest. A conservative (50% equity) investment portfolio might have an expected return of 5.1%[4].

$$\textit{Opportunity Cost} = (\textit{Home Equity Value} - \textit{Transaction Costs}) \times \textit{Expected Portfolio Return}$$

Based on this calculation, the opportunity cost of owning your $500,000 home can be estimated at $24,225 per year, or $2,018 per month. Add to that the costs of property taxes (est. 1%/year) and maintenance (est. 1.5%/year), and you are paying a monthly "rent" of $3,062. Renting the house down the street for, $2,000 per month seems like less of a waste when both the implicit and explicit costs of ownership are considered.

5 Why Does Home Ownership Have Such a Good Reputation?

Renting has some clear advantages, and you are paying rent for something whether you rent or buy, but Canadians are relentless about their desire to own a home. The culture of home ownership has likely been propagated by a handful of factors that do not normally get much attention.

5.1 Everybody wants you to buy a house

The real estate industry, the media, the government, and your parents all want you to purchase a place to live. All of them have strong incentives to make you think that buying a home is a smart decision.

The real estate industry – The motivation of builders, real estate agents, and mortgage brokers is obvious: they stand to make money when you purchase a home.

The media – Real estate TV shows do a great job tugging at the psychology of home ownership. They portray house hunting and home improvement as sources of happiness, making them attractive avenues for the home improvement industry to advertise. This is a win-win for the TV channel and their sponsors, but it comes at your expense.

The government – The government's motivation to have you buy a home is less obvious. It may be politically motivated based on Canadians' perceived benefits of home ownership, or a belief that there is some social or economic benefit to people owning their homes. Whatever their reasons, there is little question that the government wants you to be a home owner. There are multiple programs in place through which the government will help reduce the cost of purchasing a home. They also help to reduce the cost of borrowing through the Canada Mortgage and Housing Corporation (CMHC). CMHC makes mortgage lending less risky for the lender, which allows them to give you mortgage financing at a lower interest rate.

Your parents – Many people have family members who are home owners and believe that their home has been their best investment. Whether this is true or not is addressed later in this paper, but your parents' motivation to convince you to buy a house is clear – they think that they are giving you good financial advice.

[4] Kerzerho, R., & Bortolotti, D. (2016). Great Expectations: How to estimate future stock and bond returns when creating a financial plan. PWL Capital White Paper. Retrieved from https://www.pwlcapital.com/pwl/media/pwl-media/PDF-files/White-Papers/2016-03-07_-Kerzerho-Bortolotti_Great-Expectation_Hyperlinked.pdf?ext=.pdf.

5.2 Investment returns are complicated

It is very easy to find anecdotes from happy home owners (maybe even your parents) who bought for some seemingly low price many years ago and now have a home worth hundreds of thousands of dollars. Let's look at a home owner who purchased a home for the Canadian average price of $62,213 in January 1980, and sold for the Canadian average price of $470,661 in December 2016[5]. That is a tax-free 756% increase in value!

To someone who does not fully understand how to evaluate investment performance, this looks like an amazing outcome. To better understand this information, we need to incorporate how long the investment was held, how much it cost to own, and how some other investment did over the same time period. That 756% increase in home value would be a very high return over a 1-year period. Over the 37 years from 1980 through 2016, not so much. It amounts to an annualized return of 5.62%. We can conservatively estimate the maintenance cost of the home at 1.5% per year. After expenses, this investment has produced an annualized return of 4.12%.

For comparison, the S&P/TSX Composite index (an index representing the Canadian stock market) produced an annualized total return of 8.94%[6] before taxes and fees over the same time period. Taking taxes into account (assuming the highest marginal rate in Ontario in 2016 paid on dividends each year, and tax on realized capital gains in December, 2016) drops this annualized return down to 6.34%. An S&P/TSX index fund can be purchased for 0.05% per year, and there are no other costs to own the investment. The index fund's annualized return over the time period would have been 6.29% per year after taxes and fees. These are nominal (before inflation) returns, and inflation over the time period was 3.09%. This means that housing only beat inflation by 1.03%!

For comparison with the $470,661 home in December 2016, a $62,213 investment in an S&P/TSX index fund in January 1980 would have been worth $594,429 after taxes and fees in December 2016. Keep in mind this is also assuming a non-registered investment taxed at the highest marginal tax rate, when in reality an investor starting in 2017 could be using the RRSP and TFSA to invest tax-free.

5.3 Mortgages force savings

All of those people who told you that their home has been their best investment have probably never missed a mortgage payment. There are disincentives in place, like credit ratings, to make sure that missing a mortgage payment is the last thing that you will do if you get into financial trouble. On the other hand, there is nobody to scold you if you stop contributing to your investments when cash is tight. Similarly, some people will get nervous when financial markets are volatile. They may stop making contributions to their investments, or even pull their money out of the market. Have you ever heard of a home owner selling their house because real estate prices are down? People tend to be far more risk-averse with financial market investments than with real estate investments. Due to the discipline that is built into mortgages, and the general lack of discipline with financial market investments, it is likely that the average home owner has built more wealth in their homes than in their investment portfolios. This common experience likely furthers the positive reputation of home ownership.

[5] Canadian Real Estate Association
[6] S&P Dow Jones Indices

5.4 Canada has high mutual fund fees

One of the reasons that Canadians might prefer investing in their homes rather than financial markets is that they pay some of the highest mutual funds fees in the world. Mutual funds are an important part of most Canadians' financial mix. As of 2015, the average Canadian mutual fund fee was 2.35%[7]. If we revisit our previous comparison between real estate returns and financial market returns with this fee in mind (as opposed to the 0.05% fee on an S&P/TSX index fund), then the financial market investment lags behind the growth rate of real estate. With high fees leading to poor average investment performance in Canada, housing may have truly been a better alternative for many Canadians in the past. More recently, low-cost investment options like ETFs and index mutual funds have emerged, making financial market investments far more competitive.

6 Does Renting Make Financial Sense?

So far, we have seen that there are financial benefits to renting, you are paying some form of rent (interest, property taxes, opportunity costs) whether you rent or buy, and the stellar reputation of home ownership may not be based on logic. What most people want to know is this: which option is better financially in the long-run?

6.1 A brief history of real estate returns

The Canadian Real Estate Association has data on Canadian real estate prices starting from 1980. The data shows an average annual real (inflation adjusted) return of 2.53%[8] from 1980 through 2016, while Canadian stocks returned 5.85%[9] after inflation over the same period. There are much longer data sets available for U.S. and U.K. real estate. Between 1900 and 2014, the average annual real return was 0.3% for U.S. real estate in USD, and 1.3% for U.K. real estate in GBP[10]. Between 1900 and 2015, U.S. stocks produced an annualized real return of 6.4% in USD, U.K. stocks 5.4% in GBP, and Canadian stocks 5.6% in CAD[11]. Past performance does not predict future results, but it might be reasonable to state that financial markets can be expected to deliver better long-term real returns than real estate.

6.2 Renting is currently a bargain in Canada

The ratio of home prices to rent in Canada has seen a sharp increase relative to other developed countries since 2008. With rising real estate prices and stagnant rents, renting is currently a particularly good deal in Canada. Figure 1 shows the ratio of house prices to rent in Canada, the U.S., and the U.K. Canadian house prices far exceed Canadian rents on a relative basis compared to other countries.

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[7] Morningstar

[8] Canadian Real Estate Association

[9] S&P Dow Jones Indices

[10] Spaenjers, C. (2016). The Long-Term Returns to Durable Assets. SSRN Electronic Journal. doi:10.2139/ssrn.2746356

[11] Chambers, D., & Dimson, E. (2016). Financial market history: reflections on the past for investors today. Charlottesville, VA: CFA Institute Research Foundation.

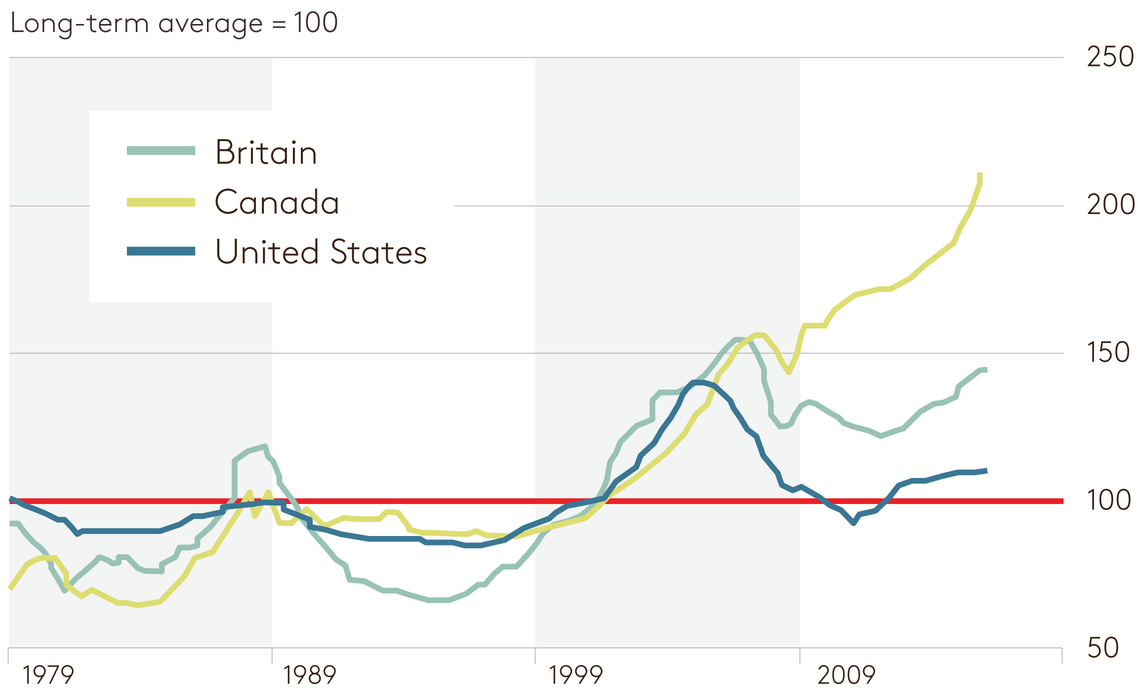

Figure 1: House Prices Against Rent[12]

6.3 A side-by-side comparison

A reasonable way to answer the question of whether or not renting makes financial sense is through a side-by-side analysis of a renter and a buyer. We will look at two people moving to Ottawa in 2016. The average rent in Ottawa in 2016 was $1,073, and the average home sold for about $375,000[13]. Our buyer will make a 20% down payment ($75,000) in order to avoid paying a CMHC premium. They will also have to cover legal fees ($1,000), title insurance ($400), home inspection fees ($500), and land transfer tax ($4,100), but as a first-time home buyer they will get most of the land transfer tax rebated. Our renter will take all of the cash that the buyer is putting toward their purchase, and invest it in a portfolio of stocks and bonds. The renter will select an 80% equity portfolio, having an expected pre-tax return of 6.14%, and a fee of 0.75%. They will be investing in a non-registered account, paying tax on their annual investment income at the highest marginal tax rate in Ontario in 2017 (53.53%). The renter will have their rent increased each year with inflation at 2%, while the owner will pay a fixed interest rate of 3% for the duration of their 25-year mortgage. We will estimate real estate returns at 3% per year. Maintenance costs can vary widely; anywhere from 1% to 5% would be reasonable. We will budget 1.5% per year for maintenance.

[12] The Economist; OECD; ONS; Standard & Poor's; Teranet - National Bank, http://infographics.economist.com/2017/HPI/index.html
[13] Canadian Real Estate Association

In this scenario, the owner will initially spend $77,000 in total to purchase their home, while the renter will invest the same amount in their portfolio. Over the course of the first year, the owner will pay a total cost of $27,893 for their mortgage payments, property tax, maintenance, and home insurance. The renter will pay a total of $13,236 in rent and renter's insurance. The renter is spending $14,657 less on their housing than the owner. To make this a fair comparison, the renter will invest the full amount of those savings in their portfolio each year – note the importance of discipline for the renter.

Fast forward 25 years. We will assume that both the renter and owner will sell all of their assets at the end of the 25th year. The renter will need to pay capital gains tax on their realized capital gains; one of the big advantages that the owner has is that capital gains accrue tax-free on their principal residence. The owner will pay 6% in selling costs to liquidate their home.

In this example, the net wealth after taxes is $738,781 for the renter, and $738,056 for the buyer – a difference of $725 over 25 years. The difference is not material over that time frame. In answering the question of financial superiority, both options can fare well under a set of reasonable assumptions.

MRS. OWNER	
Purchase Price	$375,000.00
Down Payment	20%
Legal Fees	$1,000.00
Land Transfer Tax	$100.00
Other Purchase Costs	$900.00
Amortization	25
Interest Rate	3.00%
Property Tax Rate	1.00%
Annual Maintenance Cost	1.50%
Monthly Home Insurance	$100.00
Real Estate Growth Rate	3.00%
Monthly Payment	$1,419.74
Ending Wealth	**738,056.72**

MR. RENTER	
Rent	$1,073.00
Monthly Renter's Insurance	$30.00
Investment Fees	0.75%
Asset Mix	80/20
Tax Bracket	over $220,000
Inflation	2%
Ending Wealth	**738,781.53**

6.4 What if...

In our side-by-side example, we made some big assumptions. What if we changed them? Holding all else equal:

- If real estate increased in value at a rate of 4% per year, instead of 3%, the owner comes out ahead by $131,000.
- If real estate increased in value at a rate of 2% per year, instead of 3%, the renter comes out ahead by just over $100,000.
- If inflation had been 3% instead of 2%, the renter's wealth trails the owner's by about $68,000.
- If interest rates were 5%, as opposed to 3%, the renter comes out about $145,000 ahead of the owner.
- If investment fees were 2.35%, instead of 0.75%, the owner comes out ahead by about $167,000.
- If investment fees were 0.16% (the fee on a DIY couch potato portfolio), instead of 0.75%, the renter comes out ahead by about $76,000.
- If the renter decided to be more aggressive with their portfolio, at 100% equity their net worth would exceed the owner's by about $91,000.
- If the renter decided to be less aggressive with their portfolio, at 60% equity their net worth would trail the owner's by about $75,000.
- If the renter pays tax at a lower marginal rate (the $45,916 to $74,313 bracket) instead of the highest marginal rate, they come out about $161,000 ahead of the owner.
- If the renter does all of their investing in registered accounts (RRSP and TFSA), and their tax rate remains the same now as when they draw from their RRSP, their net wealth exceeds the owner's by about $348,000.
- If the buyer purchased a home for $500,000 instead of $375,000, then the renter comes out ahead by just under $190,000.
- If the renter chose to rent a place for $1,400 per month instead of $1,073, the owner would come out ahead by about $185,000.
- If the owner moved any number of times, each transaction would reduce their ending wealth significantly.
- If the renter sold out of their portfolio and held cash for a period of time, or stopped contributing savings into their portfolio, their ending wealth would lessen significantly.

There are countless iterations that we could make to these variables to tweak the outcome and make either renting or buying appear more favourable. If you wish to make more iterations, you can download the tool used in this analysis. The reality is that either choice has its merits, and there is no way to know which one will result in a better long-term financial outcome without accurately predicting the future. One thing is clear: **renting your housing is not a waste of money, and it can even result in a greater accumulation of wealth over the long-term compared to owning**.

7 Bringing it All Home

Investing in your own housing is not a sure-fire road to wealth. Renting and owning can both result in excellent outcomes from a financial perspective. If owning your dream home will make you and your family happy, then being an owner might be the best decision that you ever make. On the other hand, happy renters should not feel pressured to become owners for financial reasons. They have the same opportunity as owners to build long-term wealth.

In assessing your housing choices, there are some conclusions that we can draw from this analysis that may be useful to remember.

7.1 If you buy

- You should aim to buy a forever home – a place that you anticipate living in for the foreseeable future – to minimize the effect of transaction costs.
- Be wary of advice from all sources. Most of the people that will give you advice about real estate want you to buy, and they want you to buy now.
- Do not count on average real estate returns being much higher than inflation in the future. The long-run returns on real estate have not been as high as many people think.
- Keep in mind the opportunity cost of having capital tied up in your home (the implied rent).
- Understand that expensive home improvement projects are not investments.

7.2 If you rent

- It is imperative that you are a disciplined saver. You will not build wealth comparable to an owner if you do not save and invest the cost difference between renting and owning.
- Avoid the typical high fee financial products that many Canadians invest in. The fees will be one of the biggest hurdles in building wealth equivalent to a home owner.
- Take a long-term view. Financial markets are priced every day, making it very easy to get distracted by short-term declines. Staying invested is crucial for building long-term wealth.
- Have a sensible investment strategy, and stick to it. Day trading oil futures is not a sensible investment strategy. I recommend investing in a globally diversified portfolio of low-cost index funds.
- You should be as aggressive as you comfortably can be with your asset allocation. This does not mean buying a handful of tech stocks. It means owning a globally diversified portfolio of index funds with a high allocation to equities.

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