

By Moshe A. Milevsky

RISK FOR SALE

A home may qualify as a financial asset, but it's too risky to be an investment.

A client's home is likely her most valuable physical asset. However poorly diversified and illiquid, this asset should concern advisors because it has an enormous impact on clients' long-term financial health and their personal risk management strategies. Think about it for a moment. While it would be highly imprudent to incur 10-1 leverage to

invest in any one stock or bond, this is routinely done in the residential real estate market.

Shouldn't the rules of diversification apply to the largest physical asset on your client's financial balance sheet? From an asset allocation perspective, Table 1 (see "Zigging and zagging" on this page) and Table 2 (see "Housing

	TORONTO	
Toronto	100%	
Montreal	69%	
Calgary	32%	
Edmonton	5%	
Vancouver	34%	
Halifax	18%	
Kingston	73%	
London	81%	
Moncton	27%	
Ottawa	23%	
Regina	36%	
Saskatoon	12%	
St. John's	36%	
TSE/TSX (CAD Stocks)	-3%	
S&P500 (USD Stocks)	-9%	

markets” on page 21) help by displaying the risk and return parameters from Canadian residential real estate compared to the stock market during the last 25 years.

Table 1 gets a bit technical by computing the correlations between the returns on the 13 housing indices and the two stock market indices. In general, the correlation numbers range from +100% to -100% and are meant to measure the extent to which prices in different geographic regions zig and zag together.

For example, the value of an average house in Toronto increased by 5.75% per annum during the last 25 years and the volatility of the investment return, which is a measure of the possible range, was 10.83%. In comparison, Vancouver increased by 3.68% per

annum, but was more volatile with an 11.14% standard deviation. Regina had the lowest volatility at 2.81%, but the annualized investment return was only 2.96%. In contrast to the return from residential real estate, the total return from TSE/TSX index was 8.64% per annum with a volatility of 16.46%. The stock market is obviously more volatile than any of the major Canadian cities but the returns from the stock market have been much higher as well.

Of course, all of these return calculations ignore leverage (standard in housing purchases), which can also be used equally effectively with equity-based investments. More important, the housing numbers displayed in Table 2 ignore the consumption dividends that come from imputed rents, which makes the true aggregate return from real

estate higher. But at the same time, we also ignored property taxes and unavoidable insurance and maintenance fees, as well as real estate commissions.

My intention here is not to race houses against stocks, since I believe the former is largely consumption while the latter is mostly investment. Regardless of whether clients believe residential real estate is a good investment, owning just one property is risky and violates most of what portfolio theory has taught us over the last 30 years.

In fact, the ideal portfolio approach would be to allocate approximately 4% of your wealth to Toronto housing, 2% to Vancouver housing, 6% to Regina housing, etc., in addition to the usual percentages allocated to Canadian and international stocks. Given the low

Continued on page 21

Photography by Geoff George

ZIGGING AND ZAGGING

The correlation between residential real estate and stock markets during the last 25 years.

TABLE ONE

	MONTREAL	CALGARY	EDMONTON	VANCOUVER	HALIFAX	KINGSTON	LONDON	MONCTON	OTTAWA	REGINA	SASKATOON	ST. JOHN'S	TSE/TSX	S&P500
	100%													
	17%	100%												
	17%	83%	100%											
	37%	41%	33%	100%										
	57%	-17%	-5%	-5%	100%									
	73%	3%	-4%	42%	43%	100%								
	72%	26%	8%	56%	21%	88%	100%							
	33%	-9%	-12%	21%	56%	63%	54%	100%						
	57%	-33%	-12%	1%	84%	51%	23%	40%	100%					
	38%	12%	-10%	27%	13%	20%	25%	9%	16%	100%				
	11%	16%	-9%	6%	13%	1%	3%	5%	-12%	34%	100%			
	59%	13%	24%	37%	47%	71%	63%	47%	51%	1%	-11%	100%		
	11%	-12%	-29%	11%	5%	-2%	3%	13%	-9%	24%	29%	-10%	100%	
	-20%	-13%	-37%	-22%	-22%	-7%	-4%	2%	-35%	7%	14%	-39%	60%	100%

Data Source: Canadian Real Estate Association, Multiple Listing Service ® system. Calculations by The IFIC Centre.

Continued from page 19

correlations between Canadian residential housing and global stock markets—and in contrast to the 30 or so stocks needed to diversify the idiosyncratic risk of individual equities—four or five well-placed houses across Canada are enough to create a balanced housing portfolio.

So what are those who can't afford to own a portfolio of houses supposed to do to manage this risk? Here are four ideas, some of which are slowly making their way to Canada, and a bird's-eye view of how they would work.

1. Residential REITS

Imagine one client owns a house in a pricey region of Toronto, while another client lives in the suburbs of Vancouver. Both of them have a relatively large mortgage and have invested a large chunk of their wealth in a personal residence. Wouldn't it be nice to broker a binding legal arrangement between these two clients—or any other ones in your book of business—to share these gains and losses? Thus, if and when the client in Toronto decided to sell her house, the Vancouver-based client would be entitled to part of the gains (or losses). The reason this risk-sharing

HOUSING MARKETS

Total risk and return from residential real estate versus the stock market during the last 25 years.

TABLE
TWO

	COMPOUND RETURN (P.A.)	VOLATILITY
Toronto	5.75%	10.83%
Montreal	5.18%	6.61%
Calgary	3.11%	6.50%
Vancouver	3.68%	11.14%
Halifax	4.68%	3.82%
Kingston	5.38%	6.91%
London	4.53%	7.64%
Moncton	3.98%	4.98%
Ottawa	5.70%	6.23%
Regina	2.96%	2.81%
Saskatoon	3.04%	3.08%
St. John's	3.59%	3.39%
TSE/TSX (CAD Stocks)	8.64%	16.46%
S&P500 (USD Stocks)	13.85%	15.71%

Data Source: Canadian Real Estate Association, Multiple Listing Service® system. Calculations by The IFID Centre.

arrangement adds value is that, according to Table 1, the correlation between these two markets is only 34% (i.e., they do not “zig and zag” in lockstep). In fact, these two markets are relatively more segmented than the TSX index versus the S&P500.

While this idea might sound impractical, scale this up and let's examine the implications. A client

could agree to own the majority of his house—say 50% to 70%—while the remaining 50% to 30% would be owned by a collection of distant neighbours, friends and business acquaintances. This agreement could be structured as a mutual fund trust. The fund would own a large number of different houses—instead of a large number

Continued on page 23

Too much work?
No time to stay in touch with clients?
Get help!



money IDEAS

YOUR PERSONALIZED, CUSTOMIZED E-NEWSLETTER

Contact us today. Find out how fast, easy and inexpensive client communications can be.

1 800 992-9498 ext 300 • 416 971-9322 ext 300
clientcontact@moneyideas.com



Continued from page 21

of different stocks—and clients could then purchase units in their neighbour's or cousin's house, if they so desire.

This concept is similar to a commercial real estate investment trust (REIT), except that I am proposing the same for a personal residence. Clients could sell a fraction of their houses into a so-called housing REIT and gain some immediate cash to make home improvements, lessen their mortgage debt burden and diversify their wealth. If and when they sell the house, the ownership fraction would determine how to allocate the sale proceeds.

2. Equity-Based Mortgages

Similar to a housing REIT, an equity-based mortgage substitutes a bank loan for an ownership stake. Typically, when a client purchases a house for \$500,000 and then only has \$200,000 for a down payment, he can borrow the remaining \$300,000 from the bank.

Under conventional mortgage terms, he would then have to make payments of \$2,500 each month for 30 years, after which the house would be completely his. However, under an equity-based mortgage, the bank would allow him to make a reduced monthly payment of only \$1,700, but in exchange would demand an ownership stake in the home.

The actual fraction he would be entitled to would depend on prevailing market conditions as well as interest rates, and even his credit rating. This means that when the client sells the house, the bank would be entitled to a fraction of the proceeds.

3. Reverse Income Mortgages

Reverse mortgages are offered by a variety of financial institutions in Canada but they are only open to people age 62 or older. If a client's home is fully paid up and she would now like to release or redeem some equity without having to sell the house, a reverse mortgage allows her to borrow money secured against the home, albeit at a higher rate than long-term mortgages. But in contrast to home equity lines of credit, she never has to pay the money back while she is alive.

So, for example, a \$500,000 house might entitle the owner to a lifelong annuity payment of \$2,000 per month for the rest of her life. The income received generates a debt on the right hand side of the personal balance sheet, but the principal and interest on this loan are not due until death, or when she moves to another residence. The lender (i.e., the bank) is taking the risk that housing prices will decline—and that you will live for a long time, and at the time of sale, they will not be able to recoup their original principal. The risk the bank is incurring is a risk your client is avoiding, which is why these arrangements are limited to a maximum of 40% of the appraised value of the house. The reverse mortgage allows a “house-rich and cash-poor” client to continue living in their home, and also takes part of the downside risk away from the concentrated real estate holding.

4. Home Equity Insurance

You've probably heard of financial call and put options. These are financial contracts that are traded on derivative exchanges that allow the holder to buy

and sell stocks, bonds and currencies at fixed prices prior to a fixed date. In fact, many segregated funds in Canada have similar guarantees embedded within them.

And, just as anyone with a large investment in gold, IBM or the Japanese yen can purchase a put option that will give them the ability to sell that position—anytime they want—for at least some minimally specified price, the same design can be applied to residential real estate. The homeowner would buy the protection from a financial services company (similar to property and casualty insurance) that insures the value of the house up to the time of resale. A pilot project of this concept was implemented in Oak Park, Illinois, more than 20 years ago and more recently launched in Syracuse, New York.

I like to think of my house—which I only recently purchased—as a big and expensive fridge that I plan to use for the next 10 to 20 years. It had to be large enough to accommodate my family's growing needs, efficient enough to avoid large electricity bills and nice enough to hang up my children's art work. I honestly never thought of it as a good financial investment—especially not in today's market—but more of a financial asset, since I would have a tough time sleeping at night with all the eggs in one fridge. **AE**

Moshe A. Milevsky, Ph.D., is the author of Wealth Logic (Captus Press) and Insurance Logic (Captus Press). Milevsky is also a keynote speaker at the Halifax, Calgary, Vancouver and Toronto Advisor Forums. To register, visit www.advisorforum.ca