

THE VALUE OF REAL ESTATE

By Mike & Richard Holmes

We have been asked many times about where the market is heading: whether this a good time to buy and related questions. We often read and hear of prognosticators calling for a crash in real estate prices and at the same time promoting bonds, stocks or other forms of investment. In reality no-one has a crystal ball. We don't say that to avoid the question. It is the truth in any forecast of the growth, or decline, of any asset class. Just ask the 19 of 20 analysts who rated Nortel a "buy" 3 weeks before it plunged from 120 dollars a share to its eventual demise to use a well known and worn example. Our great grandfather saw real estate prices decline from a peak in 1912 that in some cases did not see its re-attainment until the 1950s. So the rhetorical question we ask ourselves is why then do we remain so positive about real estate and real estate on Vancouver Island in particular?

The reasons: First the often quoted structural advantages of the Island and the demand and growth. 110 years ago the population of British Columbia and Prince Edward Island were both approximately 100,000 people. Now B. C. has over 40 times that number, Vancouver Island 7 times whilst PEI has hardly budged. In Victoria, land, despite a growth in supply in the Westshore, is in shorter and shorter supply. We are surrounded by water, the Malahat and protected farmland. Victoria is relatively safe, climatically benign, culturally and aesthetically attractive. These factors have been talked about again and again. And rightly so as they are the structural components that in the long run will hold up Victoria real estate prices.

But what is not often talked about and commonly misunderstood is the power of leverage. Archimedes said if you had a lever large enough you could move the world. He might have said in the modern world if you had enough financial leverage you could own the world. Many have made fortunes and been broken by the power of leverage. In the 90s recall the Reichmann's who owned assets in New York worth 27 billion with 20 billion of debt but when it went south their net worth evaporated. There have even been recent examples in Victoria. However this is not the leverage

available to the average family which remains one of the best and only reliable methods of wealth creation.

By the leverage available to the average family we use the example of a working couple purchasing either a \$300,000 condominium or a \$500,000 house with 20 percent down. We make a basic and conservative assumption of growth of 2% per annum. This is less than the past but we pick it as a reasonable expectation and as it follows the Bank of

Canada target for inflation. More importantly we want to show that patient investors and home owners don't need rapid increases to make money in real estate. Though these assumptions are not failsafe we believe they are more defensible than predicting 6 or 8 percent per year in the stock market.

The table below gives the return on your home investment resulting from the combination of principal pay-down over the life of a 30 year mortgage and property appreciation.

ASSUMPTIONS

Purchase Price
Original Equity
Years End Value
Equity Gain
Return On Original Equity

20% of Purchase Price Annual growth of 2% p. an.

Condominium	Single Family Home
\$300,000	\$500,000
\$60,000	\$100,000
30	30
\$543,408	\$905,681
\$483,408	\$805,681
7.20%	7.20%

At both these price levels the cost of borrowing is affordable and comparable to renting with the added value of pride of ownership of the family home. With a 20% original downpayment and a 2% annual growth, after enjoying your home for a normal working life the property is clear title and the original investment has grown by a steady 7% per year. And all tax free.

We think buyers need to focus on long term capital growth. Buying a house that one can afford, maintaining it well and paying down debt will result in a reliable investment far superior and far more enjoyable to that offered for the average person in the stock and bond markets.

That's our view.