

Should I own a home in Vancouver?

Thomas Davidoff, Sauder School of Business

1. It's ok not to own
2. There are some good reasons to own
 - ▶ Tax?
 - ▶ Contracting frictions
3. Calculation of own vs rent depends in part on
 - ▶ Where are prices heading?
 - ▶ Interest rates are low today
 - ▶ Supply elasticity: theory and reality
 - ▶ Your taste for price risk.
 - ▶ Owning a home is risky
 - ▶ Owning a home is insurance

It's ok not to own

- ▶ “I’m sick of paying the landlord, I’d rather pay myself instead”
- ▶ No. Efficient, no tax, riskless market:
 - ▶ Landlords:

$$\underbrace{\text{Rent} + \text{Capital Gain} - \text{Expenses}}_{\text{Return to owning}} = \underbrace{\text{interest rate} \times \text{price}}_{\text{Opportunity cost of capital}}$$

- ▶ Owner occupiers:

$$\text{Dividend} + \text{Capital Gain} - \text{Expenses} = \text{interest rate} \times \text{price}$$

- ▶ Own vs rent: $\text{Rent} = \text{Dividend} - \underbrace{\text{Capital Gain} + \text{Expenses}}_{\text{Stuff owners get that renters don't}}$

Rent vs. Dividend - Capital Gain + Expenses vs interest rate \times price

Why might owning be better?

- ▶ Owners have a lower cost of capital than owners [NO]
- ▶ Owner “dividend” bigger than rental dividend [YES]
- ▶ Owner capital gains bigger than landlords’? [YES]
- ▶ Owner expenses lower than landlords’? [MAYBE]

Owning and taxes

- ▶ Owners pay:
 - ▶ Property tax (with a bit of a credit)
 - ▶ Sometimes get credits for investment
 - ▶ Rarely capital gains
- ▶ Landlords pay:
 - ▶ Property taxes
 - ▶ Income tax on rent less:
 - ▶ “Depreciation”
 - ▶ Mortgage interest
 - ▶ Property taxes
 - ▶ Maintenance
 - ▶ Capital gains when and if realized
 - ▶ Net liability may be restricted to be positive
- ▶ Depending on scenario, owners pay less (Vancouver diciest)
- ▶ Frightening fact:
 - ▶ Rent to price ratio lower in Vancouver than Seattle
 - ▶ Yet renting is relatively tax-friendly in Canada
 - ▶ No mortgage interest deduction here

Mortgage payments and cost of capital

- ▶ $PMT = \text{interest} + \text{amortization}$
- ▶ Constant payment is common
 - ▶ Subject to interest adjustment
 - ▶ Early payments are mostly interest
 - ▶ Subsequent payments are mostly amortization
- ▶ Amortization is equivalent to buying a bond, so not a true cost
- ▶ But Equity in the home could be earning interest
- ▶ Is owners' interest rate less than landlords' ?
 - ▶ A bit lower default risk
 - ▶ Commonly same mtg rate, higher loan amount to owner
 - ▶ Big difference: landlords can deduct interest
 - ▶ US: owner occupiers can deduct, too.

Owner dividend vs rental dividend to landlord

- ▶ Owner dividend may be large because of “feelings”
- ▶ Owner dividend, unlike landlords’ is taxed
- ▶ *BUT* landlords get to take “depreciation”
 - ▶ Only on structure
 - ▶ Which may be less than 10% of value
 - ▶ Structure share much larger in “Flatland”

Owner vs landlord capital gains

- ▶ Not a valid argument: “Prices in Vancouver always rise”
 - ▶ That’s why your landlord invests
- ▶ Yes a valid argument: “I don’t have to pay capital gains tax”
 - ▶ But landlords can dodge in a variety of ways
 - ▶ Notably not selling

Owning vs renting: expenses and contracting frictions

- ▶ Landlord Releasing costs
 - ▶ Landlord worries you will move
 - ▶ Has to charge you for moving soon
 - ▶ Makes you want to move
- ▶ Your moving costs
 - ▶ You worry apartment won't be available in the future
- ▶ Maintenance
 - ▶ Investment not your benefit
 - ▶ So you underinvest
 - ▶ Damage not your problem
 - ▶ So landlord charges accordingly
 - ▶ Typically see “1 building 1 owner”
 - ▶ So backyard, detached home unlikely rental
 - ▶ *But:* you are a nerd, and your landlord is handy

Owning vs renting: lifecycle considerations

- ▶ Owning requires a downpayment \Rightarrow kids should rent
- ▶ Selling a home is costly \Rightarrow kids and movers should rent

Is it cheaper to own or rent?

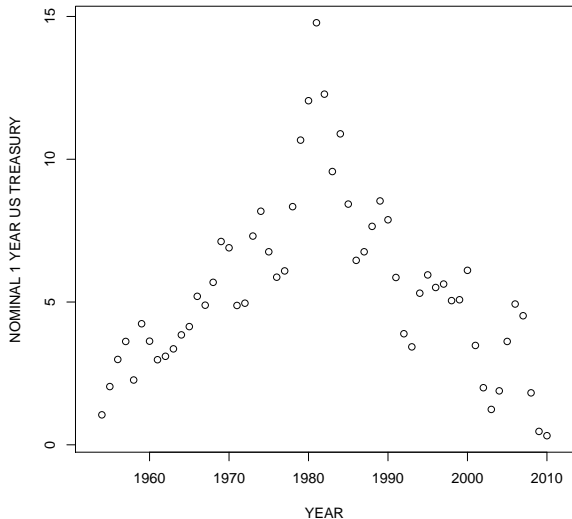
- ▶ Rent versus “user cost”
 - ▶ Mortgage
 - ▶ Opportunity cost of equity
 - ▶ Property tax
 - ▶ Maintenance
 - ▶ Insurance
 - ▶ ...
 - ▶ Less appreciation
- ▶ So we need to know appreciation rate

How much appreciation to break even?

- ▶ 4 BR North Shore home
 - ▶ Price: 1.1M
 - ▶ Rent: 35000/year \Rightarrow 3.2%
 - ▶ Mortgage + equity return: \approx 3%.
 - ▶ Maintenance: 10k \approx 1%
 - ▶ Insurance, taxes, etc: 6k \approx .5%
 - ▶ Selling costs: 4%/10 \approx .4%
 - ▶ Total owner: 4.9%
 - ▶ Appreciation rate to break even \approx 1.7%
- ▶ What's missing?
 - ▶ Will 3% interest rates persist?
 - ▶ Will prices appreciate 1.7%?
 - ▶ Related questions!
 - ▶ Yield curve says “no”
 - ▶ History says “no”
- ▶ Need a lot more than 1.7% on a detached home in Kits
 - ▶ Redevelopment options??

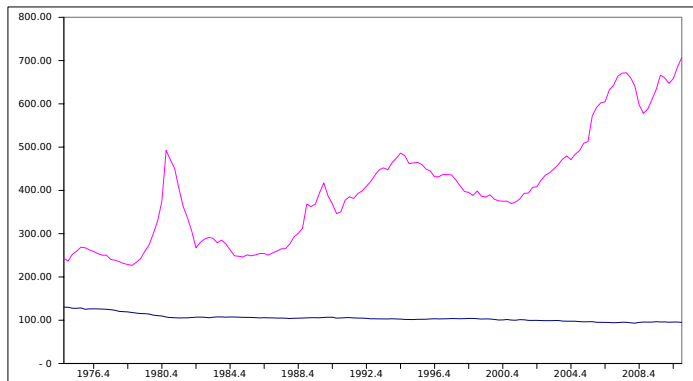
Today's interest rates are **WAY** low

If you think rates will jump 4% soon, add 4% to required appreciation



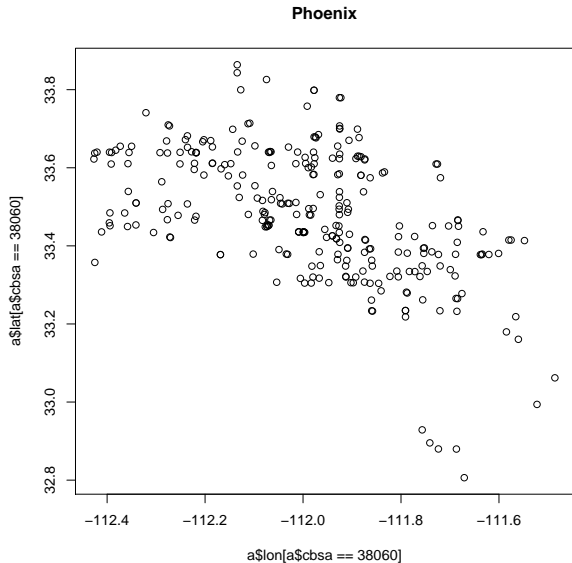
How much appreciation is reasonable?

- ▶ Giant real historical price appreciation in Vancouver
- ▶ Not so much rent
- ▶ Subject to this is the data we have (CMHC?)
 - ▶ Pink: price
 - ▶ Blue: rent



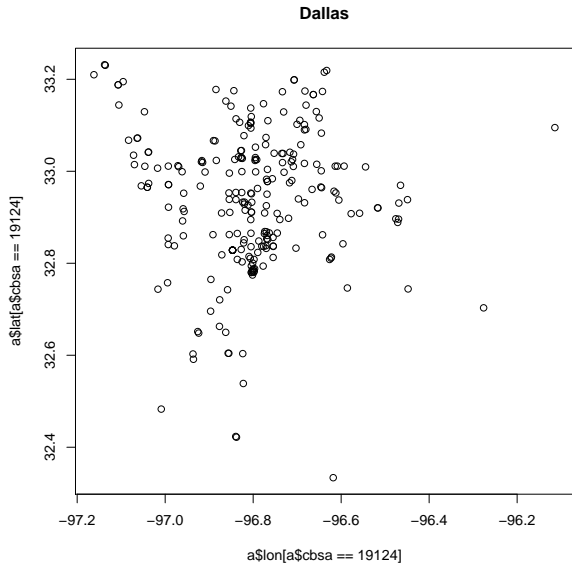
Phoenix: when prices rise, they will crash

Plotted: lat and lon of Starbucks in Phoenix



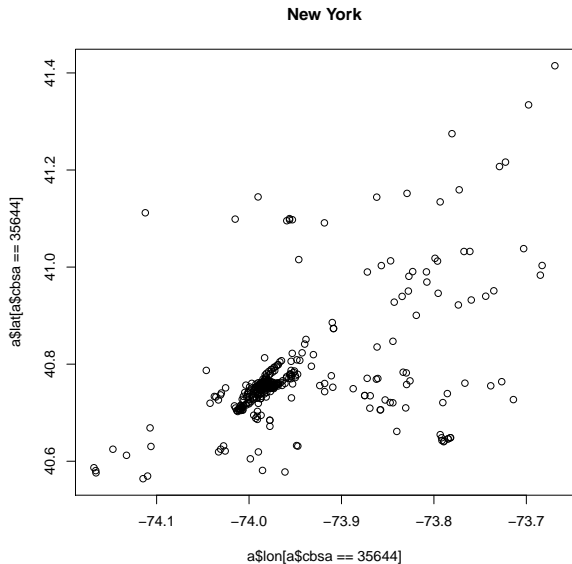
Dallas: when prices rise, they will crash

As in the 80s



New York: when prices rise, will they crash?

A bit in the late 80s, not much this time around

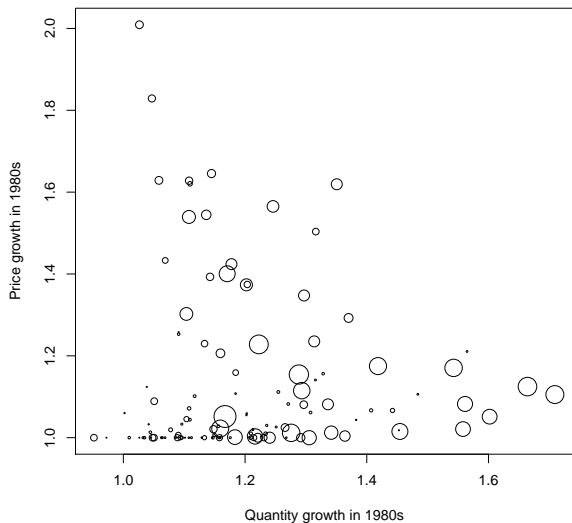


Vancouver is more like New York and will never be cheap



We know that “bubbles” are punished in “Flatland”

To a lesser extent in the “zoned zone?”



China



- ▶ Some demand in Vancouver is driven by Chinese wealth
- ▶ In the long run, nicest city in China is good
- ▶ Short run risks of bubble collapse in China
- ▶ Reasonable people disagree about magnitude of the risk

Returning to pricing

$$\frac{\text{Rent} - \text{Expenses} + \text{Capital Gain}}{\text{Price}} = r$$

net dividend rate = $r - g$

- ▶ We don't know what g is
- ▶ When r is very small, easy to believe very high prices
- ▶ Hence I can't say if we're in a bubble or not
- ▶ Many are willing to declare bubble
- ▶ Easy to see downside risks
- ▶ Easy to envision long run growth

Owning a home is risky

- ▶ I don't know value of my home today within 20%
- ▶ Over 10 years range of outcomes huge
- ▶ Housing is most of most of our wealth
- ▶ We might want a high return to compensate for risk
- ▶ Luckily, our labor income doesn't move with housing ...
 - ▶ e.g. investment banker in New York
 - ▶ Oil people in Texas
- ▶ ... but our retirement income likely does
 - ▶ Defined benefit pensions and BC economy
 - ▶ Stocks and the global economy
 - ▶ Puzzle: weak correlation (stocks, housing)
 - ▶ Smaller puzzle after '07?

Owning a home is insurance

- ▶ Bad if prices fall, but there are options
 - ▶ Trade up
 - ▶ Don't sell
 - ▶ Moving is a hassle at any age
- ▶ Good if prices rise
- ▶ In a perfect world, almost zero net exposure to housing costs
- ▶ Real world
 - ▶ Renting: negative exposure?
 - ▶ Owning: positive exposure?

Are owners long housing?

- ▶ Working backward, Grandma never sells
 - ▶ Unless she goes into a nursing home ...
 - ▶ Does she then need the money?
 - ▶ Maybe this is why no LTCI market?
 - ▶ ... Or lives a very long time
 - ▶ May be why no one buys life annuities
 - ▶ Bequest and housing risk??
 - ▶ Home equity is not a crazy buffer for old age
- ▶ Trades up are more common than down
- ▶ Is Vancouver correlated in price with your next market?
- ▶ Do you have to move or want to move?
- ▶ Owning pre-tenure is risky

Are renters short housing?

- ▶ Yes, if rental consumption is fixed
- ▶ But it's not
- ▶ And renters (no kids) are a mobile population
- ▶ So if flexible, no need to insure against high rents
- ▶ Rent control helps with this . . .
- ▶ . . . But may increase starting rents
- ▶ So only buy to protect against rent inflation if you
 - ▶ Have kids and like your school
 - ▶ Aren't productive enough to get outside offers
 - ▶ Care a lot if your grandkids can afford Vancouver

Questions?

- ▶ It's ok to rent
- ▶ What are legitimate rationalizations of owning
- ▶ Vancouver price future is uncertain with clear downside risk
- ▶ Vancouver is not going to be cheap anytime soon
- ▶ Owner housing is both risk and insurance