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WHY IT'S BETTER TO RENT THAN BUY

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Does it make more sense to buy or rent a home from an investment perspective? It's a question I get asked more than any other. The answer, in an era of historically low interest rates and perpetually rising real estate values, appears to be obvious: buy.

Just ask any real estate agent and they'll tell you, "Don't pay your landlord's mortgage for him," or "Build equity for yourself instead of flushing your money down the toilet," and our favourite, "There has never been a better time to buy."

It all sounds pretty convincing, but it's wrong. Unless you need the security blanket of owning your home, it is nearly always a better financial move from an investing standpoint to rent rather than buy. The reason: People rarely consider three major costs of owning a home.

1. The round-trip costs of buying and selling

The largest expense when buying a home is the land transfer tax. In most jurisdictions, this can amount to at least 1.5% of the purchase price. In the Greater Toronto Area, it's closer to 4%, which comes close to the rent you would pay on a similar residence for an entire year. And, keep in mind, this is paid in after-tax dollars.

When you sell your house, you will also pay about 5% in commissions. Throw in moving costs and legal expenses, and the total cost of buying and selling a home approaches 10% of the purchase price.

If you buy a home for $800,000 and sell it five years later for an impressive $950,000, your net profit (excluding the hefty annual costs discussed below) is about $80,000— or a compounded annual return of a paltry 1.6%. That's not a typo. True, this calculation doesn't figure in the so-called benefit of leverage, but we'll get to that in a minute.

2. The operating costs of ownership

The largest cost of ownership is invisible. It's the opportunity cost of not having invested your downpayment somewhere else. As the above point demonstrates, you don't have to take a lot of risks to outperform the equity appreciation of your home, even in most bull markets.

The other costs of home ownership aren't invisible at all. Property taxes, mortgage interest, maintenance and a variety of other miscellaneous expenses quickly add up. If you've ever had a leaky roof, frozen pipes, a pool to take care of, or a predilection for home improvements, you know this to be true.

Of course, homeowners aren't on the hook for paying rent, but the operating costs generally far outpace the rent that would apply to the same residence.

3. The impact of a mortgage

It is generally assumed that buying a home means taking out a mortgage, especially with interest rates at historic lows. Mortgages used to be a vehicle that homebuyers used to buy an asset well beyond their means. The goal was to pay it off over 20 or 25 years, just in time for retirement, when the home they lived in would become their physical nest egg.

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This has morphed over time to the point where buyers access the maximum amount of leverage available to them at purchase and take the longest possible amortization period available. They enter into mortgages knowing that their monthly payment is close to the maximum they can afford (assuming they stay employed and won't have any costly unexpected events), confident that if they ever run out of money, they can just extract more equity from the ever-increasing value of their home.

This isn't preparing for retirement. This is preparing for job interviews in your seventies when you should be enjoying cocktails after a round of golf.

If you would like to run some of the numbers comparing buying vs. renting for yourself, Google has a "buy vs . rent calculator" and there are a number of detailed interactive Excel templates online that allow you to enter your own assumptions and mounts. Some of these online tools are even focused on Canadian homebuyers and include local land transfer taxes.

The bottom line is that using leverage to buy a home presumes the value of real estate will always go up. Historically, the value of residential real estate has increased more or less in lockstep with inflation, meaning that the buying power of your equity will be the same in 20 years after you buy a home as when you bought it.

The same people who think buying a home with 15% down is a sound investment would never dream of applying 600% leverage on any other investment. Most conservative investors, for whom capital preservation is the primary objective, eschew any leverage at all in their investments because leverage works both ways: It magnifies gains, but magnifies losses as well.

In the case of an 85% mortgage, it is imperative to understand that a 15% decline in the value of the home results in a 100% loss of the equity forming the downpayment. The vast majority of your mortgage payments in the first five years is interest on your debt. If you sell your house after that time following a 15% market correction, you end up with nothing after you pay down your outstanding mortgage principal.

If you try to refinance your mortgage in that scenario, you will have to "re-up" on your equity, assuming you can get a new mortgage at all. This is a tame version of what transpired in the U.S. in 2007–2008. It is not fantasy; it can happen here and it will happen here.

It's just a matter of time.

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