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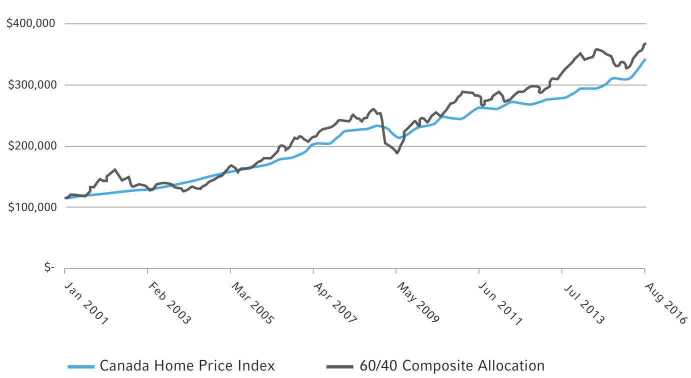
Many Canadians who purchased a home at almost any point in the past 20 years have benefited from one of the biggest housing booms in recent history.

The white-hot real estate market has been an ongoing and controversial topic in the media and among economic forecasters – divided between those who believe it is on the verge of collapse, against those who believe demographic and urbanization trends will support rising home prices, at least in the country's key cities of Toronto and Vancouver.

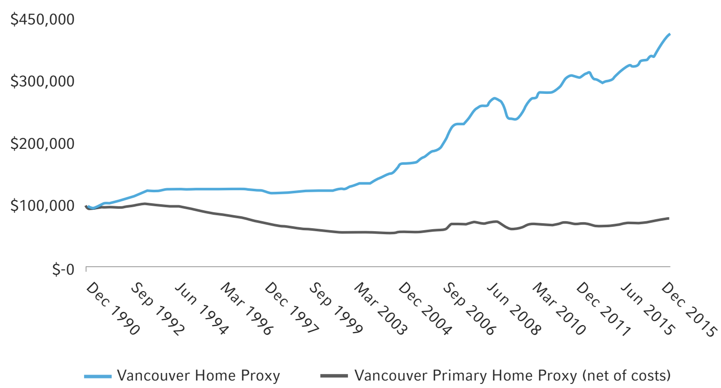
Canadians who own a home that has significantly appreciated in value may believe real estate provides better returns than the stock market. But based on a Russell Investments analysis, a simple comparison of the growth in a balanced allocation of 60% Canadian equities and 40% Canadian bonds versus the growth in national home prices indicated otherwise. As you can see in Exhibit 1, returns from the domestic housing market since March of 1999 have, counterintuitively, lagged the balanced allocation.

Exhibit 1



Source: Thomson Reuters, Russell Investments. As of August 2016. Home prices based on Teranet-National Bank House Price Index.

Exhibit 2



Source: Thomson Reuters, Russell Investments. Based on monthly data for the Teranet-National Bank House Price Index. Net of Costs refers to Net of assumed Costs for the Vancouver Primary Home Proxy: assumes annual property tax of 0.4% and annual maintenance costs of 0.5%, interest expense is based on amortized amount of $80,000 based on $100,000 property with 20% down payment. As of December 2015. Hypothetical illustration.

More importantly, when "carrying costs" of home ownership are included – such as property taxes, interest expense, and maintenance costs – the returns to a homeowner can be, in many instances, rather underwhelming. We compared the growth of Vancouver home prices, among the best-performing in Canada[1], to a "primary home proxy" where the home is financed and the typical carrying costs described above are incurred. As Exhibit 2 shows, when including rising costs over time, the "primary home proxy" considerably lags the headline home price index. A home purchased for $100,000 in December 1990 would have been worth roughly $380,000 in December 2015. However, when all the carrying costs are factored in, the return to the homeowner was approximately $82,000.

Debt levels rising in line with housing prices

With the sharp rise in home prices seen in recent years, we believe housing could be vulnerable to a downturn, especially as the gains have been partly fueled by an increased willingness to take on debt. Debt to disposable income in Canada, a key measure of risk, has risen to historic highs[2]. That could pose a problem for the economy if interest rates rise in the future. On the other hand, because rates are low, the debt-service ratio – which is the percentage of gross annual income required to meet all debt payments including housing, credit cards and car loans — was at a very manageable 14% in mid-2016. A debt-service ratio above 43% generally indicates a borrower could struggle to meet those obligations.

Our perception that housing is almost always a better investment than the stock market is falsely guided. Timing, is of course, critical, and the housing market crash in the U.S. serves as a reminder. For example, in 2015, U.S. home prices in aggregate were still below their pre-financial crisis 2006 peak levels. Meanwhile, the S&P 500 Index rose roughly 75% between 2007 and 2015.

Canadian house prices have been on a smoother upward trajectory. Prices fell by only 11% on average during the Global Financial Crisis of 2008/09. Even with the collapse in oil prices in 2014, house prices in Calgary, which had risen strongly during the commodity boom, lost only 12% on average.

[1] Source: http://www.crea.ca/housing-market-stats/national-average-price-map

[2] Source: Statistics Canada. National balance sheet and financial flow accounts, 2Q 2016 http://www.statcan.gc.ca/daily-quotidien/160915/dq160915a-eng.htm

No trend lasts forever

A quick glance at the history of financial markets shows us that no trend lasts indefinitely. Historically, boom-bust cycles have arisen anytime there is the widespread increase in the price of a scarce commodity. Behavioral economics has taught us that herd behavior – the tendency for individuals to imitate the actions (rational or irrational) of a larger group – is the main cause of financial bubbles.

This is how it works: the price of an asset or commodity rises due to a widespread belief in its scarcity or expectations for increased future demand. As the price rises, more and more people jump on the bandwagon in the belief the price will continue to rise. At some point, the price reaches a level at which fewer interested buyers can be found, and the bubble begins to deflate. Once people see prices starting to decline, herd behavior kicks in again, pushing prices lower. In a highly speculative market, the process can be rapid, and devastating.

Whenever there is talk of speculative bubbles, the "tulip mania" of 17th century Holland is invariably cited. In the space of two years, the price of tulip bulbs soared to unprecedented heights: at one point, a particularly rare tulip, Semper Augustus, was valued at 5,500 guilders per bulb – the cost of a luxurious house in Amsterdam.

Other examples of boom-bust cycles include the Roaring Twenties, in which the U.S. stock exchange moved higher over a prolonged period of time, only to end abruptly on the infamous Black Thursday – October 24, 1929. The subsequent rout sparked the Great Depression, and U.S. equities lost 89% of their value over the next two and a half years.

As in financial markets, boom-bust cycles are historically pervasive in the housing market. In recent years we have seen them in Japan and the U.S., and some believe we are seeing one in Canada. However, for the average homeowner with a typical investment portfolio, the ups and downs of the stock market are all too often evident in the quarterly statement, whereas any change in the value

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of a property is only realized upon a sale – which in most cases can be timed to benefit the seller.

Diversification of assets is crucial

Ultimately, diversification of assets is crucial for success. Investing in real estate serves a purpose beyond the potential financial gain as it provides shelter for an individual or family. But as we have demonstrated, real estate is not the unequivocal longer term outperformer as is often assumed. Timing is also critical. Real estate markets can be volatile, as the examples above show.

Considering the high valuation of domestic real estate and current household debt levels, allocating funds to a globally diversified multi-asset solution can be a way to reduce risk to your overall wealth. A properly diversified multi-asset strategy can also help provide a sense of financial security as these vehicles are designed to aim for growth while managing downside risk.

Important Information:

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