Buying in Montreal: By the Numbers

An analysis by Oliver Foster

# Inspiration

My name is Oliver. I’m 26 years old renting a 2 bedroom apartment in Montreal by Atwater Market. I’m a short commute to a job I love downtown, and as a young professional in the age of the internet, I find myself drowning in unsolicited advice regarding how I should be managing my personal finances.

The solicitors of this advice ordinarily fit into one of two groups: seniors or futurists.

Seniors fancy themselves as know-it-alls urging me to invest into the Canadian real-estate market. The futurists on the other hand arrogantly state that millennials have invalidated homeownership via the renting economy. Such stark contrast gives me pause for thought.

When asked to defend financial advice I often find both sides cite anecdotal evidence. Seniors mention their cousin who bought early in the Toronto real-estate boom, while futurists will bring up their college roommate who mined Bitcoin before Blockchain took off. While these stories make for interesting conversation, this type of advice isn’t rooted in exact science.

I decided I wanted to investigate the value of homeownership by the numbers.

Let’s assume you have a pot of money that each year you can put towards a combination of your property expenses and savings. If you decide you’re going to rent for the next 30 years, this pot would contribute to your rent, and the remaining funds would be put towards an investment in the stock market. If you decide on purchasing a condo, this pot would be put towards your mortgage payment, condo fees, property taxes, and the remainder towards the stock market (provided you still have money to spend).

Which of these portfolios would yield a better return on investment? Intuitively, a large investment into the stock market seems like a more risky play but you stand to have more upside potential. The downside to this strategy is you’re throwing away your money to rent every month. Purchasing a condo seems like a safer strategy – the returns on real-estate in Canada are less volatile and you lose no money to rent. You do however have the downside of paying condo fees and property taxes while limiting your upside potential with a smaller investment into the stock market. How can one effectively weigh their options with so much uncertainty?

# Monte Carlo to the Rescue

Monte Carlo simulation is a technique used by analysts to simulate possible outcomes to strategies containing considerable uncertainty. It starts by defining a returns distribution for your investment strategies and then simulating year-by-year performance by randomly pulling the current-year returns from this distribution. After simulating 1000 times you are left with 1000 outcomes for your return on investment given its historical uncertainty. If you decide to rent and invest all remaining funds into the stock market your portfolio’s returns depends solely on the returns of the stock market. Alternatively if you purchase a condo your portfolio’s returns depends on a combination of capital gains returns in the real-estate market and a lesser share investment into the stock market.

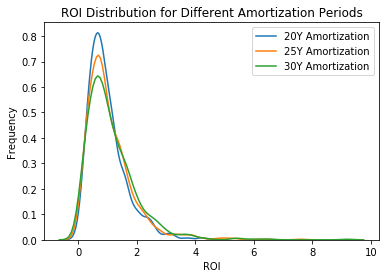
# Assumptions

Considering I currently reside in Montreal I will take its composite housing price index as a proxy for real-estate capital gains, while using the returns of the S&P 500 as a proxy for market returns. Additionally we must assume:

* You have $27K annually to invest into a combination of property expenses and stock market investments
* The property in question is a condo with monthly condo fees of $300
* Rent & salary increase by 3% annually
* Existing investment in the stock market of $20K (irrespective of the investment strategy taken)
* You can purchase a 10-year fixed term mortgage with a 3.2% interest rate
* Property taxes are 1% of the market value of the condo & school taxes are 0.15%
* There is a 20% down payment required for any condo investment to avoid penalties
* Real-estate broker fee of 5% of market value at the end of the investment horizon (assuming the property will be sold at that point)
* Start-up cost of purchasing a condo of $6K to account for inspection & administrative fees
* $100 annual transaction fees for purchasing stocks
* 30Y investment horizon for all simulations

# Case Study 1: Testing Length of Amortization Period

Let us assume that you’ve decided to purchase a condo for $300K. You are left to decide how long your amortization period should be. As humans we are naturally debt adverse so you may want to pay off your mortgage as quick as possible (pick say a 20Y amortization period). Thinking by the numbers we must ignore that bias and look at the facts.

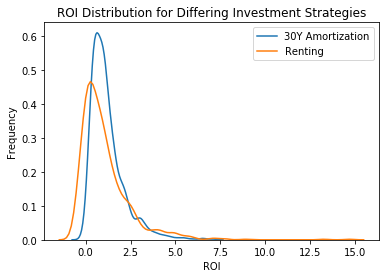


Consider the results of the Monte Carlo Simulation above. If you had decided to go with the 20Y amortization period your investment would be slightly safer – but you would be foregoing considerable upside potential when comparing to the 30Y period. Intuitively this makes sense – if you stretch out your amortization period you have more money now to invest into the stock market. While the stock market has a more risky return profile there is considerable reward opportunity on the right side of the distribution.

The preliminary conclusion is to advise maximizing the amortization period of any real-estate investment with the assumption that you can get a 10Y fixed mortgage at 3.2% interest.

# Case Study 2: Renting vs. Buying

Given the results of the amortization study let’s compare the purchase of a $300K condo with a 30Y amortization period to renting and investing all your money into the stock market.

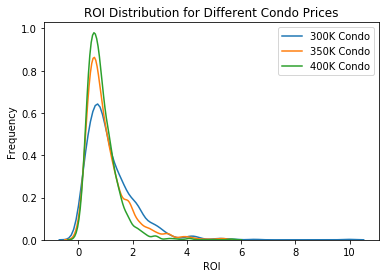


As anticipated - renting and putting all investment in the stock market is a riskier profile (wider distribution). This time however the majority of the risk is on the downside of the distribution when compared to the 30Y mortgage portfolio. It seems that the risk associated with putting all that money into the stock market might not be worth the potential downside.

Given the resultant distribution one can conclude that renting & investing all funds into the stock market poses too much downside risk to view as a viable alternative to buying.

# Case Study 3: Cost of Condo

Building off the previous analyses the best strategy would be to purchase a condo with a 30Y amortization period. You are now left with the decision: how much money should I spend on this condo? We can simulate the anticipated ROI distribution for a $300K, $350K, and $400K purchase.



The cost of your condo seems to affect your potential ROI significantly. While there is negligible downside risk to all 3 purchases there is considerably more upside potential if you purchase a cheaper property. By overspending on your real-estate purchase you can miss out on potential returns from the stock-market considering the more you spend on your condo the less you have for stocks. Given these distributions a more affordable unit is recommended to maximize your ROI.

# Conclusion

Given the results of these case studies I would recommend the following:

1. If you can afford the down payment and start-up costs - purchasing real-estate is a good investment in Montreal if the assumed alternative is to rent and put all your savings into the stock market
2. Select the longest amortization period you can while the interest rate of a 10Y fixed mortgage is hovering around 3.2%
3. Don't overspend on your real-estate purchase - if you don't allow yourself to put some of your yearly savings into the stock market you miss out on the potential upside of stock returns.

The prevailing theory stands: if you can afford it, purchasing real-estate is a wise investment. Futurists haven’t shifted the paradigm yet.