Realosophy

Defensive Home Buying Guide

Which neighbourhood is your safest investment in a fast changing market?

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INTRODUCTION

We are living in interesting economic times.

In 2007, the complex US sub-prime mortgage crisis crippled the international financial sector and led to a global economic meltdown. The crisis led to a 'freeze' in lending by banks and other financial institutions, a loss of firms and jobs among banking, legal, consulting and support sectors and sharp drops in major investment holdings for companies, institutions, individuals and families. Investment and job losses generally have spin off effects – not only does demand for high-priced goods and services drop, consumers tend to shy away from any purchase that can be delayed. Indeed savings rates jumped in North America, which had, prior to the crisis, not been notable for its 'rainy day' conservatism. For the first time in recent memory, home prices in most North American cities fell, many after seeing a record rise over the previous 8 years – or in the case of Toronto, 12 years. Even more striking, construction cranes, the ubiquitous workers that have come to dominate urban skylines, came to a standstill.

What came next in Toronto came as a surprise to all, including housing economists. In April 2009, a Toronto Dominion (TD) Bank housing market report predicted that the Toronto housing market would be "walloped". Instead, a dwindling supply of homes for sale resulted in bidding wars and rapid price escalation which continues at the time of publication.

As government spending measures aimed at reviving sluggish economies have begun to take effect, the pendulum may swing again. Experts are concerned about growing government and consumer debt, housing bubbles and inflation spurred by low interest rates. Bank of Canada Governor Mark Carney has advised Canadians to ensure that they do not take on too much debt, indicating that interest rates will rise. Economists and experts have been shocked by the threat of yet another global crisis, this time stemming from Europe, where countries have come perilously close to defaulting on loans. These developments, coupled with the HST that will come into effect on July 1, 2010 in Ontario, has led experts to forecast a cooling housing market over the next few years in Toronto.

Even in the best of times, buying a home can be a very stressful decision.

The current uncertainty surrounding our economy has heightened consumer concern. What most buyers fear is that their home will be worth less when it comes time to sell, leaving them worse off financially.

If buyers could be guaranteed that all financial risks could be eliminated, most of the anxiety associated with buying would disappear. Unfortunately, no such guarantee exists, but savvy buyers can make educated moves to reduce risk and produce positive outcomes.

OUR OBJECTIVE

Our 2010 Defensive Buying Action Plan has two key objectives. The first is to help you decide whether it is right for you to buy in a slowing market. Deciding whether or not it's the right time to buy means thinking about the current market as well as your personal circumstances. A slowing market is not for everyone, but if you are the right kind of buyer you may be able to take advantage of reduced prices and motivated sellers.

If it is the right time for you to buy, our second objective is to help you protect your investment. Unlike many real estate books, this is not a "become a millionaire home owner and get rich quick" guide. Our aim is simple – to help ensure that you break even at minimum when it comes time to sell your home. Making money from your home is certainly preferred, and if you follow many of our Defensive Buying strategies you will likely find yourself ahead when it comes to sell.

IS IT THE RIGHT TIME TO BUY?

> **"I sit down beside people on airplanes and tell them I'm an economist who studies cities, and they say, 'Oh, what's going to happen to housing prices?' All I can say is that I wouldn't be sitting beside you in coach if I really knew."**
>
> — University of Toronto Economist, William Strange, *Toronto Life*, March 2008

Regardless of whether the market is on its way up or down, buyers tend to have one question on their mind - is this the right time to buy?

Buyers understandably want to know the direction of the real estate market. Are prices on the way down or on the way up? Am I buying at the peak? How long before prices rebound? Should I wait for prices to drop a bit more?

The honest answer is that nobody really knows.

Even economists who specialize in real estate markets have a difficult time predicting the future.

Before looking at the real estate market proper, they must forecast a myriad of variables. Here are just a few:

- Where are interest rates going to be like a year from now?
- How much will gasoline and food cost in the years ahead?
- Is the average household income appreciating at the rate of inflation?
- Is immigration expected to rise or fall?
- How volatile are world financial markets? What direction will they move in?
- How are national economies expected to perform?
- How will the state of the US economy impact the state of Canada's?
- How will changes to the economy impact employment levels?

Forecasts for important economic indicators form the foundation for outlooks on the real estate market.

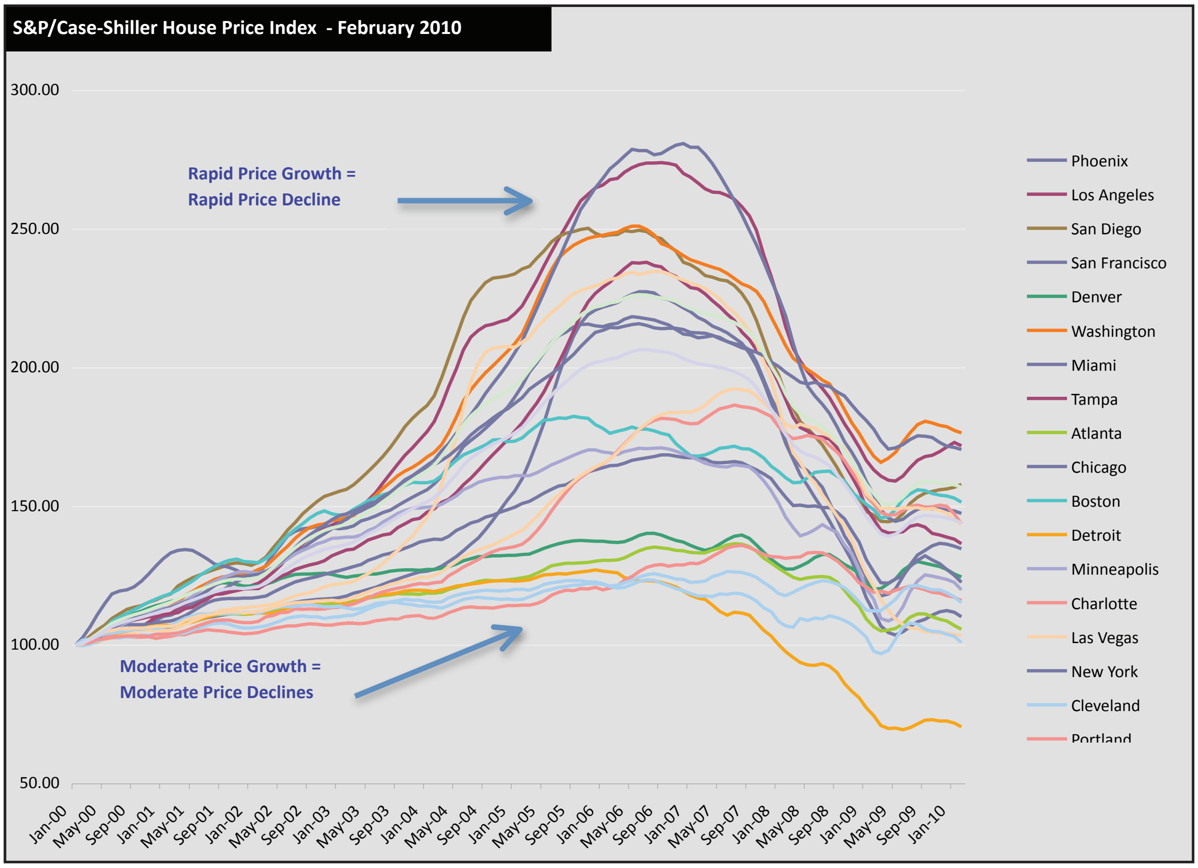
To produce outlooks for particular goods and services, including real estate, economists must concern themselves with social and demographic changes that drive demand. For real estate, factors may include:

- The size of the next cohort of first time buyers.
- Consumer preferences for urban or suburban living. (Often driven by other factors including changes to commuting times, location of employment and structure of households.)
- Impact of changes in consumer confidence. (Again related to other factors including perceptions about the general economy.)

Factors related to consumer behaviour are particularly difficult to forecast and have a profound impact on a city's real estate market. Heightened levels of consumer confidence are the fuel that drive real estate bubbles. When the economy is strong and real estate markets rise year after year, people begin to expect prices to rise forever. If consumer confidence is too high, it leads to high rates of speculation as people attempt to profit off the short term increases in property values. Eventually, prices begin appreciating not because of what economists refer to as market fundamentals (rise in incomes, increase in population, etc.) but because people simply expect them to. Prices eventually reach an unsustainable level which leads to a sudden drop in prices. The market always self-corrects. The extent of the decline in values often depends on how 'irrational' the market was before the peak. The more irrational, the bigger the drop.

Heightened levels of consumer confidence are the fuel that drive real estate bubbles.

The snapshot of the S&P/Case-Shiller House Price Index serves as a good example of how real estate bubbles impact house values. In this US survey, American cities that experienced the most rapid appreciation in property values also experienced the most rapid decline. Cities that experienced a slower (and more moderate) rise in property values generally experienced a similar ride on the way down.



Making sense of the market

The real estate market may be difficult to forecast, but we still need to make sense of what's going on to make an informed decision to buy or not. Here are a few tips that will help you make sense of the figures.

Focus on your market

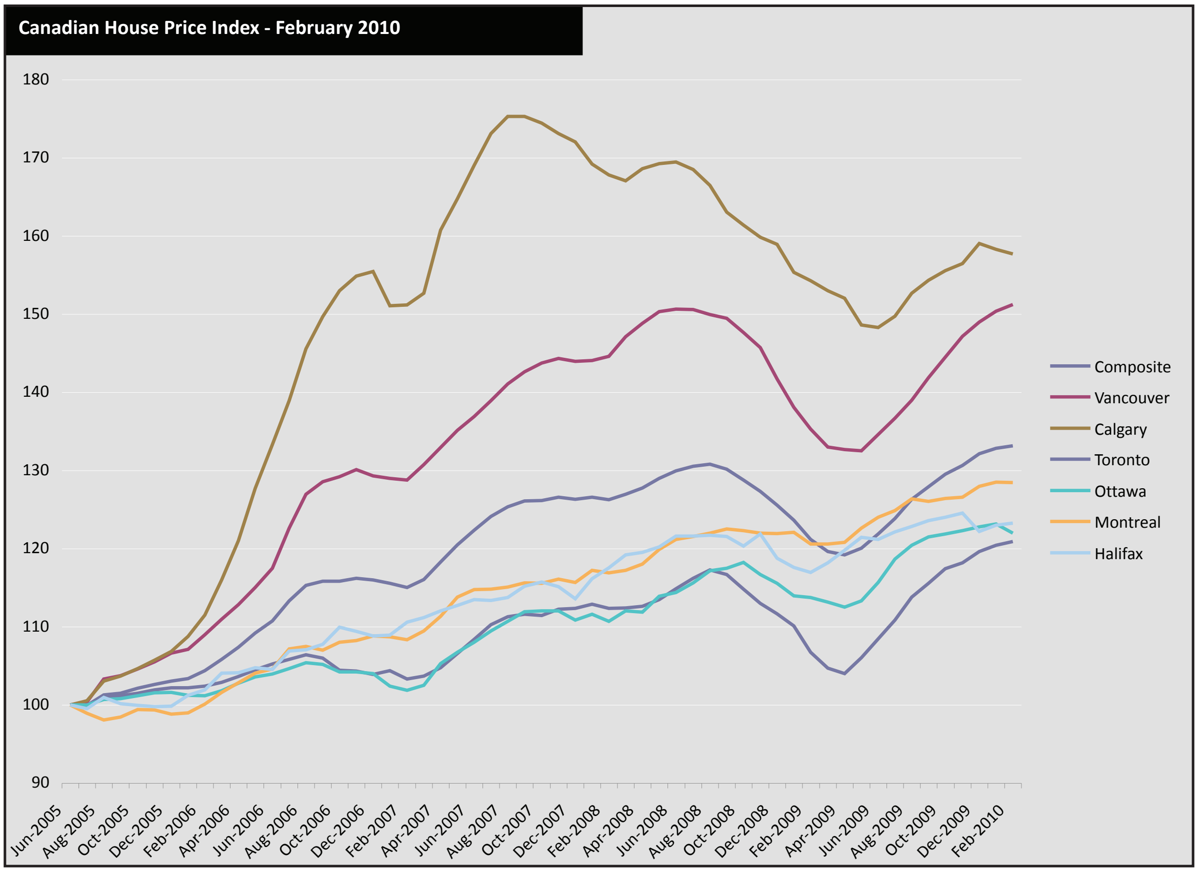
Media headlines often report changes in real estate statistics at a national level. These national figures help give you a general idea of how your specific city is performing relative to the rest of the country, but your focus should be on information related to your local real estate market.

There are many local factors that can have a positive or negative effect on a particular market. For example, some cities may experience a real estate bubble (appreciation not explained by market fundamentals) while others may not.

If we look at this February 2010 snapshot of the Teranet/National Bank House Price Index for six Canadian cities, we see that property values appreciated at very different rates over the past three years.

Calgary and Vancouver house values appreciated most rapidly of the six cities tracked. Toronto and Ottawa house values experienced more moderate appreciation.

Read multiple sources of information to look for factors that may impact your local market. Is your town more vulnerable to a loss of jobs related to a national decline in exports to the US? Are population levels rising or falling? Are average home prices reasonable given average household incomes?



Listen to reputable economists

> **"Well, obviously I sucked last year in my prediction.But I don't think ultimately that I'm wrong. I think that the timing of [the housing market] is a very difficult and problematic thing to know."**
>
> — Garth Turner, Financial Writer, 2010 Real Estate Roundtable, *National Post Magazine*

Never put too much emphasis on any one economic forecast. Instead look to see if different economists agree about the overall outlook for your real estate market or least arrive at a consensus on key factors. When you examine a particular outlook, particularly one that does not fit with the consensus, try to understand why an economist believes that the real estate market is going to go in a particular direction. After all, it doesn't take a genius to predict that prices will rise and fall – it's the 'why' that often predicts the 'when' and 'where'. What assumptions are they making and what are they basing their conclusions on?

Understanding the 'why' is important because it allows you to compare one economist's outlook to another's. It gives you the opportunity to base your decisions on the forecast that makes the most sense to you.

> **It doesn't take a genius to predict that prices will rise and fall – it's the 'why' that often predicts the 'when' and 'where'.**

Follow local real estate blogs

In comparison to the regular media, real estate blogs typically offer a far more local look at your city's real estate market. Of course, blogs are democratic – anyone can do it – so they vary greatly in quality and scope. You'll find blogs that are overly optimistic about the market, others that think the next apocalypse is coming (year after year) and a few that offer a more balanced approach. What is surprising, given the volumes on offer, is how few blogs are considered to useful reading by a wide array of readers. You will find that successful blogs offer unique insights that are appreciated by a wide audience, including the traditional media. Take note of bloggers who are often quoted in your local press. I like to read both positive and negative real estate blogs because it gives me a good understanding of what the two camps are saying and why. Reading different opinions will help you reach your own conclusions rather than being swayed by wishful thinking or simply fear helps reinforce your own views of the market.

Take your agent's advice with a grain of salt

Buyers often turn to real estate agents for insights into the housing market. While I encourage you to listen to different perspectives about the market, I recommend that you put less emphasis on your agent's personal outlook.

One problem with asking your agent is that regardless of what's going on in the market, many agents will say that it's a great time to buy real estate. When the market is on its way up, they'll tell you that if you don't buy now you won't be able to afford to buy next year. When the market is on the way down, they'll tell you that there's great value out there. While there may be some truth to these comments, it's hard to discern whether they result from actual analysis of the market or whether they are sentiments trotted out as required. The fact that agents are generally commissioned salespeople rather than salaried consultants or advisors is reason enough to take their advice cautiously.

Another reason I advise you not to depend on your agent's forecast alone is that most are not qualified to give you an economic forecast of the real estate market. Agents have a wide array of educational backgrounds and licensing requirements alone are not enough to make any of them into economic analysts or financial advisors. Most agents do not read economic forecasts. They do not read journals on the housing industry. They do not read books on long-term economic trends. Their outlooks are typically based on one of three factors:

- The same newspaper headlines that you read.
- Their "gut feeling" about the market based on what has happened in their office in the last few weeks. (Those in the business longer may refer to what happened the "last time" the market changed.)
- Popular sentiments including this old gem - "real estate is an excellent long term investment."

There are, of course, exceptions to the above rule. There are many realtors with educational and professional qualifications in the fields of economics, finance and business. Some are avid students of market developments and will offer buyers an objective opinion about the market. These agents are typically more focused on advising and coaching their clients and are less focused on making a quick sale. This is the key distinction I make between the 'consultant' and the 'salesperson'. Informed consumers should be able to differentiate between the typical real estate salesperson and the professional real estate consultant. Ask some questions. Bring up articles you have read. Challenge what you hear. Listen closely for canned, extreme responses instead of carefully explained positions that take particular factors into consideration. You will be able to hear the difference.

Bringing it all together

After listening to many different perspectives on your real estate market, you will ultimately have to decide what outlook makes the most sense to you.

Your outlook is going to be one of the key factors influencing your decision to buy or not to buy. If you determine that your city has a high proportion of jobs dependant on an industry that is particularly vulnerable in an economic downturn, than you might conclude that buying carries a high risk. If, on the other hand, you feel that appreciation in your city can be largely attributed to market fundamentals, you may feel that the risks of buying are relatively minimal.

Your focus should be to determine the approximate state of the current market – not to 'time' the market perfectly. Try to avoid the temptation to predict the short term movements of the real estate market. Everyone wants to buy at the bottom of the cycle or sell at the top, but even the experts don't know what is what until the dust has settled – and by then it's too late. A good parallel is the stock market, where people try to time their actions to make quick fortunes when study after study shows that our emotions give us optimistic outlooks long after the peak has been reached and pessimistic outlooks long after the worst has already been realized. Be comfortable understanding broad trends and general directions – they will keep you safer than you think.

Real estate is always a hot topic of discussion, so don't be surprised if people disagree with your outlook. As long as you have spent time examining the evidence, testing out your assumptions and looking out for personal biases, you should feel confident with your decision. As important as your market outlook is, it's the view from 10,000 feet up. On the ground, your personal finances, lifestyle choices and circumstances will have a profound impact on your decision-making. What to do if you have to relocate for a new job? Are getting married or divorced? Are in danger of job loss? It's time to get personal.

CAN YOU BUY SAFELY IN THE CURRENT MARKET?

Deciding whether or not to buy a home is as much about the current market as it is about your personal circumstances. The real question is not "Is it the right time to buy" but rather "Is it the right time to buy *for me*?"

Once you have done some research into the state of the real estate market, I recommend that you consult with a financial planner and a real estate professional who can recommend a solution based on your personal circumstances.

> **The real question is not "Is it the right time to buy" but rather "Is it the right time to buy *for me*?"**

There is no universal answer when it comes to deciding whether or not to purchase a home. Everyone's personal circumstances are different. What makes sense for one person may not make sense for another.

Trusted professionals can help by listening to your needs and recommending a solution that addresses your circumstances and concerns about the market.

The strategy that you, your financial planner and real estate agent come up with should reflect that there are certain circumstances under which you should strongly reconsider buying.

You should not buy in a slowing market if…

You are vulnerable to job or income loss

This one seems rather obvious, but is not always as straight-forward as it seems. Modern economies are increasingly characterized by interdependence and complexity. This means that we need to be more aware of how our jobs and personal finances are affected by economic movements at home and around the world.

For some, it is clear that the company they work for, business they own or service they provide will be affected by an economic downturn, particularly one that affects the US or particular sectors. A sluggish economy and loss of consumer confidence in the US hurts, for example, a large number of Canadian firms directly or indirectly dependent on exports. Other sectors may be relatively insulated from the turmoil. Your job, particularly in the health services, education or public service sectors, may remain reasonably secure, even though bonuses and salary increases have been eliminated. You may still be saving more than you normally would, but you can consider buying a home in the current economic climate – and benefit from increasing housing affordability.

However, if you are experiencing or expecting to experience job or income loss, now is not the right time to buy for you. It may be tempting to take advantage of falling home prices, but you need to focus on more foundational personal finance goals right now. Make an appointment at your bank or a registered non-profit agency to talk to a qualified financial planner or counselor – she will advise you on the step you need to take immediately which may be, for example, developing a strategy to get out of high interest credit card debt. Regardless of what the real estate industry may say about "not missing out" and the media may say about "being doomed no matter what", the real estate market is not a static extreme. It is your readiness – how well you have organized your personal finances and how clearly you can identify the right home for your lifestyle and needs – that will determine what the real estate market has to offer you at any particular time. You will be able to re-consider buying once you have taken some key preparatory financial steps and your job and/or income situation improves.

In the event that you are buying with a partner, you may be experiencing a mixed situation. While your job in the health services may look fairly secure, your brother's marketing job may be vulnerable as exports to the US fall. In such cases, you will need to be more cautious about buying and seriously consider adopting a more radical defensive buying strategy (which we'll look at in the next section).

You need to move within the next five years

My father is a long-time real estate investor and when a friend of mine asked him how he was able to survive Toronto's real estate crash in the early 1990s he said, "That's easy, I didn't sell in the early 90s."

One thing is almost certain – the value of your home will fall one day. If it doesn't drop today, it will drop tomorrow. Dips in value are a part of the real estate cycle and they affect everyone in the market. No home owner can avoid a downturn in real estate values.

My father's house and investments declined just like everyone else's did in the early 1990s. But these declines are just paper losses until you actually sell the property. He didn't lose money because he didn't have to sell. He didn't have to sell because he purchased properties well within his budget with large down payments resulting in manageable interest rates and monthly payments. And what's more, he did this while working in restaurants and garages, slowing saving the capital to own them and other properties.

It's encouraging to remember this because we are prone to overleveraging today because we feel that "there is no other way" – but there is. Sit down with your financial planner to develop a sound financial strategy that clearly identifies your home buying budget – and be prepared to stick to it. If you feel uncertain about setting a budget before looking for a home, talk to your real estate agent about the budget you and your financial planner have decided on and ask for an honest assessment of what is available in the market for your needs. You, your buying partner and/or family may need to separate out needs from wants in order to find a home that accomodates both your lifestyle needs and your budget. Remember, your goal is to be able to afford to stay in your house for at least five years to weather any short term slow down in the real estate market.

The actual time it will take for prices to rebound will vary from market to market. Cities that experience rapid increases and subsequent decreases in house values (ie. a real estate bubble) may take a little more time to recover than cities that didn't have a bubble in the real estate market. In Toronto, house values appreciated relatively moderately so we would expect any decline in home prices to be relatively moderate. Having said that, I still advise Toronto buyers to be prepared to stay in their homes for at least five years. Toronto's market may recover much sooner than that but your objective is to be safe in an unpredictable market.

Many buyers don't understand why they need to stay so long to be safe – which means breaking even. Buying and selling a house has many costs associated with it. When purchasing a home, your closing costs, which include legal and land transfer tax costs, could easily add up to 3% of your home's value. If you add mortgage insurance premiums to this, your total buying costs could total 4-5% of your home's value. When selling a home, it may cost you as much as 5% of your home's sale price to list it for sale with a real estate agent. Your combined costs to buy and sell your house could be as high as 10% of your home's value. This means that your house must appreciate by 10% in order for you to break even.

For many, staying put becomes a challenge when lifestyles and needs change. None of us are fortune tellers (you wouldn't be reading this if you were), but we can often foresee major life changes if we take the time to think about our current circumstances and goals. If you work in a global industry, your job may move to a new city in an economic downturn. You may be single now, but your status could change in the near future (or vice versa). Perhaps you are not satisfied with your current job and may choose to take pay cut in order to return to school. If you think that there's a high likelihood that you are going to need to move within the next five years, you should seriously reconsider buying in today's market.

One trap that buyers fall into is intending to stay put for at least five years, but not buying the home that would allow them to do so. A common example is the newly married couple who wants to start a family quickly and opts for a 'starter' condo that is very affordable – only to find themselves wanting to live by a better school or have more space within one to two years' time. If you are forced to sell too early because your home can no longer accommodate changes in your lifestyle, you may be putting your investment at risk. Think ahead to ensure that the home you buy now will still fit your needs in five years time.

REAL LIFE – BREAKING EVEN

Let's suppose for a moment that you just bought a house for $100,000. Let's also assume that you bought in a hot market so the value of your home has increased to $108,000 within several years. On the surface, selling looks like a great idea because you get to pocket a cool $8,000 - but look again.

Real estate agents charge, on average, 5% to sell your house, which means you only keep about $102,500 (of the $108,000) for yourself. When you take into account the legal and closing costs associated with buying and selling a home, as well as your mortgage default insurance premium, you are just breaking even on your initial $100,000 (or are even down a bit of money).

Now, we haven't taken into account the money that you would have saved up by paying-off your mortgage principal and building home equity. But the additional ownership expenses that you would have incurred over and above the cost of renting during this period will probably cancel out any gains in equity.

Think you may have to relocate to another city in the near future? This doesn't necessarily mean that you can't buy a home now. The key is not living in your home for at least five years, but owning it for this period. If you are willing to own your home while you are away, buying may still be right for you. You can lease out your house to help cover the costs of your mortgage, taxes and other miscellaneous expenses. Of course, this means having a frank discussion with professionals about what responsibilities come along with being a landlord, particularly an absentee one. In addition to visiting a lawyer, you should have a frank discussion with your buying partner and/or family to ensure that everyone would be comfortable taking this route.

You do not have a down payment

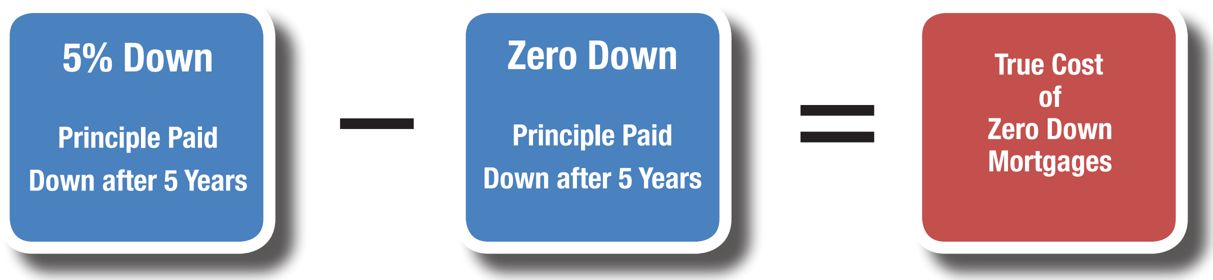
Saving a down payment of least 5% should be the first goal of any buyer to be. But why bother when there are zero down mortgage products on the market today?

While many lenders have stopped offering zero down mortgages in the aftermath of the US sub-prime meltdown, some continue to offer this product to buyers. You may also come across real estate agents who push zero down mortgages as a way to lure uncertain buyers. The problem with zero down mortgages is that they aren't zero down at all – they're actually cash back mortgages in disguise.

Zero down payment mortgages are typically fixed for a minimum 5-year term at the bank's posted interest rate, with no option to negotiate a lower rate. Once you take out your mortgage, your lender gives you 5% of your mortgage amount in cash that must be used as your down payment. Sound too good to be true? It is. Just like the cash back mortgage, the very real catch is that you are stuck with a higher interest rate for the entire term of your mortgage.

Not only does the zero down option cost you more in terms of higher interest payments, it is also more risky. You will now have to avoid incurring significant bank penalties by moving or canceling your mortgage before your 5-year term is up. If you can't sell your home at a high enough price to recover your costs, you could wind up owing the bank money that must be paid back immediately. When you don't have your own savings invested in your home from the very start, you lack a cushion for rough landings. Conversely, by saving up a down payment, you begin home ownership with instant equity in your home and more financial confidence.

Many buyers who opt for zero down mortgages don't realize that these mortgages do come with a significant cost attached to them. Unfortunately, the cost of zero down payment mortgages is a little tricky to see. To find it, you need to calculate how much of your mortgage you would have paid down after five years with a 5% down payment and then subtract the amount you would have paid down over five years with a zero down mortgage. The difference is the true cost of a zero down mortgage.



Talk to your financial planner about the smart moves you can make to save up what can seem like a daunting amount. Often we have formed financial habits and made decisions that served us well through our student or early career days that are badly in need of updating. Or we may have been swept up in the demands of raising a family and now need to reflect on the unhelpful patterns we have developed. You may be paying too much interest on credit products or putting your savings into the wrong vehicles. You may need to scrutinize your spending habits closely.

Saving a down payment is a challenge but it's doable. And most importantly, it sets you up with the right framework to make good financial decisions long after you've moved into your new home. With the help of the right professionals and a good strategy, you can reach your 5% goal – and even surpass it.

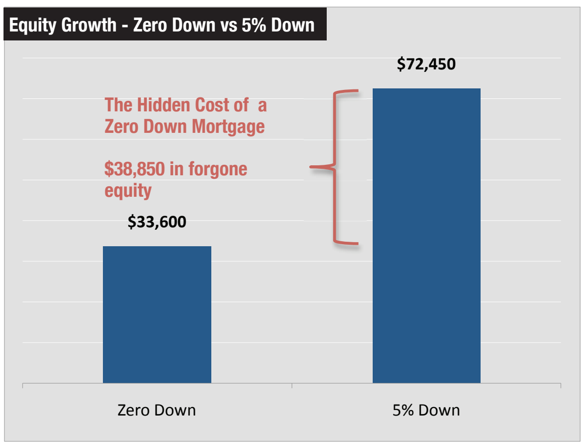
REAL LIFE – THE TRUE COST OF ZERO DOWN

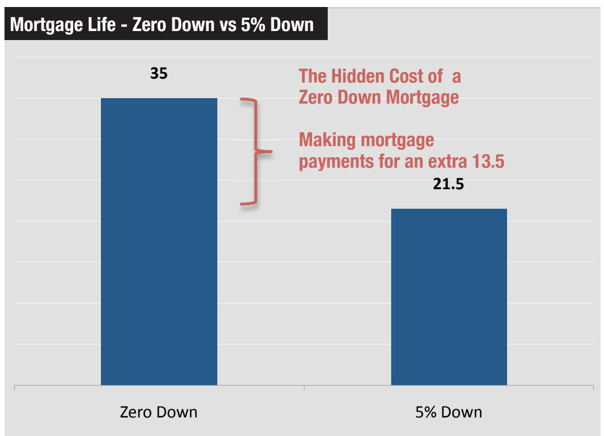
Imagine you are about to purchase a home valued at $400,000 and are trying to decide between using the $20,000 you have saved up as a down payment or opting for a zero down mortgage so you can use the $20,000 to buy furniture and do some minor renovations.

If you opt for the zero down option, your total mortgage amount including mortgage loan insurance would be $411,600. If we assume an interest rate of 6.5%, accelerated bi-weekly payments and a 35-year amortization, your bi-weekly mortgage payment would by $1,230. After five years, you would have paid down your mortgage by $33,600.

If you had opted to purchase with a 5% down payment, your total mortgage amount including mortgage loan insurance would be $390,450. We will also assume a 5% discounted interest rate and accelerated bi-weekly payments. If we keep the mortgage payment the same at $1,230, we find that it takes you 21.5 years to pay down your mortgage instead of 35 years. After five years, you would have paid down your mortgage by $72,450.

The hidden cost of taking a zero down mortgage in this scenario is $38,850, or the $72,450 in equity you would have accumulated in 5 years with a 5% down payment minus the $33,600 you accumulate with no down payment. Not having a 5% down payment costs you $38,850 during the first five years of your mortgage. The other hidden cost is the fact that it would take you 13.5 years longer to pay down your mortgage than if you bought with a 5% down payment.





DEFENSIVE HOME BUYING STRATEGIES

After examining the current market and taking stock of your personal financial situation, you've decided that you are ready to buy a house. Maybe you're looking to capitalize on falling home prices or perhaps a life change is making a new home a necessity. Whatever your personal circumstances, you need to make the right decisions today to ensure that your investment is secure in the future.

The fear of financial loss is the one fear that virtually all buyers confront. When buying in a slowing market, this fear is even more pronounced. That is why is it important to identify and mitigate major risks associated with buying a home. Our defensive buying strategies are designed to help protect your initial investment, even if your house does not appreciate in value by the time you decide to sell it. They are designed for today's market.

We will examine ten strategies – three of which we have already reviewed. If you have identified issues with any of the following strategies, you need to seriously reconsider buying a home in today's market.

1. **Assess vulnerability to job or income loss.**

   You need to focus on more foundational personal finance goals if you are experiencing or may experience significant income or job loss. Talk to your financial planner or consult with a registered non-profit counseling agency about developing a proper strategy immediately. If you are buying with a partner and only one of you is vulnerable to job or income loss, you should consider a more radical defensive buying strategy, such arriving at a buying budget based on <u>only one</u> of your salaries and/or income.

2. **Plan to stay put for at least 5 years.**

   You must be able to afford to stay in your home for at least five years or more to weather a slowing real estate market. Identify a budget to ensure that you do not overextend yourself and make staying in your home difficult. You will also need to consider your current and future lifestyle needs to ensure that the home you buy today can accommodate potential life changes within the next 5 years.

3. **Save up at least a 5% down payment.**

   Regardless of what financial products are on offer, you must first save up at least a 5% down payment to protect the significant investment you will make when you buy a home. Realizing this critical goal will provide a framework for realizing other key financial goals.

We'll now turn to six additional defensive buying strategies.

4. **Get your finances in order.**

5. **Save up an emergency cushion.**

6. **Don't overextend yourself.**

7. **Choose a home first, neighbourhood second.**

8. **Look for value.**

9. **Think twice about pre-construction.**

10. **Buy a house with a rental.**

Get your finances in order

Before you start looking at houses, you want to make sure your personal finances are in good shape. Just because your bank is willing to give you a mortgage pre-approval, it doesn't mean that your finances in order.

The goal here is to try to adjust your personal debt obligations to reduce the overall interest you will pay on your mortgage. You want to get this sorted out before you buy your home. If you have followed the 5% down payment strategy, you are well on your way to making sure your finances are in order as you will have already followed some of these steps.

Credit card debt is one of the first things you should be taking a look at. If you are carrying balances on your credit cards you need to meet with your financial planner or contact a registered non-profit conselling agency to eliminate these balances before buying a house. Saving money to pay off those balances should be your first plan of attack, but your financial planner may also suggest helping you lower the amount you need to pay by consolidating the debt into a loan or line of credit with a lower interest payment. If your plan is to consolidate, make sure to inform your financial planner of any other loans you might have. They may be able to consolidate all of your outstanding debt obligations into one loan with a lower interest rate and a lower monthly payment.

In addition to getting your debt obligations in order, you're going to want to get your savings in order as well. As we have discussed, you should make it a goal to save at least a 5% down payment. For a $200,000 home, your down payment would be $10,000.

You will also need to save up to pay the closing costs associated with the purchase of a home. Closing costs include all the taxes and fees, including legal fees required to process the transaction, and are usually between 2-3% of the purchase price. Looking at a $200,000 home, this would amount to approximately $4,000-$6,000 in closing costs. If you are not a first-time buyer and/or are purchasing property over $400,000, you will also need to take into account recently introduced land transfer taxes in Toronto as well as the recent provincial shift to the harmonized sales tax (HST). First-time buyers and/or those buying property under $400,000 qualify for rebates that offset many of these taxes.

Adding down payment and closing costs together, you should aim to save about 7.5% of the purchase price of your home (5% for your down payment and an average of 2.5% for your closing costs). If you and your financial planner have budgeted for a home valued up to $200,000 and you qualify for a mortgage in this amount, this means that you should begin saving approximately $15,000. See the following table for more price points, keeping in mind that these rule of thumb amounts will change according to your own particular circumstances.

Savings Required to Buy a Home

Home Price	Down payment (5% min.)	Closing costs (2.5%)	Total savings required (7.5%)
100,000	5,000	2,500	7,500
150,000	7,500	3,750	11,250
200,000	10,000	5,000	15,000
250,000	12,500	6,250	18,750
300,000	15,000	7,500	22,500
350,000	17,500	8,750	26,250
400,000	20,000	10,000	30,000

Save an emergency cushion

Given the uncertainty of the economy at present, personal finance experts advise their clients to save up an emergency cushion to cover core living expenses (including mortgage payments) for up to six months. The purpose of this fund is to be able to cover your expenses in the event of unforeseen job or income loss. This is another step in ensuring that your finances are in order.

While it is necessary for you to save up to cover your down payment and closing costs *before* you begin your search for a home, you can save your cushion while looking for and even after purchasing your home. The idea here is not to set up an unattainable goal but rather to further develop your positive financial habits and build up a financial defense given the state of today's economy.

You can speak to your financial planner about setting aside a reasonable amount of your income each month. Many experts use 10% to 12% of your weekly, bi-weekly or monthly salary payment as a good rule of thumb. You can arrange for your bank to transfer this amount directly from your account to an appropriate saving account or fund. It is also important to note that there are a number of new products on the market, including tax-free savings accounts for non-retirement use. Talk to your planner to identify the right vehicle for you.

Don't overextend yourself

We have touched on this in previous sections, but the danger of overextending yourself when you buy a home cannot be overemphasized. Even in the best of markets, I advise buyers not to spend the most that they can on a home but rather the least they can to meet their key needs. This advice is particularly important in a slowing market.

Before you head out home shopping, you will need to create a personal budget in order to understand how much you can afford to spend on a home. Your lender will tell you the maximum amount they'll lend you to buy a home. You can use online tools (see realosophy.com for home buying calculators) to calculate the amount you may receive from the bank, but remember that you should always verify this information by formally applying to your bank for pre-approval.

Receiving a pre-approval from your bank only gives you a part of picture in determining how much you should spend on your new home. Every buyer is unique. The formulas that banks use to determine your mortgage amount do not take into account your personal lifestyle choices or long-term goals. Perhaps you would prefer to spend much less on a house than you actually could in order to put the extra money towards an education fund or a hobby that you're passionate about. Whether it's earning a university degree or becoming an amateur haiku poet, if it's important to you, be sure to include it in your planning. If you are self-employed you may also want to spend less on your home to give yourself some breathing room in case you find that your sales are down in the current market. The same applies to salaried employees who normally rely on bonuses to top up their income.

Your home should enhance your life, not limit it. You may have heard the expression "house poor" used to describe those who make financial sacrifices to live where they do or provide their children with a large backyard. These decisions are highly personal ones and they may be right for some. Whatever you do decide to do, make sure it is your own choice. Develop a detailed budget and figure out how much you really want to spend each month on home-related expenses. In making your budget, make sure that you take the time to think about your lifestyle choices over the next five years.

It is helpful to develop your budget with your financial planner as she may be able to point out costs and considerations that you may otherwise forget to take into account.

REAL LIFE – BUYING A HOME THAT'S MANAGEABLE ON ONE INCOME

Given the current state of the economy, it may be prudent to take a more radical approach to avoiding overextension. A couple I recently worked with earned incomes which together qualified them for a $650,000 mortgage. Even though this price point left them with monthly payments that were manageable given their joint income, the couple decided to spend what they could afford based on one income alone. They both felt their jobs were relatively secure but wanted to be safe as they were buying their home in a period of economic uncertainty. Importantly, they were very happy with their housing and neighbourhood choices in the $325,000 price range and knew they could live there comfortably for the next five years. It can be psychologically and emotionally difficult for buyers to spend less than the mortgage amount they qualify for, but those that spend cautiously stand to gain over the long run.

In addition to offering you more security should you or your buying partner lose a job and/or income, it also means more money in your pocket if you decide to accelerate your mortgage payments. In the above example, the couple's mortgage payment on the $325,000 home was based on a 35-year amortization mortgage which left them with payments that were manageable on one income. But since their double income allowed them to put more towards their mortgage, they decided to double up their payment each month. If a financial emergency came up, they could always revert back to their lower monthly mortgage payment. But if their finances remained strong, they could continue to double up their payments for the life of their mortgage, becoming mortgage free in 11.5 years instead of 35 years.

A slowing market is not the time to overextend yourself on a home, particularly when falling home prices mean that there is greater selection available at a range of price points. Focus on spending as little as possible on your home. It will mean a world of difference to your peace of mind and long-term financial prospects.

Choose house first, neighbourhood second

Choosing the right neighbourhood is a very important part of the home buying process. Unfortunately, many buyers often find that they cannot afford the type of house they want in their first choice neighbourhood. They are then faced with the decision to purchase the perfect house in their second choice neighbourhood or the not so perfect house in their preferred neighbourhood.

REAL LIFE – CHOOSING BETWEEN HOME AND NEIGHBOURHOOD

Here's a real life example of two buyers who were faced with the challenge of prioritizing between home and neighbourhood.

Steven and Sarah were looking for a well maintained 3 bedroom house with parking in a well known and established Toronto neighbourhood. They were planning to have children over the next couple of years and wanted a big enough house for them to grow into. As they started to look for homes in their preferred neighbourhood they quickly realized that the most they could afford was a 2 bedroom house with no parking. After visiting a few open houses in a nearby up and coming neighbourhood they saw that they could easily afford the house they wanted in a less established neighbourhood.

Steven and Sarah were faced with a decision that many buyers come across, deciding between the house they want and the neighbourhood they want.

The best solution for them really depends on how long Steven and Sarah are prepared to live in each of the houses. If they can realistically commit to living in the two bedroom home in their preferred neighbourhood for at least five years then they could buy in their preferred neighbourhood with confidence. If, on the other hand, they know that they'll outgrow the two bedroom house in the next two to three years, but can stay in the three bedroom house in the up and coming neighbourhood for at least five years, they should buy in their second choice neighbourhood.

In a slowing market, preference should go to the house that will accommodate your lifestyle and needs for at least the next five years. This may mean choosing a bigger home over a preferred neighbourhood.

For others, this may mean choosing an established neighbourhood that has the schools your family will soon need over an up and coming neighbourhood that is still developing.

Some might argue that real estate is all about "*location, location, location*" and it's always better to buy in the best and most established neighbourhoods. While location is an important factor in your buying decision, it's not the only factor. Location is just one of several factors that will ultimately determine which house is right for you. Remember, the goal of our defensive buying strategies is to minimize the risk of losing your investment in a slowing market which means avoiding the risk of having to move too early.

Look for value

There are two key things you should look for when you are out looking for a home that offers good value for its price.

The first is the physical features of a home. As you walk through each house, determine whether the bedrooms are big enough, the closets ample in size, the kitchen functional and the backyard spacious. Another important physical attribute you need to consider is the floor plan of the house. Do you like the way the house is laid out? Keep in mind that some walls can be removed to create a more open concept layout, if that is what you prefer. Make sure you get in touch with a reputable contractor to see if the renovation you have in mind is doable and be sure to get a rough estimate of the cost before you buy. Whatever changes you would like to make, know that the general layout, the footprint of the home, cannot be changed, so make sure that the basic frame is something you are really happy with. Homes that can be modified to suit your needs at a reasonable renovation expense can be good value choices.

The other thing you want to take note of is your emotional reaction to a home. The real estate industry has long realized the power of the emotional reaction and an entire industry called 'staging' has spawned as a result. Listing agents transform (or stage) the interior decor of home for sale into something they believe will trigger the sensation of 'love at first sight.' Staging can be as simple as cleaning up clutter and re-arranging furniture, to something as extravagant as repainting and renting furniture and artwork to give the house a very specific look and feel. Regardless of whether a home is being staged or if the seller is actually selling a stunning home, the point here is that the emotional reaction that most people have when looking at a home has a lot to do with its interior design.

It can be really hard to imagine what a house would look like once liberated from 1970s pea-green wallpaper.

In a slowing market, home prices are likely to decline in the near term – even after you buy. It is not the time to pay extra for good packaging – you want to pay as close to the true value of the home as you can. This will help ensure that you will fully recover your investment as the market balances out over the longer term.

When you are out looking at home, ask yourself what it is that you do not like about a home before you simply dismiss it. If you find that a home has all of the physical features you are looking for, but just doesn't excite you, maybe you are being influenced by the interior decor of the home. If you find yourself in this situation, do your best to picture what the home would look like if you were to re-design or decorate it. This exercise requires a lot of creativity on your part, and unfortunately, the more unsightly a home is, the harder this is to do. It can be really hard to imagine what a house would look like once liberated from 1970s pea-green wallpaper. But the effort is well worth it - the buyer who can look beyond a home's current decor has a better chance of finding a good value.

Think twice about pre-construction

> **"It's another feature of the speculative mode that, as time passes, the tendency to look beyond the simple fact of increasing values to the reasons on which it depends greatly diminishes."**
>
> — John Kenneth Galbraith, Economist and Author, *The Great Crash 1929*

The past ten years were kind to buyers and real estate speculators who invested in pre-construction homes and condominiums. Purchasers who bought in the early stages of a new development were able to realize a significant return on their investment by the time their home or condo was completed.

Long lineups of purchasers eager to buy early before prices went up were a staple of new condo openings during this decade's condo boom. When Toronto's Tannery Lofts sales office opened in 2004, the sales team would ring a cowbell to inform the lineup of waiting purchasers that prices had just been jacked up. The height of Toronto's condo madness was reached when realtors began paying students to wait in line outside the sales office of 1 Bloor, up to a week before the sales office opened.

For too many years there has been an underlying assumption among many condo purchasers that you can't lose when buying a new construction condo. The assumption is that if you buy early enough, you are virtually guaranteed to make a significant return on your investment by the time your condo is completed. This underlying belief about the condo market reminds me of something John Kenneth Galbraith once wrote, "it's another feature of the speculative mode that, as time passes, the tendency to look beyond the simple fact of increasing values to the reasons on which it depends greatly diminishes."

Do new construction homes and condos always increase in value or were the increases this decade a function of a booming real estate market? What happens if prices remain flat, or even drop slightly, over the next five years? How will this impact your investment by the time it is completed? If you assume that your new construction home/condo will not appreciate in value by the time you take possession, would you still buy?

Our booming real estate market has made many people forget that there are risks with buying new construction. Even the assumption that your condominium will be completed is something that purchasers need to start questioning. Jane Renwick from the condo consulting firm Urbanation reported in October 2008 that up to 30% of the 120 new condos being marketed and not yet under construction may never even break ground, "the "A" locations – the ones downtown, or near subway lines and being built by proven developers – aren't affected. It's the "B" locations being presold by unproven developers that are causing concern."

The market has changed significantly over the past year. Your buying decisions should not be based on the same assumptions you had two years ago. If you're contemplating buying new construction, leave your previous assumptions at the door and look closely at all the factors that may impact your investment. Ask yourself whether the home or condo you are looking at will keep you within your budget and satisfy your needs for at least the next five years – without the expectation of any quick return on your investment.

"…the "A" locations – the ones downtown, or near subway lines and being built by proven developers – aren't affected. It's the "B" locations being presold by unproven developers that are causing concern."

— Jane Renwick, Urbanation

With condos, remember that location does tend to matter when it comes time to sell as many buyers look to sacrifice living space for a more convenient lifestyle. While market fundamentals in Toronto are generally sound, there is more uncertainty about longer-term supply and demand prospects for condos given the city's recent boom. In the condo market it is difficult to determine how much demand is driven by residents choosing to live closer to work and play and how much is driven by absent, often foreign, speculators. If too many units come onto the market at the same time, owners may increasingly turn them into rentals affecting the quality of resident communities in some buildings. More generally, increased supply may lead to downward pressure on prices. In a slowing market, it is important to remember that there is indeed an A list and a B list. After visiting a condo, look for reasonably good quality amenities like grocery stores, restaurants and public transit. Better yet, take the bus or subway home and evaluate the duration and ease of travel.

If you have settled on a home or condo that fits your budget and lifestyle needs and are satisfied about its value, you should spend the rest of your time researching outside of sales rooms and model suites. Check into the track record of the developer and try to speak to people living in the same complex or other buildings. Many internet groups and websites have been set up by consumers for this purpose. Call local authorities to ensure that firms involved with the project are registered properly. Make sure your agent and a reputable real estate lawyer look at any document before you sign it.

Buy a house with a rental

Houses with rentals come in various styles, locations and price ranges. They range from an entry level bungalow with a basement apartment to a luxurious duplex in a high end neighbourhood. Regardless of what price range you're in, a house with a rental can be a great defensive strategy in a slowing market.

The key to this strategy is to apply the monthly rent you're receiving from your tenant directly to your mortgage. This payment should be over and above the monthly mortgage payment you make each month. For example, if your monthly mortgage payment is $1,500 and you have a tenant paying $700 for a basement apartment, you should be paying $2,200 directly to your mortgage each month.

By applying the additional rental income directly to your mortgage, your tenant's payments are lowering your mortgage amount and increasing the equity in your home. This additional equity gives you a bigger cushion to work with should house prices not recover completely by the time you want to sell.

This strategy is particularly effective for individuals who find they need to sell their house much sooner than they originally planned, for example, due to job relocation. Suppose that three years into buying your home, you suddenly need to sell. In order to break even you must have accumulated enough additional equity in your home to cover all the closing costs of buying and selling which can run as high as 10% of your home's value – equity over and above your original down payment for the home.

There are two main ways to accumulate additional equity in your home. The first is capital appreciation, which is a fancy way of saying that your home rises in value (as determined by the market). As your home increases in value over time, this translates into more money in your pocket when you decide to sell. The other way to accumulate additional equity is by reducing the outstanding amount owed on your mortgage. This amount declines naturally as you make your regular mortgage payments, and can be accelerated by making additional payments, for example, by applying your tenant's rent payment to your mortgage.

When you make these additional rent payments towards your mortgage, you end up developing a protective cushion that protects your down payment from a potential loss in the future.

REAL LIFE – USING A RENTAL TO PROTECT YOUR INVESTMENT

If your tenant's rent is $700 per month and you apply that rent towards your mortgage each month, you'll have roughly $25,000 in additional equity after three years, thanks to your tenant. You have also given yourself a $25,000 cushion that will protect your down payment from any potential loss should you need to sell suddenly. This means that should you sell your house after three years and find yourself down $25,000 after the transaction has been finalized, your tenant's rent will cover this loss, leaving your down payment safely in your pocket.

Act Defensively, Buy Safely

We are all feeling anxious these days and it's no wonder – media headlines continue to trumpet bad news and friends and family are worrying about their jobs and personal finances. It's a difficult time, and yet, it's still the right time to buy for some.

Take the time to consider whether it's the right time to buy for you. If you are reasonably secure about your job and/or income, can save up a down payment of at least 5% and plan to stay in your home for at least five years, you can buy a home with a degree of confidence. Follow our defensive buying strategies to further protect your investment and this confidence will grow.

Choosing Help Carefully

As you study these defensive buying strategies and work to implement them, it is important that you consult with professionals who are trained to tailor these strategies to fit your personal circumstances.

Real Estate Agent

A real estate agent specializes in buying and selling homes. Provincial legislation requires real estate agents to identify themselves as salespeople, but when you choose a buying agent, you should look for someone that acts as a consultant rather than a salesperson. You may wish attend free workshops or read local real estate blogs to identify agents who are committed to providing an objective analysis of the market. Visit websites to understand how brokerages aim to oversee their agents and ensure a consistent level of client service. You can also ask family and friends for referrals.

Real estate agents must operate with a provincial license and be registered with the Real Estate Council of Ontario (www.reco.on.ca). Real estate brokers have additional license to be responsible for a brokerage.

Financial Planner

A financial planner is trained to help you realize your short and long term financial goals. Look for a planner that is able to explain complex financial issues in plain language and willing to advocate for your interests. Certified financial planners have achieved professional standards required by the Planners Standards Council (www.fpsc.ca), a Canadian not-for-profit organization. Contact banks in your area and interview planners to find one that meets your needs. You may also wish to ask friends and family for referrals. You should not hesitate to seek a second opinion from another planner if you are uncertain about a proposed a course of action.

If you are experiencing debt or financial problems, you may wish to contact a not-for-profit credit counseling agency that is member to the Ontario Association of Credit Counselling Services (www.oaccs.com).

Mortgage Broker

A mortgage broker works to help you finance your home purchase through a mortgage (loan). A good broker is more interested in understanding your financial needs and goals than selling the financial product of the day. Your broker should be able to explain how much you will owe, and what your interest rate and payments will be over the entire length of your mortgage. Visit several banks in your area to find the right broker and the right financial products for you. Your real estate agent may be able to provide a referral as well.

In Ontario, mortgage brokering professionals are licensed by the Financial Services Commission of Ontario (www.fsco.gov.on.ca), an arm's-length agency of the Ministry of Finance.

Lawyer

A lawyer is responsible for drafting your paperwork and looking after your best interests. Your real estate agent may be able to refer you to a trusted lawyer or you may contact reputable firms that specialize in real estate. Your lawyer should be able to explain complex issues in plain language and help you determine your level of risk in a transaction. If you are buying a new construction condo or home from a builder, it is especially important that your lawyer review any documentation before you sign.

The Law Society of Upper Canada (www.lsuc.on.ca) is the governing body for lawyers and paralegals in Ontario.