Lorraine landed her first big job, can she afford to buy a home in three years?

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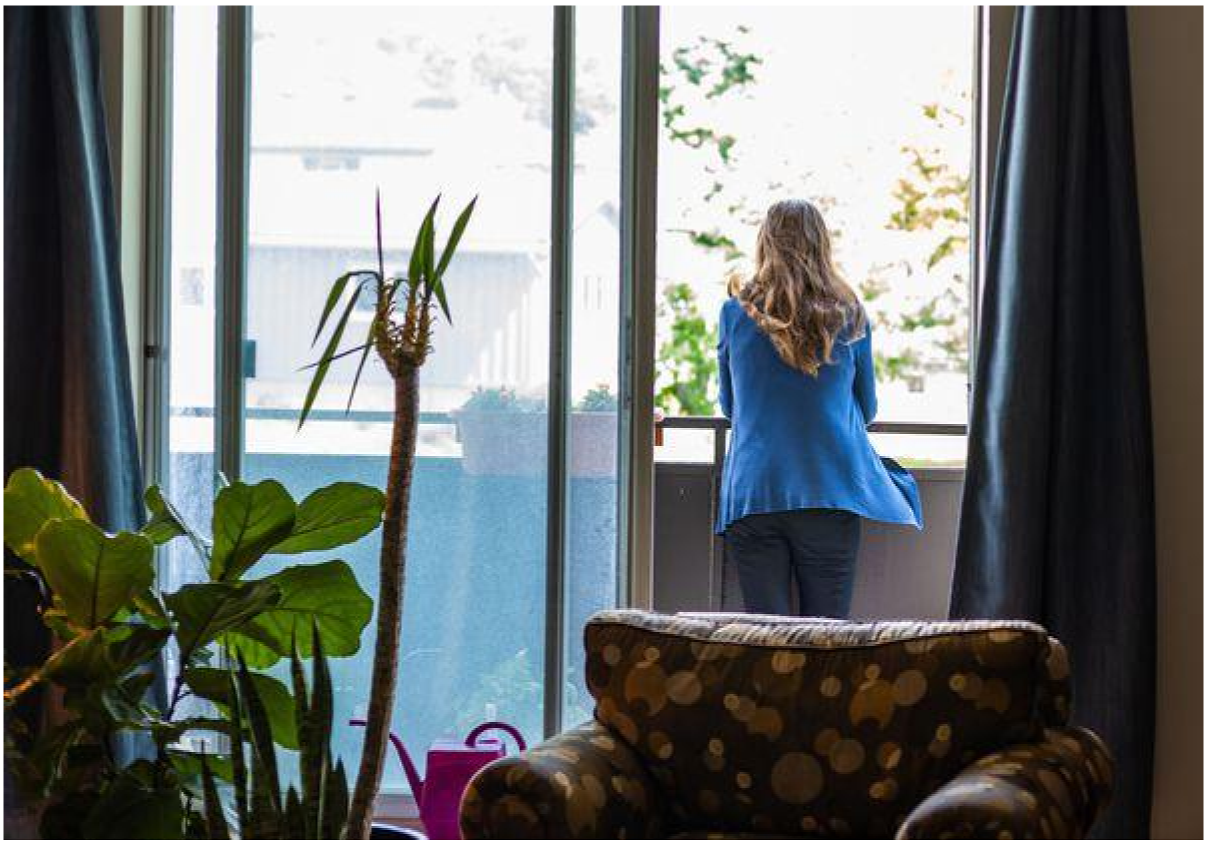

At age 26, Lorraine is well on her way to becoming a highly paid professional. She recently landed her first big job and now she's hoping to buy a detached house in the Southern Ontario city where she lives and works.

Lorraine's new job comes with an $85,000 a year salary, a substantial increase from her previous position. She also has a group registered retirement savings plan.

"I'm wondering how to best invest my additional cash flow such that I can meet my goal of purchasing a home in about three years," Lorraine writes in an e-mail. "Should I maximize my

RRSP contributions or invest in a personal non-registered stock and bond portfolio?" So far, she has amassed an impressive $110,945 in savings.

Lorraine is paying about $1,575 a month in rent, home insurance and electricity.

Because she lives in a university town, she would consider renting out a room to help with the carrying costs of the new house. She anticipates her annual earnings will rise to the $100,000 range over the next three years.

We asked Barbara Knoblach, a certified financial planner and money coach at Money Coaches Canada in Edmonton, to look at Lorraine's situation.

What the expert says

"Lorraine has set her sights on an older, detached home close to a city park and trails," Ms. Knoblach says. Houses in this neighbourhood are listed in $750,000 range. Lorraine, who is single, wants to buy the property on her own without relying on her parents, whom she feels have done enough by helping her with university tuition.

Lorraine contributes 3 per cent of her base salary to a group RRSP at her new job and gets a matching contribution from her employer. She also has a group RRSP from a previous employer and she contributes the maximum each year to her tax-free savings account.

Excluding her TFSA contributions, Lorraine's living expenses are about $3,105 a month, about half of which goes to housing. She has a surplus of $920 a month to put toward a down payment on a first home.

Lorraine plans to use most of her savings for the down payment, including her TFSA and $35,000 from her RRSPs under the federal Home Buyers' Plan. She plans to set aside the savings in her non-registered investment account for long-term capital appreciation.

Although not specifically requested by Lorraine, Ms. Knoblach analyzed the feasibility of Lorraine's plan, comparing the cost of continuing to rent or buying a $750,000 house. If Lorraine saves and invests her surplus from now to early 2025, when she closes the purchase, she could accumulate $83,300 in her TFSA and an additional $35,000 in non-registered savings and investments, the planner says. Together with the $35,000 from her RRSP under the Home Buyers' Plan, she would have $153,300. That assumes a rate of return of 4.5 per cent.

Subtracting $15,000 for closing and other costs, she'd be left with a down payment of about $138,000. If she cannot come up with a 20-per-cent down payment, she will require mortgage insurance, which would add to the cost.

The planner stress-tested Lorraine's potential mortgage payments using both a 3-per-cent and a 5-per-cent mortgage rate. At 5 per cent on a $612,000 loan, Lorraine's mortgage payments would be $3,559 a month, Ms. Knoblach notes. At 3 per cent rate, she'd pay $2,896. Property tax would add another $500 or so a month.

“Assuming utility costs in the range of $500 a month, home insurance $150 and maintenance and repair of $625 a month (1 per cent of the home’s value a year), Lorraine’s housing costs would spiral to a whopping $5,334 a month,” the planner says.

Even if Lorraine rented out a room for $800 a month, she’d still be paying $4,534, or $3,024 a month more than she is paying now. With a 3-per-cent mortgage and a rented room, she’d be paying $2,361 a month more.

“For these reasons, I strongly advise Lorraine to re-evaluate her current strategy,” Ms. Knoblach says. Lorraine could either buy a lower-priced property or “push the purchase further out into the future to come up with a more substantial down payment.” By then her income may have increased beyond the projected $100,000 a year.

Lorraine also needs to consider the long-term ramifications of property ownership, the planner says. Will the costs allow her to save adequately for retirement? Would she be able to take time off work if she decides to have children at some point? “Or will she be left house-rich and cash-poor for as long as she owns the property?”

Lorraine can take some steps to facilitate saving for a down payment.

All of Lorraine’s investment accounts are in a balanced portfolio of exchange-traded funds with about 65 per cent stocks and 35 per cent fixed income investments. There is no distinction in asset allocation between accounts that will be accessed for the down payment and those that will be kept for the long term. Lorraine should use a separate investment strategy for each, Ms. Knoblach says.

The accounts intended for the long term should be invested aggressively in 80 per cent to 90 per cent equities and only a small portion of fixed income investments. “This reflects Lorraine’s long-time horizon to retirement and ensures maximum long-term growth of these accounts,” the planner says. Lorraine could use dollar-cost averaging to ride fluctuations in the financial markets, she says.

For the down-payment savings, Lorraine should reduce the stock component to about 50 per cent immediately and invest only in dividend-paying blue-chip stocks, the planner says. She should gradually reduce the percentage of stock holdings as she approaches the actual purchase date so that within a year of purchase, she should not have more than 20 per cent to 30 per cent, Ms. Knoblach says.

The rest should be invested in guaranteed investment certificates with maturities that coincide with the earliest possible purchase date.

Most of Lorraine’s RRSP investments are in group plans with only a small amount of money in her personal RRSP. It may not be possible to withdraw funds from a locked-in RRSP or a group RRSP. “However, many employers allow their employees to transfer funds from a group RRSP to a personal RRSP, which is accessible,” Ms. Knoblach says.

If Lorraine can move funds from her group RRSPs, she should focus on saving additional monies in her non-registered investment account, the planner says. Lorraine could consider opening a second non-registered account to have a clear separation from her existing account, which is intended for long-term investments. Conversely, if it turns out that Lorraine is unable to use her group RRSPs, she should focus on contributing to her personal RRSP to ensure she will have $35,000 available by the time of the home purchase.

Client situation

The person: Lorraine, 26

The problem: Can she accumulate enough in three years for a down payment on the kind of house she wants in the neighbourhood she favours?

The plan: Consider buying a less expensive house or deferring the purchase until she can save more and her salary will likely be higher.

The payoff: Avoiding being house-poor for many years.

Monthly net income: $4,535

Assets: Chequing $5,635; non-registered investment account $8,860; TFSA $58,255; personal and group RRSPs $38,195. Total: $110,945

Monthly outlays: Rent $1,510; home insurance $25; electricity $40; transportation $355; groceries $500; clothing $70; gifts, charity $70; vacation, travel $100; dining, drinks, entertainment $200; personal care, club membership $20; sports, hobbies $25; subscriptions $10; health care $20; phones, TV, internet $160; TFSA $510. Total: $3,615

Liabilities: None