



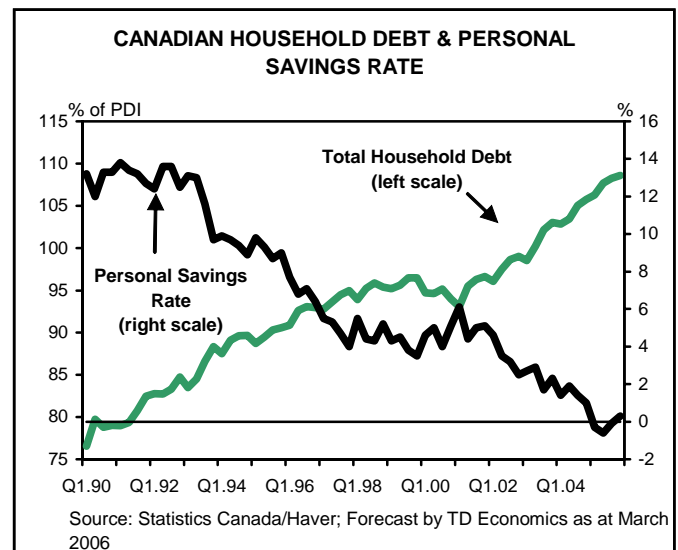
TD Economics

Special Report

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MANAGING DEBT AS IMPORTANT AS MANAGING ASSETS

There is widespread recognition that Canadians have become more indebted than ever before, which has periodically raised concerns about the financial well being of households. Our long-standing view has been that the rapid growth in personal liabilities is largely a rational response to the increasing availability of credit and to a sustained low and relatively stable interest rate environment. It also reflects a societal trend towards instant gratification and consumption and away from saving. While some individuals may have overextended themselves, it appears that the finances for the vast majority of Canadians are healthy, as evidenced by rising personal net worth and historically low debt service costs. Nevertheless, the growth in liabilities has been a powerful trend that has greatly impacted the balance sheets of households. This has a major implication for financial planning, which has traditionally focused on the accumulation of assets, particularly through portfolio decisions. However, the management of liabilities has now become just as important as the management of assets. The good news is that many of the key tenets of

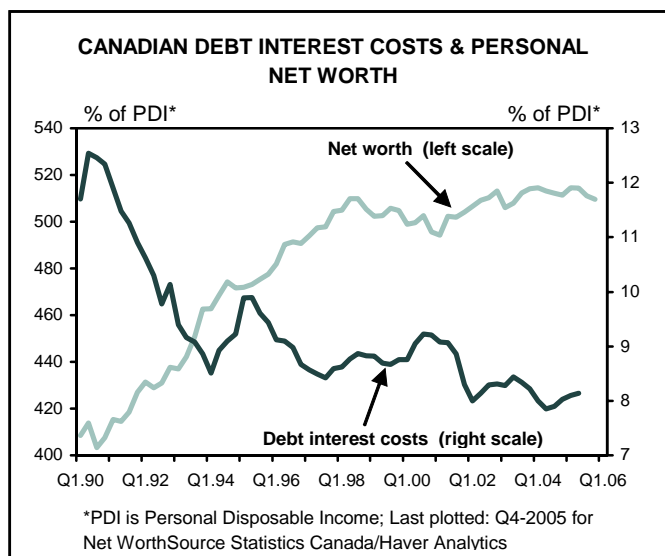


financial investing can be applied to debt management. Volumes could be written on this subject, but we can illustrate this conclusion by taking the basic guidelines of financial investing and applying them to the largest financial obligation that individuals take on – a home mortgage.

Understand the financial commitment

Just as it is important to research financial investments, it is equally imperative that home buyers understand the available options and their financial obligations with respect to a particular mortgage. A critical assessment will ensure that the mortgage meets the individual's needs. It may also affect the financial risk taken on by the borrower.

There are many choices to be made, such as whether to go with a fixed mortgage rate that is constant for a set period of time or a variable mortgage rate that floats on a monthly basis. There is no right or wrong decision here; it is all about personal preference – just like financial risk tolerance. Variable rate mortgages have historically proven to be less costly, but the protection provided by fixed mort-



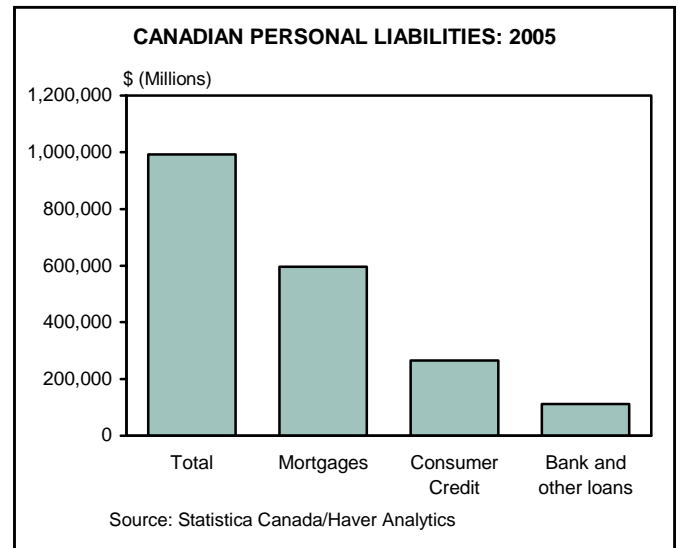
gages against interest rate swings can often provide psychological comfort. It is also important to note that the monthly payments with a variable mortgage usually do not fluctuate unless there is a large swing in rates. Instead, modest changes in rates usually affect the portion of the monthly payments that go towards repayment of the principal. When rates rise slightly, more of the payment goes to interest and less to paying down the principal.

There are also many options available today beyond the choice of fixed versus floating. For example, many lenders offer the flexibility to divide the mortgage, with part being paid at a fixed rate and the remainder being at a variable rate. Another recent popular option has been financing through a Home Equity Line of Credit (HELOC). A HELOC is a revolving line of credit that is fully secured by the equity in your home. It provides instant access to cash up to your approved limit and is extremely flexible, since you can draw down on the credit, repay at will and borrow again in the future without new loan applications. Many institutions will allow homes to be purchased with a HELOC, so long as there is a significant downpayment.

Individuals need to make a decision regarding the length of time over which they wish to pay back the loan, which is called the amortization period. A shorter time horizon will raise the monthly payments, but reduce the total interest paid. There is also the duration of the current mortgage contract, called the term. For example, one can take a 5-year term, locking in the current financial commitments over the five year period, but with the full mortgage being paid off over an amortization period of 25 years, or longer.

It is also important that home buyers investigate the prepayment options. Some mortgages are closed, meaning that there are limits on prepayment of the loan. Other mortgages are open, which allows the borrower to pay off a portion of the principal without penalties, which can provide huge savings that we will discuss later in the paper.

There are also an array of other issues that should be considered, but we lack the scope to discuss them here. These include subjects like high-ratio mortgages, collateral mortgages, government-assisted mortgages, assumed mortgages, builder's mortgages, vendor mortgages, and options related to assumability and portability. Nevertheless, the main message is that home buyers should do their research on mortgages. If there are questions, ask mortgage lenders about the options. There is also a wealth of books published on the Canadian mortgage market and a wide array of web sites with mortgage-related content. And, given today's competitive mortgage markets, it pays to shop around.



Manage mortgage risk like any other investment

Home buyers should only take prudent financial risks, just like investors. However, the nature of the risk assessment is very different. When shopping for a home, start with an evaluation of what can be afforded. As a general rule, mortgage payments and property taxes should not exceed 32% of household income. It is also critical to judge affordability on the basis of other financial commitments as well, such as student loans, auto loans and credit card payments. A usual recommendation is that total debt service costs should not exceed 40% of gross income. Getting pre-approved for a mortgage can help in these assessments. But, just because one is approved for a certain mortgage limit does not mean the whole amount should be used. Like all financial decisions, it is important to understand the difference between needs and wants.

The risk profile for individuals is also very different with respect to investing than managing liabilities. In the case of the former, younger individuals can take more risk because their investment horizon is much longer. In the case of the latter, the financial capacity to carry debt is much less in your early working years. This can affect decisions regarding whether to go with a variable or fixed mortgage, or the choice of term and amortization.

There is also an inherent difference in managing financial assets and financial liabilities. For assets, the recommendation is to diversify across many products in order to spread the financial risk. For liabilities, the general suggestion is consolidation, as pooling debt can sometimes result in lower interest rates and reduced monthly payments -- but this tends to apply more to credit card debt and other loans than to mortgages. With respect to mortgages, new financial innovations do offer the opportunity to diversify

interest rate risk, by having the mortgage divided, with a portion at fixed rates and a portion at variable rates.

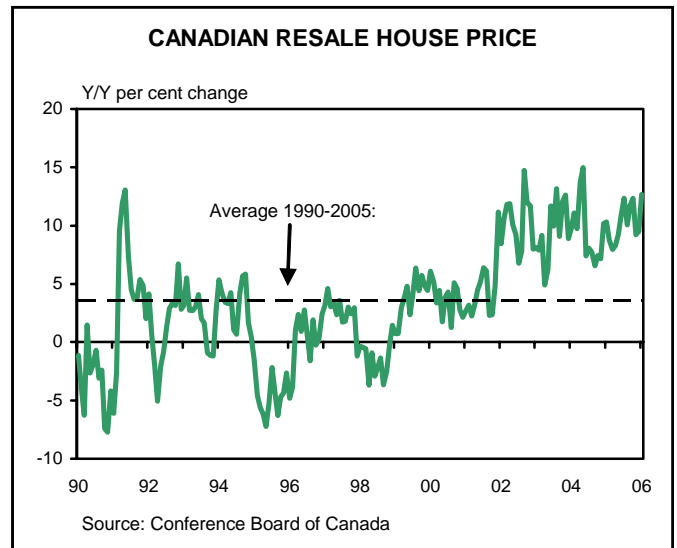
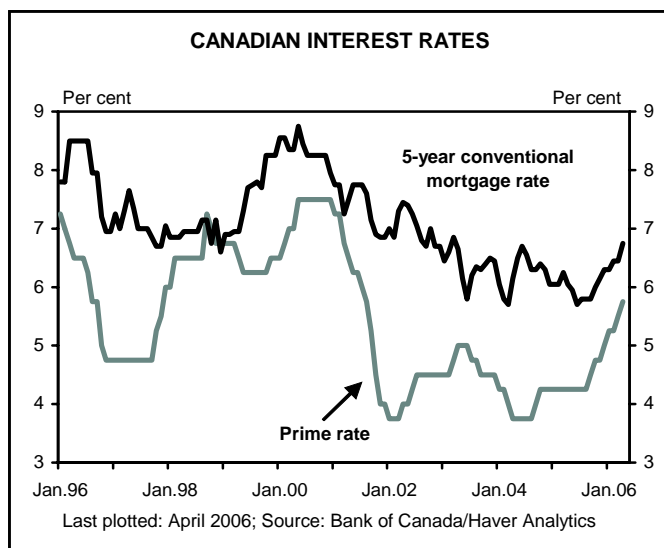
Timing interest rate swings is ill advised

The financial planning recommendation of not trying to time the market is also relevant to the mortgage market. It is often suggested that individuals might want to take a short term mortgage, say six months, if they believe interest rates will fall. The idea being to avoid locking in at higher interest rates. However, one should recognize that this strategy can be risky, as the expected decline in rates may not materialize and rates might even head higher if unanticipated economic developments unfold. It is true that interest rates have become more stable over the past decade than in the past, but they still experience considerable volatility.

'Good' debt versus 'bad' debt

Individuals should differentiate between 'good' debt and 'bad' debt. Good debt is the assumption of liabilities for financial gain or a superior quality of life. For example, education loans and mortgages represent investments that can provide significant returns. In contrast, sustained high credit card balances that are acquired through impulse purchases represent consumption and undesirable debt.

To reinforce the role of 'good' debt, consider that while a mortgage is usually the single biggest liability that Canadians acquire, it is also the debt taken on in order to finance the purchase of a household's largest financial asset. And, since the value of real estate generally rises over time, home ownership can play a role in saving for retirement. From a historical point of view, the after-inflation rate of return on home ownership has been modest,



with a national average annual increase of roughly 2%. Adding on the expected future rate of inflation, this would suggest a nominal annual return of roughly 4% in the future. However, if the property is a principal dwelling, there are no taxes paid on the appreciation. This means that the 4% return on real estate is equivalent to a close to 6% return on another investment that is taxed at the highest marginal tax rate. This is still lower than the expected return on equities, which we estimate is likely to average 7 to 8% per annum over the next decade, but the capital gain on housing still represents a solid appreciation on a large financial asset. Moreover, on a risk-adjusted basis the difference in returns is less pronounced, as home prices are less volatile than equity prices. But, investment in real estate has greater associated costs than stocks. While the latter involves commissions or management fees, these pale in comparison to the fees paid on the purchase of a property or the funds required to maintain the value of a home. The bottom line is that investment in home ownership can play a role in a diversified financial portfolio.

Debt reduction is part of saving

Another fundamental principal of financial planning is save early and often. This recommendation is based on the advantage of compound returns. In other words, the financial return obtained in one year will itself create financial returns in subsequent years. For debt management, the role is reversed. In order to save, debts should be paid down as quickly as possible, so that future interest payments can be reduced. For example, consider an individual that has a \$250,000 mortgage with a 5-year fixed mortgage at 6.75% that is amortized over 25 years. Making monthly payments of \$1,712.63, the owner pays a total

of \$263,994 in interest over the lifetime of the mortgage. However, if that individual instead made bi-weekly payments of \$856.32, the mortgage is paid off over 20.6 years and with \$55,684 in interest savings. This is not pocket change and it can help materially with saving for retirement or funding other priorities, such as a child's university education. It goes almost without saying that debt reduction should be targeted first on the liabilities with the highest borrowing costs.

Liabilities should be factored into financial plans

There is an old adage that if you don't know where you want to go, you won't get there. The implication is that one needs to build a financial plan that realistically assesses the lifestyle that an individual wants during their working career and during retirement in order to identify the financial requirements necessary to achieve these goals. The plan should take into account life events and all financial commitments, such as planning for children, education, care of family members and charitable giving. The financial plan should be reviewed regularly. For example, when there is a major life event, such as the birth of a child, it is prudent to ensure that the financial road map is still accurate and achievable.

Clearly, debt management should be included in the financial plan. The discussion about the objectives should include consideration of how long an individual plans to stay in their current dwelling, where they want to reside during their retirement years, and where their home fits into their estate plan. The upsizing and downsizing of housing to reflect any prospective change in the family situation is also warranted. And, when the financial plan is reviewed, any changes in the housing situation should be considered.

Conclusions

To wrap up, we live in a credit-driven society today. Students typically graduate from university or college with large debts. Individuals rely on financing for the purchases of autos and other big ticket items. Rising home prices have required the assumption of larger mortgages. And, credit has never been more available, with credit card of-

RATES OF RETURN					
	Dec. to Dec. % Change (unless otherwise noted)				Avg % change
	2002	2003	2004	2005	2000-05
Resale Home Prices					
National Average	7.3	9.5	10.9	9.8	8.1
Halifax	3.4	14.5	3.2	3.7	7.9
Montreal	16.3	14.4	13.3	6.3	10.0
Toronto	7.6	3.6	10.8	3.5	5.9
Calgary	15.5	0.6	10.2	17.6	8.4
Vancouver	7.2	15.5	11.8	16.3	7.3
Financial Assets					
Cash (3-month T-bills)*	2.6	2.9	2.2	2.7	3.3
Bonds (SCM Bond Index)	8.7	6.7	7.2	6.5	7.9
Cdn Equities (S&P/TSX)	-12.4	26.7	14.5	24.1	6.8
U.S. Equities (S&P500)**	-22.1	28.7	10.9	4.9	-1.1
Int'l Equities (EAFE)**	-15.7	39.2	20.7	14.0	1.5
* Cash is the average annual yield on 3-month T-bills					
** U.S. and Int'l Equities are in local currency terms					
Source: CREA, Global Insight, Globe&Mail, TD Economics					

fers arriving daily in the mail. Meanwhile, the Bank of Canada has wrestled inflation down to a sustained low single digit pace, creating a subdued and more stable interest rate environment that has encouraged households to become more leveraged.

There is nothing inherently wrong with this situation. The use of financing allows households to make purchases that are otherwise unattainable. And, some debt is better than other debt. The purchase of a home is usually an investment in an appreciating asset. Student loans pay for education that can open the door to greater income over a lifetime. An auto loan for the purchase of a vehicle provides a transportation service that may be necessary for work and life, even though the value of the vehicle will decline over time.

The key is that individuals must be financially responsible. It also means that financial literacy should include an understanding of debt management and financial planning should include discussions about liabilities as much as assets.

*Craig Alexander, VP & Deputy Chief Economist
416-982-8064*

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