

# ➤ leveraging

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## Borrowing To Invest

### What Is Investment Leveraging?

In its broadest sense, leveraging means borrowing to achieve desired goals. A common example of leveraging is a residential mortgage, where the goal is home ownership. What it comes down to is borrowing money to achieve your objective. Investment leveraging is similar, except that money is borrowed for investment purposes. The goal is accumulating greater wealth. If your investments perform well, the use of leverage can greatly magnify those returns. This, of course, explains its appeal. While leveraged investing is not suitable for all investors, it provides an opportunity to enhance your long-term portfolio returns through the use of prudent borrowing.

### How Does Leveraging Work?

Many investors use a portion of their income each month for investment purposes, with their investments accumulating gradually over time. With leveraged investing, borrowed money is used to make a single large investment purchase all at once. A portion of your monthly income is then used to make interest payments on your investment loan.

Leveraged investing has the potential to generate greater returns than traditional investing, although at the risk of greater investment losses. There are two primary reasons for this.

**1. Compound Returns.** With compound returns, the growth of an investment accelerates over time as growth from each year is added to your initial investment, resulting in a larger investment that can grow the following year. With a leveraged investment, since you contribute a much larger amount to begin with, the whole amount is able to grow for the life of the investment loan. Compounding allows a leveraged investment to potentially grow faster, compared to investing a fixed amount generating the same investment returns over the same period of time. This can result in better results over the long term.

**2. Tax deductibility.** The interest you pay on a loan for investment purposes is normally tax deductible, however this does not apply to amounts borrowed for an RRSP or other tax sheltered investment vehicles. This reduces the overall cost of a leveraged investment strategy. However, you should also keep in mind that any income generated from the leveraged investment will be subject to income taxes.

## LEVERAGE AND BREAK-EVEN RETURNS

You don't need huge returns for leveraging to work for you. The break-even point of a leveraged investment is the minimum return required to cover your after-tax interest expense. While it varies depending on factors such as tax rates and interest costs, this break-even point is lower than most people think because of the tax deductibility of the interest expense. It may also help to keep this thought in mind: simple interest is what you pay, compound

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## THERE ARE RISKS INVOLVED IN LEVERAGE INVESTING

While leveraging can magnify gains, it can also intensify losses – it makes good returns better and bad returns worse. Interest rate changes can also have an effect. Before implementing any leveraging strategy, it makes sense to be aware of these risks, and to take steps wherever possible to mitigate the level of risk. For these reasons, you should consult closely with a qualified investment advisor when considering a leveraged investing strategy. When prudently applied, leveraging can be a powerful tool for investment growth, but it makes sense to understand and be comfortable with its potential downside as well. I can help you determine if leveraging is a sound strategy for your personal circumstances.

## FOUR COMMON SOURCES OF LEVERAGING

**Line of credit.** Borrowing from your personal line of credit is an easy and convenient way to fund a leveraged investment strategy. However, if you also draw upon your line of credit for other purposes, then it becomes necessary to manually calculate the interest paid for investment purposes (tax deductible) as opposed to other purposes (generally not tax deductible).

**Margin accounts.** Clients of Dundee Securities Corporation also have access to leveraging through margin accounts, wherein Dundee Securities lends funds to the investor to purchase securities within the margin account. The loan in the account is secured by the securities and cash held in the account. However, if the value of the securities decline in value beyond a specific threshold, the investor is required to deposit more cash or sell securities.

**RRSP loan programs.** Sensible borrowing can enable you to make a larger contribution to your RRSP, and entitle you to a larger tax refund from Canada Revenue. That refund can then be used to pay back a significant portion of the loan, reducing the amount you owe and the interest payable. Some RRSP loan programs even offer a “grace period” to give you an opportunity to obtain your tax refund before loan payments begin. The key to this strategy is to repay the loan as scheduled, and avoid paying more in interest than the tax refund you receive.

**Home equity loans.** If you have paid off all or most of your mortgage, you can use some of the equity you have built up by borrowing with your home as collateral, and investing the money. Options include refinancing an existing mortgage, taking out a new one, or obtaining a line of credit secured by your home. In this case, the intention is that the investment you make will not only cover the loan and any borrowing costs, but also generate added income. Like any investment strategy, however, there are risks involved in borrowing against the equity in your home. If you are interested in leveraged investment, I can work with you to determine the appropriate leveraging strategy for you.

## CHECKLIST FOR SUCCESS

Since leveraged investing involves greater risk than traditional investing, wise investors will take steps to reduce those risks. Any or all of those steps can be the key to a successful leveraging strategy:

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- Have a specific financial goal in mind, and commit to leveraging for the long term – a minimum of 8 to 10 years will lessen the impact of possible market fluctuations.
- Determine your tolerance for risk – we can evaluate your risk level, and determine if a leveraging strategy makes sense for your circumstances.
- Keep your debt load under control – borrow modestly, so that you can cover your costs out of your own cash flow. A good rule of thumb is that your total borrowing cost each month, including the interest on an investment loan, should not exceed 35% of your before-tax income.
- Be an informed borrower – make sure you understand all the conditions and fees associated with repaying the loan.
- Maintain income stability – this makes it easier to meet the required monthly interest payments.
- Consider a “no margin-call” loan – this eliminates the need for additional deposits if your investment value falls below a pre-determined level. If you are interested, I can tell you more about this option.
- Diversify your investments and avoid high-risk investments – this can help reduce your leveraged risk.

## IS LEVERAGING RIGHT FOR YOU?

Borrowing to invest is a sophisticated strategy that calls for the expertise of a financial professional. If you are seeking the potential to accelerate asset growth and your level of market participation by borrowing, let's get together and talk about it. I can answer your questions, explain the pros and cons, establish your personal break-even return, and discuss whether or not leveraging is suitable for your circumstance. If it is, I will design and implement a strategy that minimizes the related risks, and recommend appropriate diversified investments. Working with a trusted advisor can be critical to your leveraging success, so give me a call today.

At DundeeWealth, we believe that having a financial plan forms the foundation necessary to grow, protect and transfer wealth from one generation to the next. We are committed to provide information on a variety of financial planning topics so our clients are able to make informed decisions.

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