Introduction to Investment Debt

Dispelling the Myths of Borrowing to invest

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What is Investment Debt?

Investment debt is simply borrowing to invest, a wealth-building strategy that has been used for thousands of years. Often used by the "rich," borrowing to invest is also becoming more popular with middle-income Canadians, but unfortunately is poorly understood by most investors.

Use the Tool Responsibly

Like a car, investment debt is a tool that can help or hurt you, depending on how it is used. Because investment debt magnifies returns, both good and bad, it can be very profitable when used properly, or it can increase losses. If you use the tool responsibly, with all of the appropriate precautions and guards in place, you can reasonably expect positively magnified results to get you to your goals faster. If not used carefully, investment debt — as with vehicles — can hurt you more than if you didn't use the tool.

The critical issue is how you use the tool.

> **Warning**
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> Investment debt magnifies returns, making good returns better and bad returns worse. Only consider borrowing to invest responsibly, after you full understand the pros and cons, with the guidance of a trusted advisor.

What is Responsible Investment Debt?

While some consider borrowing to invest a riskier strategy, it is possible to borrow in a cautious, responsible way. My definition of responsible investment debt is to borrow such a small amount that there is no financial or emotional strain. This generally results when borrowing 10-50% of the amount that you or your lender think you can handle. For example, if you have $400/month to invest, use at most $200/month for payments on an investment loan, and invest the rest as you do now.

Dispelling the Myths

Due to a lack of information, there are several myths about borrowing to invest that prevent people from objectively evaluating whether responsible investment debt might make sense for them.

Some believe that borrowing to invest is just for the rich. While many who have become wealthy have borrowed to invest in the markets, real estate, or their own business to create wealth, they're not the only ones who can benefit from the strategy. In fact, the fastest way to become richer is to study what the rich do and do the same thing on a smaller scale.

A popular belief, especially with skeptics, is that all debts are bad. The reality is that there are two types of debt. Expensive, personal debt used to purchase consumer items that quickly drop in value is bad for your financial health and should be avoided.

But in addition to this "bad debt," there is also "good debt," where money is borrowed at lower interest rates to purchase investments or businesses that are expected to increase in value. As a bonus, the interest expense on "good debt" is generally tax deductible, saving taxes and reducing the real interest cost.

Even critics of borrowing to invest would have to acknowledge that bad debt always causes financial harm, and if the loan payments used for bad debt were instead used for good debt, individuals would be further ahead.

Another myth is that investment returns must exceed the cost of borrowing for investment debt to benefit investors. For example, if the average interest expense was 7%, most people think that they need returns of 7% or higher for investment debt to make sense. While this is a reasonable conclusion and it is true for interest investments like GICs, it is not true if any of the investment return is a capital gain.

With investments that are mostly capital gains, like equity funds or stocks, the minimum return needed for investment debt to be better than not borrowing is reduced because capital gains are often tax deferred and only 50% taxable, while the interest expense is generally tax deductible.

Example: Lynn is a baby boomer in the 40% tax bracket who uses investment debt for 10 years with an average interest expense of 7%. If Lynn invests into “regular” equity funds, she benefits from investment debt when returns are only 5.0%, not 7% as most expect. If Lynn pays off the loan over 10 years, instead of making interest-only payments, the return needed drops from 5.0% to only 4.5%.

If you think that you must average 8% returns or more for investment debt to make sense, you will probably avoid the strategy. If you realize that you only need to average returns of about 5% to benefit from borrowing to invest, you might want to learn more.

Investment Debt Magnifies Returns

Unlike conventional investing, there is a cost to borrowing to invest — the after-tax interest expense — that must be covered before you profit. The return where you *start* to earn a net profit is called the breakeven point.

If your breakeven point is 4% and you borrow to invest and average 3% returns, you still lose money. This is fundamentally different than traditional investing, where even a savings account earning 0.25% interest is profitable.

The "Better Than" Return

Much more important than the breakeven point is understanding the return where investment debt starts to be better than not borrowing to invest. This minimum return, which we might call the "better than" return, is critical to understand for your unique situation because it defines when investment debt starts to benefit you. For all returns below this hurdle, you are better off not borrowing to invest. For all returns above the "better than" return, you profit more by using your cashflow to finance an investment loan.

To accurately assess your probability of being helped or hurt from borrowing to invest, it is critical to understand the minimum return needed based on your unique combination of tax bracket, time horizon, investment tax-efficiency, and type of investment debt. Ask your advisor for a personalized projection.

Mathematically, investment debt magnifies returns and offsets the breakeven point. One way to think of investment debt is like a tool or machine that changes or transforms returns.

To illustrate how borrowing to invest changes returns, consider Lynn's situation from our example. Assuming a 7% cost of borrowing over 10 years in a 40% tax bracket, the following table shows how various returns from equity fund investments are transformed.

The middle column reveals results for interest-only borrowing to invest, where the investment loan is not paid off until the end of 10 years. The third column shows the more conservative approach of using a term loan that is paid off over 10 years.

With interest-only investment debt, 0% returns are transformed into -100% returns. In other words, all of Lynn's invested cashflow over 10 years is lost. The "better than" return is 5.0%, and 7% returns — matching the 7% cost of borrowing — are magnified up to 15%.

Investment Debt Annual Returns
7% Interest, 40% Tax, 10 Years

Traditional Return	Interest-Only Inv, Debt Return	10-Year Term Inv. Debt Return
0%	-100%	-5.4%
2%	-21.4%	-0.9%
4.5%	2.1%	4.5%
5.0%	5.0%	5.6%
7%	15.0%	9.7%
9%	22.6%	13.7%
11%	29.1%	17.6%

Assumptions: Equity fund returns with 30% of returns taxable annually, and 50% of capital gains taxable. Source: *Talbot's Leverage Professional* software.

Using a term loan that is paid off over 10 years, even if Lynn has no growth with 0% returns, borrowing to invest does not hurt her nearly as much because at the end of the term, she has paid off and owns the amount borrowed. In this case, 0% annual returns are transformed to -5.4% instead of -100% with the interest-only approach. Investment debt benefits Lynn when returns exceed 4.5%, and 7% returns are magnified to 9.7% instead of 15%.

Note that paying off investment loans is a safer, more responsible approach for borrowing to invest. This makes sense because with every payment, the amount borrowed decreases until the loan is completely paid off. Many investors will prefer the term loan approach for borrowing as it significantly reduces the magnification of bad returns, gives most of the positive magnification, and lowers the minimum return needed to benefit.

How Much Faith Do You Have?

As shown, Lynn needs 4.5% to 5% returns to benefit from borrowing to invest. Since 10-year Government of Canada bonds guarantee returns of less than 4%, a rational equity investor expects to average more than say 5 or 6% returns over 10 years or they wouldn't invest at all in equities.

Based on this, is the level of faith or confidence in the markets required for borrowing to invest any higher than the faith needed for traditional equity investing? Not in Lynn's case.

Benefits of Investment Debt

Are you interested in a way to save taxes while investing beyond RRSPs? That answer is easy for most over-taxed Canadians.

- **Tax savings.** Whenever you invest outside of RRSPs, the interest expense is generally tax deductible.

The deductibility of investment debt interest has been a source of confusion in the past. The good news is that a Supreme Court of Canada ruling and Canada Revenue Agency's (formerly Revenue Canada) interpretation bulletin IT-533 have clarified that as long as the investment has the potential to produce income in the form of interest or dividends, the interest expense is deductible.

> **Fact**
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> $1,000 of investment debt interest expense produces the same tax deduction as $1,000 RRSP contribution, regardless of your tax bracket.

Interest deductibility for Quebec residents may be limited. As always, you should seek professional tax advice for your situation.

Note that any interest expense from borrowing for RRSPs or TFSAs is not tax deductible.

- **Potential for increased returns.** The big appeal of borrowing to invest is the potential to make more money than you could normally. As shown, when returns match the interest expense on an investment loan, borrowing for equity funds in Lynn's case magnifies 7% returns up to 15% for interest-only investment debt.

Example: If Lynn invests $3,000/year after-tax using investment debt with interest-only payments and averages 9% equity returns with an interest expense of 7%, she will net about $83,000 after 10 years instead of $44,400. In this case, Lynn gains an extra $38,600 by borrowing to invest, or 87% more than if she didn't use investment debt.

The critical parameter for investment debt is the relationship between returns and the cost of borrowing. Historically, stock markets have averaged 9-11% over the long term, depending on when and where you measure, while the prime interest rate in Canada has averaged 7.0% over the last 70 years.

■ **Increased discipline.** For many people, the most important benefit of a small, responsible investment debt program is not the probability of increased returns, it is the increased discipline that results from starting a forced saving approach.

Like with a mortgage, once you start an investment loan, you are much more likely to continue the payments and fuel your investment plan than with "ad hoc" or "pay yourself first" savings approaches that are easily suspended.

Note

Although borrowing to invest can be one of the most effective long-term wealth-building strategies, the real benefits of any responsible investment debt plan are the forced higher level of commitment to your investment goals and strategy diversification.

Risks of Investment Debt

Because investment debt magnifies losses as well as gains, there is a risk of losing more than you would without borrowing to invest.

Example: If Lynn's $3,000/year investment debt plan averages 0% returns with an interest expense of 7%, she will net $0 after 10 years instead of $30,000. In this case, Lynn loses $30,000 by borrowing, ending up with 100% less than if she didn't use investment debt.

There are several additional risks associated with borrowing to invest. The manageable risks include interest rate risk, cashflow risk, and margin call risk.

If interest rates rise or your cashflow drops due to job loss, it will be more difficult to continue loan payments. These risks can be handled by using only a small portion of your investable cashflow and having extra emergency funds to sustain the loan payments. The risk of margin calls — where your lender demands additional cash or collateral when investments drop — can be eliminated by using the new "no margin call" investment loans that became available through many lenders in 2001, or by using a home equity line of credit.

Investing using any one strategy, including RRSPs, is risky. The political risk that the government could negatively change the rules can be reduced by diversifying by strategy, ideally combining the benefits of RRSPs and responsible investment debt.

The major risk for most investors using investment debt is emotional — the risk that due to greed or desperation they borrow too much and when times get tough, they get scared and sell at the worst possible time. To reduce emotional risks, you should fully understand the strategy, start with a small amount, stay responsible, and work with a trusted advisor.

Implementing Responsible Investment Debt

The key to benefiting from borrowing to invest is understanding and implementing responsibly.

Borrowing to invest should only be considered as a small part of an integrated financial plan. While there are no guarantees, following this Responsible Investment Debt Checklist should significantly increase the odds of benefiting.

Talbot's Responsible Investment Debt Checklist

- [ ] Stay responsible on cashflow, collateral, and emotions
- [ ] Eliminate the risk of a margin call
- [ ] Invest long term, min. of 8-10 years
- [ ] Diversify in several (global) funds
- [ ] Use a trusted advisor to help understand all pros and cons, implement, and stick to the plan

Borrowing aggressively is gambling and a recipe for disaster. The best way to reduce all of the risks of investment debt is to start small and stay responsible. Use a maximum of 50% of your investable cashflow for payments on an investment loan. If your lender thinks that you can handle borrowing $80,000, start with at most $40,000. That way, if markets drop initially, you will be much less stressed, and you will have the ability to buy more at lower prices if you truly have confidence in the long-term plan.

Everyone's definition of what amount of investment debt is "responsible" is different. As your experience, investments, and confidence grows, so will your definition of responsible investment debt. The key is to start small.

Is Investment Debt Suitable for You?

Borrowing to invest is not a strategy that is available to everyone. Until your financial situation allows you to qualify for a loan, you won't be able to borrow to invest. Even if you qualify for a loan, investment debt may not be appropriate. Investors who are nervous, conservative, or have little experience with the ups and downs of equity markets shouldn't use investment debt.

A critical ingredient for responsible investment debt is solid, long-term investable cashflow to sustain the loan payments. If your income fluctuates greatly, or your career prospects are uncertain, wait until you can easily handle the payments in the worst case.

Note that high incomes are not required. Disciplined savers with modest incomes who have the capacity and character to consistently invest are often more financially successful than those who earn more but save little.

Owning a home that is at least 25% paid off is another good indication of suitability. This demonstrates a level of financial accomplishment and a discipline for making regular loan payments.

Those best suited to consider borrowing to invest should have most or all of the following characteristics.

Investment Debt Suitability Profile

- ❑ Capacity to qualify for a loan
- ❑ Solid, investable cashflow for 8+ years
- ❑ Moderate to aggressive tolerance for investment risk (an equity investor)
- ❑ Experienced with equity investing during down markets
- ❑ Disciplined, invest regularly
- ❑ At least 25% of home paid off
- ❑ Middle or top tax bracket

Must ACT to Benefit

The key to financial success is not what you know, it's what you *do*. Now that you're aware of the basics of responsible investment debt, you must ACT if you want to benefit from:

- ❑ Tax-deductible investing beyond RRSPs
- ❑ Converting "bad debt" into "good debt"
- ❑ Increased discipline using forced savings
- ❑ Making decisions based on objective understanding instead of myths and fear

Next Steps

To help you understand and implement responsible investment debt for your unique situation, see your trusted financial advisor. They can help you decide what responsible amount of investment debt, if any, makes sense as a part of your financial plan.

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