

Introduction to Conservative Leverage

Dispelling the Myths of
Borrowing to Invest



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What is Leveraging?

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

Use the Tool Responsibly

Like a car, leverage is a tool that can help or hurt you, depending on how it is used. Because

Warning

Leverage magnifies returns, making good returns better and bad returns worse. Only consider leveraging conservatively, after you fully understand the pros and cons, with the guidance of a trusted advisor.

leverage 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,

leverage — as with vehicles — can hurt you more than if you didn't use the tool.

The critical issue is how you use the tool.

What is Conservative Leverage?

While some consider borrowing to invest a riskier strategy, it is possible to leverage in a conservative, responsible way. My definition of conservative leverage is to borrow such a small amount that there is no financial or emotional strain. This generally results when leveraging 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 conservative leverage might make sense for them.

Some believe that leveraging 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 leveraging 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 leverage to benefit investors. For example, if the average interest expense was 7%, most people think that they need returns of 7% or higher for leverage 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 leverage to be better than not leveraging 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 leverages for 10 years with an average interest expense of 7%. If Lynn leverages into “regular” equity funds, she benefits from leveraging 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 leverage 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 leveraging, you might want to learn more.

Leverage Magnifies Returns

Unlike conventional investing, there is a cost to leveraging — 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 unleveraged 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 leverage starts to be better than not leveraging. This minimum return, which we might call the “better than” return, is critical to understand for your unique situation because it defines when leverage starts to benefit you. For all returns below this hurdle, you are better off not leveraging. 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 leveraging,

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 leverage. Ask your advisor for a personalized projection.



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

To illustrate how leveraging 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 leveraged or transformed.

The middle column reveals results for interest-only leveraging, 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 leveraging, 0% returns are leveraged 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%.

Leveraged Annual Returns 7% Interest, 40% Tax, 10 Years

Unleveraged Return	Interest-Only Leveraged Return	10-Year Term Leveraged 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, leverage 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 leveraged to -5.4% instead of -100% with the interest-only approach. Leverage 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 conservative approach for leveraging. This makes sense because with every payment, the amount borrowed or leveraged decreases until the loan is completely paid off. Many investors will prefer the term loan approach for leveraging 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 leveraging. Since 10-year Government of Canada bonds guarantee returns of about 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 leveraged investing any higher than the faith needed for unleveraged equity investing? Not in Lynn's case.

Benefits of Leveraging

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 leveraging 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.

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 is not tax deductible.

Fact

\$1,000 of leverage interest expense produces the same tax deduction as a \$1,000 RRSP contribution, regardless of your tax bracket.

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

Example: If Lynn invests \$3,000/year after-tax to leverage 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 leveraging, or 87% more than if she didn't leverage.

The critical parameter for leveraging 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 7.4% over the last 66 years.

■ **Increased discipline.** For many people, the most important benefit of a small, responsible leveraging program is not the probability of increased returns. It is

Note

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

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.

Risks of Leveraging

Because leverage magnifies losses as well as gains, there is a risk of losing more than you would without leveraging.

Example: If Lynn's \$3,000/year leverage 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 leveraging, ending up with 100% less than if she didn't leverage.

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 conservative leverage.

The major risk for most leveraging investors is emotional — the risk that due to greed or desperation they leverage 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 conservative, and work with a trusted advisor.

Implementing Conservative Leverage

The key to benefiting from leveraging 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 Conservative Leverage Checklist should significantly increase the odds of benefiting.

Talbot's Conservative Leverage Checklist

- Stay *conservative* on cashflow, collateral, and emotions
- Eliminate the risk of a margin call
- Invest long term, minimum 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

Leveraging aggressively is gambling and a recipe for disaster. The best way to reduce all of the risks of leveraging is to **start small and stay conservative**. Use a maximum of 50% of your investable cashflow for payments on an investment loan. If your lender thinks that you can handle leveraging \$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 leveraging is "conservative" is different. As your experience, investments, and confidence grows, so will your definition of conservative leverage. The key is to start small.

Is Leverage 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 leverage. Even if you qualify for a loan, leveraging may not be appropriate. Investors who are nervous, conservative, or have little experience with the ups and downs of equity markets shouldn't leverage.

A critical ingredient for responsible leveraging 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 leveraging should have most or all of the following characteristics.

Leverage 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 (monthly)
- 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 conservative leverage, 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 leveraging for your unique situation, see your trusted financial advisor. They can help you decide what conservative amount of leveraging, if any, makes sense as a part of your financial plan.

“Help a Friend”

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