

Understanding Investment Leveraging

Borrowing to invest can be an effective way to reach your financial goals faster

William Shakespeare wrote *Neither a borrower nor a lender be*. And while Will was undoubtedly a great writer, he may not have been such great shakes as an investor - because for many people it definitely can pay to borrow for investment.

Some call it 'borrowing to invest,' to others, it's 'leveraged investing' or 'investment leverage'. But by any name, it all boils down to this: You are using someone else's money to help you reach your investment goals.

Now, you may think that leveraged investing is only for the extremely wealthy - but that isn't necessarily the case, although it is a strategy that is only suitable if you can afford to sustain any losses associated with your leveraged investments. It is a powerful tool for helping people achieve their financial goals sooner - but it's not suitable for everyone. To find out whether or not you should consider borrowing to invest, let's take a closer look at why more and more Canadians are looking at leveraged investing.

How is the concept of 'borrowing to invest' different from traditional investing?

With traditional investing you set aside money each month to purchase investments. With leveraged investing, you take out a loan to make investments then you set aside a portion of your

income each month to make the loan payment. The monthly payment amounts are likely to be the same in both cases but your leveraged investment has the potential to generate greater wealth for you over the long term as compared to using just your own money.

Leveraged investing can work because it allows you to:

- ▶ Invest more today than you would be able to afford using only your own money. By dramatically increasing the size of your investment, you can also dramatically increase the potential for compound growth of your overall wealth.
- ▶ Deduct the interest payments on the loan. Based on the expectation that non-registered investments purchased with borrowed money will produce some income, interest costs incurred on investment borrowings are tax deductible. This effectively lowers your tax bite and your overall cost of borrowing. It also reduces your 'break-even' point - the return you must achieve to make leveraged investing worthwhile.

Leveraged investing does not outperform the returns on investment available through traditional investing, and does present higher risk - especially in the short-term. But over the long-term, a 'borrow to invest' strategy can deliver a greater increase in your wealth than traditional investing because you have more money working for you than otherwise would be the case. And you don't

necessarily need huge returns for leverage to work.

There is more risk when you borrow to invest

There's no doubt that there is more risk with leveraged investing than with traditional investing. However, you can reduce the risk by:

- ▶ Investing for the long-term. Mutual fund investments are subject to fluctuations but tend to grow over the longer term. Therefore, you should plan to hold a leveraged investment for at least 10 years so that you can reduce the effect of short-term fluctuations.
- ▶ Staying the course. The leveraged investor requires a high tolerance for volatility. It's easy to become emotional when your investment encounters short-term volatility. But you must be able to resist the urge to sell at the first sign of trouble - and stay committed for the long term to give the strategy time to work.
- ▶ Borrowing prudently. Don't make yourself loan-poor by borrowing more than you can afford. By over borrowing you may be forced to sell your investment early because you can't make the loan payments.
- ▶ Arranging a *no margin-call* loan. When you borrow to invest, your lending institution usually holds your investment as security in case you fail to cover the loan. If the value

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of your investment falls below a predetermined threshold, you'll be asked to make an additional pledge of collateral known as a margin call. In most cases, you can arrange a *no margin-call* loan, usually at a slightly higher interest rate, that protects you against having to provide additional collateral.

- ▶ Diversifying your investments. Although a leveraging strategy is best suited for equity investors, the risk associated with market volatility can be reduced by investing in equity based mutual funds that are diversified in terms of sectors, geography and management style.
- ▶ Investing your tax savings. By investing the tax savings generated from

the deduction of interest on your investment loan, you can significantly reduce your overall risk of loss. In essence, you will be combining the benefits of leveraging with the benefits of dollar-cost averaging.

- ▶ You can reduce your financial exposure by choosing to make lump sum principal payments on your investment loan.

Let us help you understand whether borrowing to invest is right for you

Leveraged investing isn't appropriate for everyone. Working together, we will:

- ▶ Determine if this type of strategy fits in with your long-term investment objectives.

- ▶ Discuss the long-term time horizon of the investment.
- ▶ Review whether you can meet all of your loan and income tax obligations.
- ▶ Review your comfort level with taking on long-term debt and added risk.

Borrowing to invest is a proven investment strategy that can accelerate your ability to build a portfolio if you are comfortable with taking on debt and additional risk.

For a better understanding of the 'borrow to invest' strategy and whether it's right for you, talk to us today.



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¹Quebec residents should note that in calculating Quebec provincial income tax, the deduction of investment expenses, including interest, is limited to the amount of taxable investment income reported in the taxation year from all sources.

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