

## About the Author

Talbot Stevens is the President of a financial education firm that specializes in teaching people how to benefit financially without sacrificing their standard of living. Whether speaking to the public, corporate staff, or the financial industry, Talbot enthusiastically integrates humour with innovative strategies that add immediate and long-term value.

He is also the author of the bestseller *Financial Freedom Without Sacrifice*, now in its 15th printing with over 135,000 copies sold.

With degrees in Engineering and Computer Science, Mr. Stevens has become recognized for his comprehensive education of *conservative leverage*. Talbot's latest research pioneers fundamental analysis of which investment strategies produce the most after-tax retirement income.

Talbot is a columnist for *Investment Executive* and a contributing editor to *Money Digest*. He was a weekly columnist for the *London Free Press* and has been interviewed by numerous newspapers, radio and television programs across the country.

To ensure that future generations are aware of how easy it is to achieve their own financial freedom, Talbot has started a petition to make basic financial education a mandatory part of the school system. He has also initiated a "**Help a Friend**" campaign to encourage everyone to share valuable ideas with those they care about.

Talbot grew up on a small farm in Southwestern Ontario. He currently resides in London, Ontario with his wife Theresa and their young, tireless, endurance testers, Derek, Ryan, and Kristin. To learn more, visit his web site at [www.TalbotStevens.com](http://www.TalbotStevens.com).

*“In this clear, concise, and balanced booklet, Talbot takes the reader by the hand and shows how to build wealth quicker through conservative leveraging while avoiding the pitfalls. Any investor – whether large or small – can benefit from Talbot’s simple but effective techniques. Don’t even think of leveraging until you’ve read this booklet!”*

Dr. Chuck Chakrapani, Chairman, Investors Association of Canada,  
Editor, Money Digest

*“An objective and comprehensive summary of the key issues on a poorly understood strategy. While leveraging is not for everyone, this is destined to dispel the myths of borrowing to invest for both investors and financial professionals.”*

David Edey, Columnist, Investment Executive

*“A balanced account of the risks and rewards of leveraging.”*

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*“While Talbot Stevens forthrightly sets out the risks of leverage, the probable impact of this ground-breaking investment booklet will likely be to increase its intelligent use by overly cautious Canadian investors.”*

Jonathan Chevreau, National Post columnist, Publisher of The Boomer.com.

*“Whether a financial professional or novice investor, Dispelling the Myths of Borrowing to Invest gives you the knowledge and methods to magnify your personal wealth over time.”*

Catharina Jutting, CFP, Canadian Association of Pre-Retirement Planners

*“Talbot dispels the myths about the leveraging process, and offers well-researched conservative leveraging strategies that benefit almost anyone who wants to magnify investment profits.”*

Alan Caplan, CFP, RFP, Personal Finance Columnist, The Edmonton Sun

*“Talbot is a leader in the research and education of advanced financial strategies. Dispelling the Myths of Borrowing to Invest is the most comprehensive and objective study available on the pros and cons of borrowing to invest.”*

Ed Rempel, Certified Financial Planner

*Talbot's Summary Booklets*  
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who want to quickly learn more effective  
ways to manage their finances.

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## Preface

As a financial educator, speaker, and author, I have learned that, for various reasons, borrowing to invest is poorly understood by most investors.

Not being taught even the basics of managing money in school makes it difficult to understand advanced strategies like leveraging, or borrowing to invest. The resulting misconceptions or myths often prevent people from objectively assessing the real risks and rewards of leveraging conservatively as a part of an integrated financial plan.

Most Canadians are quite comfortable borrowing at high, non-deductible interest rates to purchase consumer goods that depreciate quickly. Used responsibly, borrowing can also be a strategy for achieving investment goals, where you pay lower, tax-deductible interest rates to purchase investments that grow in value. However, leverage does not increase returns. It simply magnifies them. When leveraged investments decrease, the financial losses and emotional stresses are magnified as well.

While the *potential* financial benefits from leveraging are quite enticing, the most important benefit of any investment loan program is often the forced discipline that locks in your commitment to your financial future. For some people, the *forced savings* of making payments on an investment loan might be a more effective way of achieving their goals than automatic “pay yourself first” plans that can easily be suspended.

Because of the magnified risks and emotions related to leveraging, working with a trusted financial professional is strongly recommended. Only you and your financial advisor can decide if conservative leverage is right for you.

One of my goals for *Dispelling the Myths of Borrowing to Invest* is to provide such an objective and comprehensive explanation of the pros and cons of leveraging that it impresses and educates the critics. Only by achieving this high standard will *Dispelling the Myths of Borrowing to Invest* be regarded as a valuable tool to help advisors and investors understand and implement leverage in a conservative manner that results in no financial or emotional stress.

With the help of this *Talbot's Summary Booklet*, you can make an objective, informed decision about whether borrowing a small amount to invest in or outside of RRSPs makes sense as a part of your financial plan.

*Talbot Stevens*

# Introduction to Borrowing to Invest

Borrowing to invest is a wealth-building strategy that has been used for thousands of years. The financial term for borrowing to invest is *leveraging*. An advanced investment strategy that is often used by high-income investors, leveraging has also become popular with middle-income Canadians.

Borrowing to invest is fundamentally different from conventional unleveraged investing, and very poorly understood. As we will see, the strategy is a double-edged sword. Because **leverage magnifies returns, both good and bad**, it can be very profitable when used properly, or it can cause investors to lose more money than they would without borrowing.

## Understand and Use the Tool Carefully

Leveraging is like a power tool. Depending on how it is used, it can either help or hurt you. Most of us use power tools to speed up or magnify our efforts, often without enough thought about our safety.

If we use a power saw carefully and responsibly, we might be able to saw ten times as quickly as we could with a hand saw. If we use the same power saw carelessly, without the appropriate precautions and guards in place, we could get hurt.

## Why We Use Power Tools

Cars are another tool that almost everyone uses to get us where we're going faster. In spite of the risks, we choose to drive automobiles and use power tools because we want, and reasonably expect, to get the *positively* magnified results.

The **critical factor is *how responsibly we use the tool***, whether it's a power tool, an automobile or leveraging. If we use it carefully, with an understanding of how to reduce the risks, then we can reasonably expect to benefit. If we don't, we could get hurt, sometimes badly.

### WARNING!

Leverage magnifies returns, making good returns better and bad returns worse. Do not consider the strategy until you fully understand the risks and how to reduce them.

Understanding how to use the tool properly increases the odds of benefiting, and reduces the possibility of getting hurt.

## What is Conservative Leverage?

Used aggressively, leverage can produce significant gains or losses. Since no one likes losing money, I have always advised investors to **consider only conservative leverage**. My definition of conservative leverage is where the strategy is understood and implemented in a way that causes no financial or emotional stress.

As with unleveraged investing, there are **no guarantees that you will benefit from borrowing to invest**, even if you fully understand the potential downside and implement responsibly.

The goal for most investors is to choose the investment strategy that produces the highest net personal benefit for the level of risk you are comfortable with. To make an objective assessment of what level of leveraging, if any, is right for you, you first need a comprehensive understanding of the risks and potential rewards.

The purpose of this *Talbot's Summary Booklet* is to help you make an informed decision by providing an efficient review of the key issues related to borrowing to invest in or outside of RRSPs.

## Why Leverage is Controversial

Borrowing to invest is one of the most controversial subjects in financial planning. Opinions from investors, financial advisors, experts and the media vary and conflict.

Much of the controversy arises from a lack of information on leveraging. While there are dozens of books on basic financial planning and all of the intricacies of investing in RRSPs, there are very few resources available to gain even a basic understanding of leverage.

## Myths About Borrowing to Invest

Much of the misunderstanding surrounding leverage is related to five myths about borrowing to invest. These myths and other misconceptions often prevent people from objectively evaluating the pros and cons of leveraging in a responsible manner.

### Myth 1: Leverage is Only for the Wealthy

One common belief, especially with middle-income investors, is that only the rich borrow to invest. While it is true that the so-called wealthy are bigger users of advanced financial strategies like leverage, this doesn't mean they're the only ones who can use them.

If a strategy can benefit high-income Canadians, it **can also benefit lower- and middle-income individuals** in a similar way. Although the

benefits might be smaller, anyone can act on the ideas of others if they have the same knowledge, attitude, and commitment.

### **Myth 2: All Debts Are Bad**

The second myth is that all debts are evil and should be avoided like the plague. Many of our parents were taught that all debts should be paid off as quickly as possible. This is certainly the right approach for most of our personal debts, like credit cards, where the after-tax interest charge can range from 15 to over 33%. This expensive, non-deductible consumer debt usually results from the purchase of products that drop in value very quickly, and *should* be avoided and/or paid off as soon as possible.

But in addition to this “bad debt”, there is also a “good debt” that is often used by the wealthy. This constructive type of borrowing is used to purchase things like investments or businesses that increase in value. The interest charges on “good debt” are much lower, and the real interest rate is usually further reduced by being tax deductible.

(Cont'd in Booklet)



## Borrowing for RRSPs

Perhaps because the interest expense of borrowing to invest in RRSPs is not tax deductible, many investors and financial professionals do not feel that RRSP borrowing makes sense for more than modest amounts that can be paid off within a year.

### RRSP Refund Strategies

Before we can assess the merits of larger loans to “catch-up” on RRSP contributions, we must recognize that there are at least 5 different RRSP refund strategies. How you invest in RRSPs, and what you do with the refunds, are important parameters that define your investment behaviour.

Behavioural finance is a relatively new field of psychology that studies why we manage money the way we do. How you view and act towards money can be the most important factor in financial success. With respect to investing, *investor performance is more important than investment performance*. For example, a good saver can produce a larger retirement fund than a good investor who saves less, particularly for procrastinators with shorter time periods.

With RRSPs, one of the most important factors affecting the size of your retirement fund is what you do with the refunds. This investor behaviour parameter is often overlooked and rarely discussed. Yet, as we will see, acting on a more effective RRSP refund strategy can increase your retirement fund by 25 to 50% or more.

To introduce the 5 RRSP refund strategies, let's consider Anne's situation. To make the math easier to follow, we'll assume that Anne is in the 50% tax bracket, and she has an after-tax cashflow of \$1,000 per year available to invest. It is important to keep in mind that we can only invest after-tax dollars, dollars that already have been taxed by the government.

Beyond RRSPs, there are many non-registered investment strategies that could be considered. For now, let's discuss only the different ways that the cashflow can be invested using RRSPs. Each of the following *RRSP refund strategies* defines a different behaviour and commitment to the retirement goal.

**1: Spend refund.** If Anne is in the 50% tax bracket, and contributes \$1,000 to an RRSP, she will get a refund of \$500. Unfortunately, the first and most common RRSP refund strategy is to spend it. If Anne spends the \$500 refund, her \$1,000 a year of after-tax cashflow adds only \$1,000 a year to her RRSP.

**2: Reinvest refund.** As a disciplined investor, Anne knows that she can increase her retirement funds by reinvesting the \$500 refund. By reinvesting her refund back into her RRSP, her \$1,000 a year of after-tax cashflow results in annual RRSP contributions of \$1,500. Simply reinvesting her 50% tax refund increases Anne's retirement fund by the same 50%.

Obviously, any portion of the refund can be reinvested. For labeling purposes, I have defined the second refund strategy where 100% of the refund is reinvested.

While reinvesting the refund is a notable improvement over spending the refund, there are several ways Anne can do even better.

**3: Gross-up refund.** The third refund strategy allows Anne to increase or "gross-up" \$1,000 a year of after-tax cashflow into annual RRSP contributions of \$2,000. Conceptually, the approach is not as straightforward as the other refund strategies. The strategy's "gross-up" label should not be confused with the gross-up of dividends for the calculation of the dividend tax credit.

The gross-up refund strategy produces the maximum RRSP contribution possible per dollar available to invest, without maintaining an RRSP loan. The approach can be implemented in several ways.

With \$1,000 to invest, Anne can borrow an extra \$1,000 to "gross-up" or increase her total RRSP contribution to \$2,000. In a 50% tax bracket, her \$2,000 RRSP contribution produces a refund of \$1,000. The \$1,000 refund is used to completely and almost immediately repay the \$1,000 loan so that she pays a negligible amount of interest.

For those in the 50% tax bracket, this approach grosses-up \$1,000 into a \$2,000 RRSP contribution, doubling their retirement fund relative to the common approach of spending the refund.

The gross-up result occurs whenever you do not get a refund. With the gross-up loan approach, you don't get the refund, the lender does.

Another way to get the gross-up result is to increase your regular RRSP contribution to the appropriate gross-up amount and have your employer adjust your withholding taxes so you do not get a refund.

### Math Details

To calculate the RRSP contribution produced by reinvesting all of the refund, simply increase the after-tax amount by the rate of the tax bracket. For example, in the 40% tax bracket, investing \$1,000 and the 40% refund produces a total RRSP contribution of \$1,400.

Gross-up amounts for different tax rates are shown in the table.

By appropriately reducing the amount of taxes withheld by her employer by \$1,000, Anne could contribute \$2,000 a year on a monthly basis. She would also eliminate the possibility of spending the refund because she wouldn't get a refund.

A third way of getting the gross-up result occurs when you make an RRSP contribution to reduce the taxes that you owe. Here again, no refund is generated that could potentially be spent.

### Math Details

The total RRSP contribution produced by the gross-up approach can be calculated by dividing the after-tax amount by one minus the tax rate. For example, with a 50% tax rate, 1.0 minus 0.5 is 0.5. \$1,000 divided by one-half is \$2,000, meaning that \$1,000 after-tax can be grossed-up to a \$2,000 RRSP contribution.

### RRSP Contribution from \$1,000 After-Tax

Refund Strategy	25% Tax	40% Tax	50% Tax
Spend Refund	\$1,000	\$1,000	\$1,000
Reinvest Refund	\$1,250	\$1,400	\$1,500
Gross-Up Refund	\$1,333	\$1,667	\$2,000

Many people set up monthly “pay yourself first” RRSP plans. It is important to note that unless your current monthly contribution is grossed-up the right amount as shown in the table, having your employer withhold less tax does not increase your RRSP fund at all. Simply reducing your withholding taxes amounts to getting your RRSP refund back a little bit each pay period instead of all at once when you file your taxes.

Note that the gross-up refund strategy results in **no loan outstanding** and is different from the following two strategies where a larger loan is paid off over one or more years.

(Cont'd in Booklet)

## Evaluating RRSP Catch-Up Loans

Now the merits of the catch-up RRSP strategy can be compared to the other strategies where a loan is not used. Because the catch-up strategy applies more to middle-income Canadians who do not maximize their RRSPs every year, let's consider the case of Bob, who is well into the 40% tax bracket.

Bob has \$20,000 of unused RRSP contribution room available. By taking out a \$20,000 RRSP catch-up loan, he will get a refund of 40% of \$20,000 or \$8,000. This refund is immediately paid against the loan, reducing the balance to \$12,000. Assuming an 8% interest expense, the remaining \$12,000 can be paid off over 10 years with after-tax annual payments of \$1,656.

If Bob can commit to investing at least this amount in each of the next 10 years, even during his lowest income periods, he can consider four RRSP approaches. He could use \$1,656 of after-tax annual cashflow to pay off the \$12,000 remaining on a catch-up loan, allowing him to get \$20,000 growing in his RRSP right away. Alternatively, he could use the same after-tax cashflow and invest it into RRSPs each year, with the refund either spent, reinvested, or grossed-up.

If he contributes \$1,656 into an RRSP and the 40% refund, his annual contribution totals \$2,318. For someone in the 40% tax bracket, \$1,656 of after-tax cashflow can be grossed-up to \$2,760 per year.

The table summarizes the RRSP value for each strategy after 10 years, when the loan is paid off completely, assuming that Bob can borrow at 8% interest. Since no one knows what Bob's RRSP returns will be in the future, the strategies are evaluated for a range of returns, including returns that are higher, lower, and matching the 8% cost of borrowing. Although the results for other interest rates, tax brackets, returns, and time horizons will vary, the general conclusions still apply.

As the table shows, choosing the most effective RRSP refund strategy makes a big difference, regardless of the actual RRSP returns achieved.

(Cont'd in Booklet)

<b>RRSP Catch-Up Loan Analysis</b>				
<b>RRSP Value After 10 Years, 8% Interest, 40% Tax</b>				
<b>Return</b>	<b>Catch-Up Loan \$20,000</b>	<b>Spend Refund \$1,656/yr</b>	<b>Reinvest Refund \$2,318/yr</b>	<b>Gross-Up Refund \$2,760/yr</b>
0%	20,000	16,560 (-17%)	23,180 (16%)	27,600 (38%)
4%	29,610	20,680 (-30%)	28,950 (-2%)	34,460 (16%)
8%	43,180	25,910 (-40%)	36,270 (-16%)	43,180 (0%)
12%	62,120	32,550 (-48%)	45,560 (-27%)	54,240 (-13%)

Evaluation of \$20,000 Catch-Up loan at 8% interest. 40% tax refund reduces loan to \$12,000, paid off over 10 years with after-tax payments of \$1,656/yr. Compared against investing \$1,656/yr annually with refunds spent, reinvested for contribution of \$2,318/yr, or grossed-up to \$2,760/yr. Figures in brackets show the percentage increase relative to the Catch-Up strategy. Source: Talbot's Leverage Professional software.

### When RRSP Returns Match the Cost of Borrowing

When RRSP returns average 8%, matching the 8% interest rate charged on the loan, the catch-up strategy produces \$43,180, the same benefit as making annual contributions with the refunds grossed-up. Disciplined investors who reinvest all of the refunds would end up with \$36,270, or 16% less.

If Bob's normal RRSP strategy was to invest annually and spend the refunds, he would have \$25,910 in his RRSP after 10 years. This is 40% less than if he had committed to the catch-up loan and used the same after-tax cashflow to get \$20,000 growing in his RRSP from day one.

### When RRSP Returns Exceed the Cost of Borrowing

As you might expect, when returns exceed the cost, you benefit from borrowing to get more money compounding sooner. With 12% returns, investing annually with the refunds spent produces \$32,550, 48% less than the catch-up strategy. The best annual approach of grossing-up every refund produces \$54,240, 13% less than the \$62,120 that results by committing to a catch-up loan.

We can conclude that when returns match or exceed the cost of borrowing, the catch-up strategy is at least as good as any of the annual approaches, even the best grossed-up strategy.

## When RRSP Returns Are Less Than the Cost of Borrowing

Many investors will be surprised to discover that the [catch-up loan strategy](#) often makes sense even when returns are substantially lower than the cost of borrowing.

Consider RRSP returns averaging only 4%, half of the 8% interest expense on the loan. If Bob invests annually and spends the refunds, he will have \$20,680 in his RRSP after 10 years. If he is more committed to his retirement goal and reinvests the refunds, he will produce \$28,950. If he uses the catch-up strategy, he will have \$29,610, slightly more than if he reinvests *every penny* of every refund for *each* of the 10 years. Very few people have the discipline to do that. Only by grossing-up each of the 10 years could Bob end up slightly (16%) ahead of the catch-up approach.

### Commitment is the Key

Even if returns are lower than the cost of borrowing, the catch-up loan approach can be best because it forces a higher level of commitment to your retirement goal. While Bob may *intend* to reinvest or gross-up the refunds obtained from contributing to his RRSP every year for 10 years, the loan locks in his commitment.

Once started, the loan becomes a *forced savings* plan, like a mortgage, that is not likely to be stopped. As long as you can handle the payments during the lowest income years, the [forced discipline](#) of an investment loan is often better than an automatic “pay yourself first” plan that can easily be suspended.

[Each refund strategy essentially equates to different levels of commitment to your retirement goal.](#) Financial success is more dependent on your behaviour as a consumer and investor, than choosing good investments. If your retirement goal is important to you, you will want to evaluate the most effective way for you to achieve it.

Truly disciplined investors do not need the forced commitment of a catch-up loan. Those who acknowledge their tendency to procrastinate or become distracted from their retirement goal might benefit from the forced discipline of making payments on a catch-up loan.

The [real benefit](#) of the catch-up loan strategy is the [forced higher level of commitment that produces a larger RRSP fund in almost all cases, even when returns are below the cost of borrowing.](#) This forced discipline can protect investors from the temptation to spend the refunds or suspend RRSP contributions.

# Traditional Leverage Outside of RRSPs

Having addressed borrowing for RRSPs, the remainder of this *Talbot's Summary Booklet* covers the key issues of traditional leverage, or borrowing to invest outside of RRSPs.

## How Investors Can Leverage

Leveraging investments can be accomplished in many ways, sometimes without even realizing it. As pointed out, using a mortgage to buy a house is leveraging.

### Sources of Investment Loans

■ **Personal loans.** Banks, trust companies, and credit unions all offer personal loans that can be used for any purpose, including investments. Personal loans can be secured, or unsecured. With secured loans, the lender has access to some form of **collateral**, anything of value like a car or investments, to protect them from the possibility that the loan won't be repaid. Because the lender's risk is low, **secured loans charge a lower interest rate** than unsecured loans where no collateral is pledged.

■ **Lines of credit.** Lenders also offer lines of credit, which allow you to borrow any amount up to a predefined limit at any time. Lines of credit are more **flexible** than loans, allowing you to pay for money only when you need it.

Most secured lines of credit offer the option of paying only the interest expense, without paying down any of the principal. This keeps the payments as low as

possible, but the loan never gets paid off. They can be secured, perhaps by your home, or unsecured. Home equity loans or lines of credit are generally the cheapest source of financing available, often at prime.

■ **Investment loans.** Loans specifically set up for investing are available from most conventional lenders as well as some insurance and fund companies. There are a wide variety of programs available where existing non-registered investments are usually held by the lender as collateral for 1:1, 2:1, or even 3:1 loans. (Cont'd in Booklet)

### Definition

The prime lending rate is the lowest rate generally charged to the bank's best customers. It is the benchmark that most floating rate loans are based on.