



Leverage Risk Decreases Over Time

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Last month's Strategy Sheet explained several reasons *why* the breakeven point for leverage is lower than you think. The breakeven point is critical because it defines the risk, and the investor's confidence that *they* will make money.

In most of my leverage analyses, I assume a long-term cost of borrowing of 9%. This should be conservative because the prime interest rate has averaged 7.4% over the last 64 years. More importantly, many experts predict that inflation and interest rates in the future will be lower than normal.

The following table summarizes the gross, *before-tax* breakeven returns over time, assuming a 9% cost of borrowing where most of the growth is deferred capital gains, and 50% of capital gains are taxable.

For example, someone in a 40% tax bracket that leverages over a 20 year period with a 9% cost of borrowing would only need to achieve a **before-tax equity return of 4.2% to break even**. One of the myths of borrowing to invest is that returns must be higher than the cost of borrowing to break even. This is a reasonable and rational conclusion, but it is not true — especially when some of the returns are deferred capital gains that are taxed less and later.

Thinking that you must achieve 9% returns for leverage to be profitable, it is natural to view leverage with skepticism. However, once you know that you only need to exceed 4 to 6%, it is possible to be open to exploring the strategy in more detail.

Understanding the real leverage breakeven point, and how it decreases over time, is important to make an informed decision about leveraging.

Leverage Breakeven Point For Equities, 9% Interest Expense		
Years	40% Tax	50% Tax
1	6.7%	6.0%
5	5.9%	5.3%
10	5.1%	4.7%
15	4.6%	4.2%
20	4.2%	3.9%
30	3.6%	3.4%

It should be clarified however, that while it is valuable to understand the breakeven point, there is a difference between breaking even and benefiting. The breakeven point is the return where you *start* to profit. The more important issue is to know what return is needed for leveraging to benefit the investor. In other words, when is leveraging more profitable or better than not leveraging. The **“better than” return for someone in the 40% tax bracket leveraging over 10 years is about 6.3%**.

If you feel that you can produce long-term diversified equity returns of over 5 or 6%, sit down with your advisor to fully understand the pros and cons of leveraging up to *your* definition of conservative.



A basic understanding of the opportunities available will help you achieve *Financial Freedom Without Sacrifice*.

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