

Talbot Stevens'

Emotional Acid Test

for Conservative Leverage

The “Emotional Acid Test” helps advisors professionally address several critical aspects of dealing with emotional risks. The Emotional Acid Test:

1. Identifies if the client is truly emotionally suitable for leverage.
2. Provides documented proof of the client’s suitability and awareness of the risks.
3. Confirms if the client understands the issues and is ready to act.
4. Provides a useful document to help clients stick to the plan during tough times.

It is suggested that the one-page Emotional Acid Test be reviewed and signed by the investor and their spouse just *before* implementing the plan. In fact, this tool can be useful for the advisor to “close the sale”, and to the investor to confirm they are really ready to act now.

The advisor can inform the potential leveraged investor that obviously if the answer to the Emotional Acid Test Question is either D, E, or especially F, then leverage will have to wait until they become more emotionally ready for the concept.

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The purpose of this Emotional Acid Test is to:

- determine if an investor is emotionally ready for potential downside of leveraging
- help them stay focused on the long-term plan when investments are down

Leverage is merely a tool that magnifies returns both up *and down*. It is critical to understand that selling for any reason when the leveraged investments are down will result in the investor losing more money than would have occurred without borrowing to invest.

For example, consider someone in the 50% tax bracket that pays a tax-deductible 10% interest to borrow and invest \$10,000. After one year, the individual's investment is \$1,000 before-tax. After the interest expense deduction, the after-tax cost is \$500.

- If the leveraged equity investment gains 20% after one year, leveraging produces a before-tax gain of \$2,000. For capital gains, the after-tax gain from investing \$500 is \$1,250, 2.5 times the amount invested, or an increase of 150%.
- If the leveraged equity investment loses 20% after one year, leveraging produces a before-tax loss of \$2,000 *in addition* to the \$500 of interest payments for a total loss of \$2,500. Losing \$2,500 on an investment of \$500 is a loss of five times the amount invested.

Emotional Acid Test Question

If *my* leveraged investments drop 30% in value 3 weeks from now, I will:

- A: Want to buy more, because investments are now "on sale"
- B: Have faith and hold, committed to the long-term plan
- C: Hold somewhat nervously, questioning why I leveraged
- D: Want to sell, unable to sleep at night due to stress
- E: Insist on selling, stressed and upset with my advisor
- F: Shoot my advisor, and/or educator who introduced leverage

Date

Signature

Spouse's Signature