The Smart Debt Coach

Secrets of the Rich to Increase
Your Wealth and Security

by
Talbot Stevens
www.TalbotStevens.com
www.SmartDebtCoach.com (soon)

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Reviewer Feedback Only

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The Smart Debt concepts in this book should help people in three dimensions: reducing bad debts, increasing cashflow for investing, and improving investment returns.

Feedback in the following areas is most helpful:

- Any suggestions on **how to make the message more valuable** for middle- and upper-income Canadians are greatly appreciated.
- Identify any areas that are **not easily understood**. As a guideline, if you have to reread it, it is not clear enough.
- What ideas or areas do you think **could be eliminated** because you **didn't find them valuable** ('everyone knows that'), or they **didn't hold your interest**.
- **What ideas did you like the most**?

Thank you!

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Many Smart Debt Strategies Exist

"Stick to vehicles you are comfortable driving"

In terms of finances and optimism about the future, the first week in the New Year was one of the best ever. That is, until that Friday when I learned something that could derail everything.

Perhaps the year started off great because the change in the calendar represented a fresh start. While it is common to make New Year's resolutions about improving one's health, weight, or finances, I chose not to. Although I was a little concerned about my increasing girth, it had not reached the critical point of taking action. For me, other popular approaches to fitness didn't seem to work. I once tried joining a gym to lose some weight, but after a year, the only thing I had lost was the six hundred dollar membership fee!

But this year, we didn't need any New Year's resolutions. With Bruce's help, our financial priorities and commitments were already in order. We were clear on what was most important for us, and why, and were taking steps in the right direction.

Despite the kids playing their hearts out in the hockey tournament, they didn't make it to the final day. This allowed me to get home a day earlier and do some research on getting a gently-used truck, *and* invest the savings. Comparing alternatives online helped me be prepared for hitting the car lots.

After looking at vehicles from five dealers, I was pleasantly surprised by how professional they are these days. Most of the salespeople made the process ... almost painless. But after the sales rep at one of the smaller, independent car lots dodged a question three or four times, I became so infuriated that I wanted to strangle him. Fortunately, I resisted the temptation, as I remembered that in some provinces, it's still a misdemeanor to kill a used car salesman.

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In the end, I found a two-year-old truck with low kilometers on it, for at least $12,000 less than the price of a new one. To fully benefit from this, my monthly savings from buying slightly used was added to our Painless Pay-Yourself-First plan we started with Bruce last month. After the discussion about squirrels needing to stockpile nuts to get through the summer, Michelle and I decided that our highest priority was building an RRSP income buffer – using fully-cooked pasta, of course – to boost our short-term security, just in case. After that, we would focus on helping with the kids' education while they were still young enough to qualify for the RESP government grants.

To complete the experience of acquiring our 'new' vehicle, I even picked up some new car scent. This was partly to provide a sensory reminder of our new approach to vehicles that itself should reasonably add hundreds of thousands to our retirement fund. When I smelled it, I visualized the additional trips to exotic places on our bucket list that we would now be able to afford in retirement. Financial planning was starting to be fun!

With our mortgage renewal, Bruce helped us set up a home equity line of credit. We were able to consolidate all of our non-mortgage debts – the credit cards, boat and Michelle's car loan – at a much lower rate, and have a little extra credit available to only be used for real financial opportunities or emergencies. As Bruce advised, to benefit from the debt consolidation, we kept the same terms on the loans. The monthly savings from the lower interest rate on the HELOC were not squandered, but – per our pre-commitment to direct 'new money' towards our highest priorities – also added to our Pay-Yourself-First plan.

With Bruce's coaching, we were learning and acting on simple ideas that would move us from Wannabe Rich towards Gonnabe Rich. We were really starting to feel good about the changes we had already made, and confident about our financial future. Then, at the end of the week, my company announced news that threatened everything. Our company was purchased by a larger

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competitor. The merger would be finalized in next few months.

While most accept that job security has gone the way of the dinosaurs, being involved in a takeover is even more precarious, especially if you work for the smaller, acquired company. Part of the reason for consolidating two companies is that – like a debt consolidation – costs can be reduced and the savings flow right to the bottom line. This, of course, means that anyone could be let go. As well, there was also the risk that even if I was still part of the merged company, the culture of the new firm might result in me wanting to leave.

All of a sudden Bruce's talk about the importance of building RRSPs ahead of paying down debts moved from a good idea in theory to hitting too close to home. With the major breadwinner's income now more uncertain than ever, Michelle and I now had an easy decision to not join Lisa's family in the Caribbean during March break.

Ironically, even though we wouldn't be going, my sister's suggestion for a winter family getaway resulted in a major benefit that we were even more grateful for now. If she hadn't initiated the trip, we wouldn't have learned how she could easily afford it on a lower combined income. We wouldn't have met the Smart Debt Coach and discovered how much difference a few concepts and a little behavioural coaching could make. And as Kim prompted, we hadn't yet gotten into the more powerful ways to build wealth like the rich do.

Personally, I never needed to be 'wealthy', but with my new financial uncertainty, I was more determined than ever to do everything I could to get to become financial independent. I wanted to get to the point that we had enough finances to not be concerned about taking the family on a nice vacation, whether my employer merged with another company, or how well we would be able to live during 30 years of retirement.

When we all convened and settled at Chris' next hockey game, I was more keen than Kim to learn about ways to invest more effectively. Both Bruce and Kim assured me that everything would work out with the new company.

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But they weren't the ones deciding whose jobs would be consolidated during the merger.

"Bruce, can we talk about how the rich invest to build their wealth?" I initiated, not waiting for Kim. "We don't earn a doctor's income, but I'm sure we can do much better with the money we do have, and with the money we're committed to add in the future."

"There are lots of ways to improve investment returns," Bruce began, "beyond the ideas we discussed briefly and in my office. Since Kim wasn't there for all of it and she initiated this, let's make sure we're clear on some of the basics.

"Fundamentally, an investor can either be an owner or a loaner. In the long run, do owners of businesses, stocks, and real estate do better or worse than those who seek guaranteed returns with the loaner approach?"

"Warren Buffet and Donald Trump didn't become billionaires investing in bonds and GICs," Kim replied, confidently. "So to build wealth in the long run, we need to be equity investors, like the rich do."

"That's right. In the short term, investing in equities of some flavour *will* be financially and emotionally challenging – some might even say painful. But in the long run, the decision about what portion of your investments should be in equities will make a huge difference.

"And Joe, Michelle, do you remember the behavioural challenge for most equity investors?"

"I do, thanks to *The Behavior Gap* book that you gave us," I beamed proudly. "The bottom line is that while equity markets have averaged long-term returns of around ten percent, the average investor's returns in equities might be half of that. That behavioural gap is because we're hard-wired to make behavioural mistakes like chasing last-year's winners and trading too often."

"Excellent. And Michelle keeps saying you can't read!" Bruce teased, sarcastically. "So we need to **own equities, and more than most people think** – especially if you have the predictability of a pension. Step two is to simply **diversify into equity markets and hold long term** to

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overcome the behavioural gap. It's easier, less stressful, and much more effective.

"And for some, those two steps might be enough, especially when combined with tax sheltering in RRSPs and TFSAs, and you start when you're young."

"But what if you're no longer young, behind in your retirement plan, or committed to have more than just 'enough'?" Michelle asked.

"Then you should be aware of, and objectively consider, some of the secret investment strategies of the rich. As you probably already know, the wealthy build their wealth much faster than simply owning equities long term, and you can too."

"We're listening," Kim interjected, attentively.

"There was an article in *The Globe and Mail* a while back that revealed the general approach. It explained that 46 percent of RBC's wealthiest clients were using investment debt strategies. When you factor in the reality that many of these investors are in or near retirement and might have significantly reduced their exposure to risk, it's obvious that a large portion of the rich think about, and use debt differently than the majority."

"But what if, like me, you don't want to take a lot of risks with your investments?" Kim shrugged.

"**When it comes to money, you should never do something you're not comfortable with**. Kim, do you remember how we talked about debt being like a vehicle?"

"Yes."

"Well, just like there are all sorts of vehicle makes and models with different benefits, there are over twenty different investment debt strategies, each with different levels of risk. Obviously, driving a 600-horsepower Ferrari or an 8,000-horsepower race car is a completely different level of experience – and risk – than driving a huge tractor, or say, a light-armoured tank. Being in a much larger and slower vehicle is clearly much safer."

"Unless there are missiles being shot at you!" Kim quipped.

"Good point!" Bruce chuckled. Then, out of his jacket, Bruce produced a few pieces of paper and handed one to each of us.

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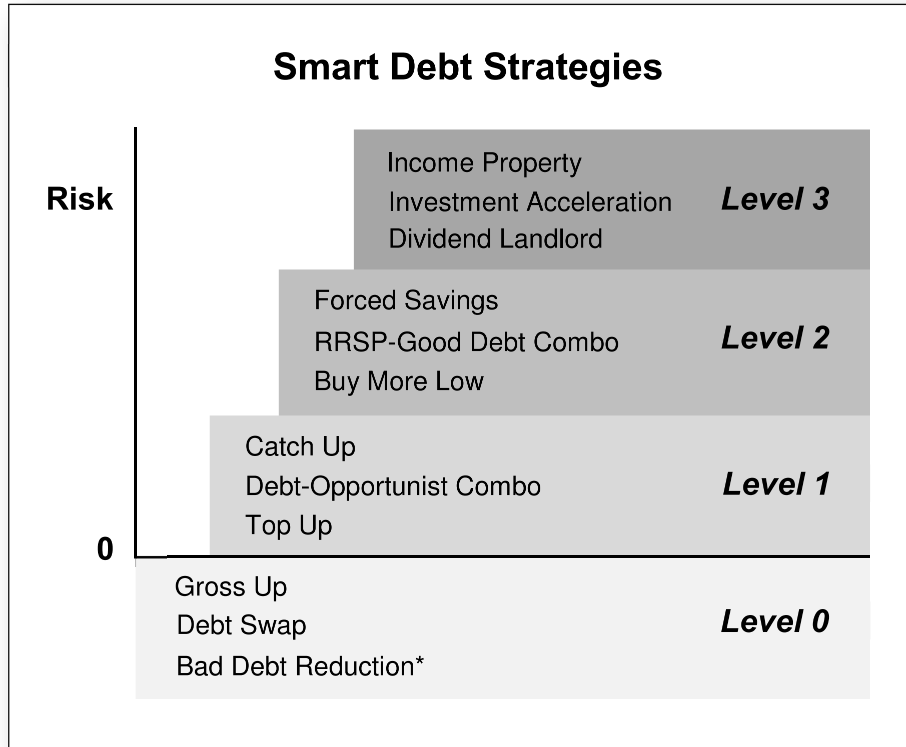
"One of the realities that investors need to be aware of, is that there are over 20 different good debt strategies, each with different levels of risk. The important point is – whether you think that investment debt is too risky or one of the best ways to build wealth – **no matter what your current attitude is towards investment debt, it can't apply to all strategies available** to investors.



"This chart shows a dozen or so of the simpler, safer investment debt concepts – what I call Smart Debt Strategies. There's a wide range of risk levels, including some 'can't-lose' strategies like a Debt Swap and a Gross Up that benefit anyone, regardless of their risk tolerance."

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"It looks like the Level 0 strategies at the bottom of the chart have risk below zero," Michelle pointed out. "Is it possible to have *negative risk*?"

"Yes," the financial advisor answered. "In general, **Smart Debt strategies include both smart *bad* debt concepts, and smart *good* debt concepts**. Any idea that reduces bad debt is a strategy where you 'can't lose'. On the good debt side, the Gross Up and Debt Swap strategies are also guaranteed to increase your net worth, and thus have negative risk. **Everyone should be aware of, and act on, these 'can't lose' Level 0 strategies**, regardless of their age, risk tolerance, or experience.

"*Determined Drivers* would be comfortable giving Level 3 strategies a spin," Bruce continued, appreciating Kim's quick wit. "*Cautious Cruisers* might want to stick to Level 1 strategies, while *Moderate Movers* should also consider how Level 2 Smart Debt strategies might accelerate their wealth-building efforts."

"And, if like most, you're not comfortable with the higher-powered, higher-risk vehicles?" I queried.

"Don't get in them," came Bruce's frank reply. "At least not until you've learned enough about them to be confident you can use them safely. Naturally most people aren't ever going to want to be in race cars that can go over 350 kilometers an hour, or …" Bruce looked directly at Kim, "any vehicle that's being shot at!

"But I think that **everyone should have a basic understanding of the Smart Debt strategies** that the rich use, **so they can benefit from those that they're comfortable with**, **and know which ones to avoid**. The chart should make it clear that it's possible to be skeptical and fearful of some investment debt concepts while being completely comfortable with others."

"Someone I know said that it's hard to benefit from a strategy if you don't understand it," I reminded.

Bruce applauded my increasing knowledge with a smile. "So the **first step in implementing Smart Debt is to stick to responsible strategies**. You need to determine the type of driver you are, and only get in vehicles you're comfortable with. Of the many Smart Debt

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concepts that exist, only consider responsible strategies that make sense for *you*."

"So what Smart Debt strategy is best?" I asked.

Without hesitation, Bruce countered, "What car is 'best'?"

"Fair enough," I consented, realizing it was a loaded question. "Everyone's situation and comfort level is different.

"So which Smart Debt strategies should we understand first?"

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Good Debt Fundamentals

"Shifting into drive"

"First it's best to understand two of the foundational good debt strategies, as all of the others are some variation on them," Bruce responded. "What I call **the Investment Acceleration strategy is the basic approach where you borrow to invest and make interest-only payments**, over the long term. This is the way most investment borrowing is done, and can result in the biggest increase in long-term wealth.

"The math of the upside is quite compelling. Over reasonable investment periods of ten years, higher-income investors would have turned average equity market returns of ten percent into Warren Buffet-like returns of over 20 percent."

"And the downside?" Kim inquired.

"The faster the vehicle goes, the more you get hurt if you end up off the road," Bruce replied. "Whenever you're borrowing to invest, negative returns are magnified even more than positive returns, particularly with the Investment Acceleration strategy.

"If you borrowed $100,000 to invest and sold when the investment was down twenty percent, you'd have not only lost all of the cashflow you put in to finance the strategy – a minus 100 percent return right there, but an additional $20K of borrowed money as well."

"Which you're still on the hook for," I confirmed.

"That's right. That's why it's one of the higher-risk Level 3 strategies. It's also why you should have a long-term investment horizon. Over the short term, no one knows what the stock markets will do. But over the long term, returns are more predictable, and likely to be magnified in the positive direction."

"And what's the other fundamental approach?" Kim pressed.

"The other fundamental approach is **the Forced Savings strategy, where your investment loan is**

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paid off over time. Compared to the more popular approach of interest-only payments, making principal and interest payments is the neglected little sister. But it shouldn't be that way. There are a number of reasons that the Forced Savings strategy is better than the Investment Acceleration interest-only approach, at least for less aggressive investors."

"Such as?"

"For starters, because part of each payment goes to reducing the principal, the same amount of cashflow borrows a smaller amount than if you just paid the interest expense. Since amortized loans are eventually paid off automatically, there is no need to time when to get out of the market, which can be tricky. And in terms of performance, you generally get most of the upside magnification and eliminate even more of the downside magnification. These factors are important, especially for those who have never used investment debt before. But there's an even better reason that many should consider the amortized Forced Savings strategy over the more powerful Investment Acceleration approach."

"What's that?" I urged.

"With your monthly Pay-Yourself-First plan, is it possible to 'temporarily' suspend the savings?"

"Sure."

"But once you start a mortgage, do you have a choice about continuing the payments?"

"Not really, if you want to keep your house."

"The same is true for an investment loan," Bruce explained. "Once you start it, **a Forced Savings strategy is a behavioural solution that locks in a higher level of discipline and commitment** to fueling a retirement plan. The automatic savings approach of paying yourself first truly is worlds better than no savings commitment. But for those who don't have robot-like discipline, a modest Forced Savings approach could be more effective. The secondary bonus is that returns are magnified slightly, which historically meant building wealth faster.

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"Based on this behavioural reality, there's one or two more thoughts you might consider. Then, I've got to get a coffee," Bruce grinned.

"We've talked about focusing on your highest priorities, and not letting your money unconsciously flow to companies that are good at selling you things, or even to your lower priorities. We've talked about pre-committing a portion of future income as well as 'new money' windfalls towards the financial goals that are most important to *you*.

"In today's finance-everything society, we make payments for homes, vehicles, student loans, and of course lots of stuff on credit cards. If a stress-free, 30-year retirement in the lifestyle you want is as important as these things, maybe **including a '*retirement payment*' in our monthly commitments is an effective way to make it happen**.

"That makes sense," Kim concurred. "Especially for those like my A.D.D. ex who struggle to follow through on commitments and can't resist whatever catches their attention."

"One more reason some should consider a Forced Savings approach," said Bruce. "The huge milestone of funding retirement can be discouraging. **When a milestone is too far away, it's helpful to break the journey into smaller 'inchpebbles'** that are easier to reach.

"What is less intimidating: doing 50 pushups, or doing five sets of ten? Instead of one, long, seemingly endless journey, some might find it better to chunk the retirement savings task down into five-year Forced Savings periods where an investment commitment is locked in, paid off, celebrated, and adjusted as the journey continues."

"I can see how that would be an effective approach for a lot of people," Michelle conceded.

"After they fully understood the pros and cons," Bruce clarified. "Why don't we discuss some more of the fundamentals of using investment debt after a coffee? Who else wants one?"

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After watching a bit of the game, the four of us returned to our seats with java fixes for the guys and decafs for the girls.

Kim seemed unsettled, and resumed, "Bruce, I hear what you've said about investment debt. Logically, what you've said so far makes sense. But the attitudes about money I grew up with were that almost all debt was bad and should be avoided. Even a mortgage was something my parents worked hard to pay off as fast as possible."

"I understand where you're coming from," Bruce empathized. "In previous generations, those who weren't wealthy did avoid debt, especially those who had any exposure to the Depression. Having debt and no ability to pay meant you could lose everything.

"But clearly the attitude of the general public towards debt has changed, and we how have record-high debt levels. And aside from the wealthy, are most people using good debt or bad debt?"

"I'd say most of it is bad debt," replied Kim.

"So most people are deep in debt – some up to their eyeballs. But most of it is debt that's guaranteed to hurt them financially. On the other hand, good debt strategies are typically only used by the few who are rich, and there's little information available to inform and guide those who aren't wealthy, but want to lean in that direction. And the little that you do hear is either the person who lost a lot of money – like Kim's colleague, or a handful of people like Trump who made it big.

"So for the Wannabe Rich, the reality is that for a few reasons, **investment debt concepts are still very controversial**, and it's not easy to make an objective assessment. In many cases, investors must unlearn what they've learned, so they can have an open mind to properly determine what investment approach best meets their needs."

"For their patients' sake, doctors need to keep an open mind about new approaches to treatments that are being discovered all the time and learned through continuing education," Kim chimed in. "If we didn't, there wouldn't be any improvements to health care, and our patients

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would only benefit from what we learned in medical school."

"So **everyone needs to keep an open mind if they want to benefit from better ways** of producing results," Bruce emphasized.

"Kim, speaking of doctors, that reminds me of something I've been meaning to ask you," I stated. "I know the system does its best, but you know how patients often have to wait days to get an appointment, and then when they get to the doctor's office, they're in the waiting room for a long time, before they're ushered to another room where they wait some more before seeing their doctor?"

"It happens more than we like," she admitted.

"Do you think that doctors' clients are called 'patients' because they need to have so much *patience* waiting so long for their doctor to see them?" I asked with a smirk.

Kim smiled. "How long have you been waiting to ask that?"

I just smiled back.

"I think you should wait in my office for an answer!"

"Bruce," Michelle sighed. "Ignore them. They've been going at it like this for years. Are there other good debt fundamentals that we should know about?"

"There's a key misconception about investment debt that investors need to understand," he replied.

"What's that?"

"The prime borrowing rate in Canada has averaged about seven percent over the last 70 plus years. If you could borrow with an interest rate of seven percent, what return would an investor need to benefit from an investment debt strategy?"

"I'd say seven percent," Michelle replied.

"Almost everyone gives the same answer. It's very reasonable and rational to conclude that if you borrow at seven, you'd need returns of at least seven percent to benefit," Bruce stated softly. "But the only problem with that very reasonable conclusion … is that it's wrong – at least if you borrowed to invest in equity investments where part of the return is in the form of a capital gain.

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"If you could only borrow for interest-paying investments, you'd be right," he conceded. "But if some of your investment returns are capital gains – which are taxed less, and taxed later – someone in the 40-percent tax bracket who borrows at seven percent might only need returns of *five* percent to net more from an Investment Acceleration strategy, compared to not borrowing to invest."

"How is that possible?" I asked, puzzled. "Borrowing at seven percent and getting five percent sounds like the kind of logic that creates government deficits."

"You need to account for the interest being tax deductible," Kim astutely pointed out.

"That's a big part of it. And many conclude that investors need their after-tax returns to exceed their after-tax cost of borrowing to benefit from investment debt."

"But?" Kim prompted, anticipating more.

"But that only tells the whole story if you invest for one year," explained Bruce. "If you hold for longer periods, the deferred taxation on capital gains results in additional growth, just like the tax deferral inside RRSPs or TFSAs produces additional growth. Because of this, as your holding period increases, the return you need to benefit from investment debt actually decreases."

"Sounds like the math isn't so simple," I said.

"It isn't as simple as calculating the proper amount to Gross Up contributions to make sure you don't put dry pasta in your RRSP. But don't worry," Bruce assured. "My clients who are interested in Smart Debt investment strategies receive personalized projections for a range of returns so they clearly understand the potential gains or losses for their unique situation.

"The same software I use is available on my website with a 30-day free trial. This allows investors who are curious more than enough time to find out what return is really needed for an investment debt strategy to benefit their personal situation."

As the hockey game was wrapping up, so was Bruce.

"The bottom line is that **the equity return needed to**

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benefit from an investment debt strategy is lower that most people think, and it decreases over time.

"I'm not trying to steer anyone towards any of the Smart Debt strategies. My goal is to simply help people understand the different approaches that exist so they can make a better decision about what's best for them. And you can't do that if you don't know high the real hurdle is that your investments need to clear for you to benefit from borrowing to invest."

The next day, I called Lisa to inform her about the company merger, and that we wouldn't be joining them during March break. I also updated her on how Michelle and I were now also Bruce's clients, and some of the ways we had already benefited. While I appreciated the better-late-than-never result, I was a bit disappointed in my sister.

"Lisa, ten years ago, did Bruce or his uncle have a '*Help a Friend'* campaign where they encouraged clients to share valuable ideas with others they cared about?"

"Yeah," she replied. "It existed when I first became a client. So?"

"So, after you started learning that simple ideas that we're not taught can literally add hundreds of thousands to a retirement fund, didn't you think that your only brother might also want to benefit the way you were?"

There was a pause before she replied. "I didn't know that you didn't go see Dad's financial advisor as he suggested to both of us. So I didn't know you weren't already benefiting. I guess like most people, we don't talk much about money, even with family. I think that like sex, money is a topic that's either kept private, or not talked about at all."

"Maybe **everyone could benefit if we were all more open to talking about financial ideas more**," I commented. "The topic of financing planning, or more specifically, how we can be more effective with money, doesn't have to be taboo."

"I agree," she concurred. "Let's get finances out of the closet, starting now. But let's keep our sex lives private!

"Now that you're a client, has Bruce talked to you about his latest Smart Debt concept? He just came up with it a

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few weeks ago. It's a variation on his favourite strategy 'Buy More Low' and a simple way that the most conservative investors – those who would never consider using investment debt – can outperform the stock market."

"He hasn't mentioned it yet, but we've just started discussing smart good debt strategies. I'll ask him about it at Chris' next hockey game on Wednesday."

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Is Some Investment Debt Better Than None?

"What is the optimal speed to drive?"

At work, the week started off better than the previous one ended. Naturally, there was lots of discussion about the merger and what it could mean to all of us. As one of the managers, I had to provide a reassuring calm about the future, even though I knew that my job could be gone just as easily anyone else's. My three-part plan was straightforward. I would continue to give 110 percent at work, hope for the best, and prepare for the worst by exploring what other options were out there.

After discussing the uncertainty of the months ahead with numerous colleagues, I realized that we were in much better financial shape than some, especially now that we were learning and acting on ways to increase our short- and long-term security. This led to news that I was eager to share with Bruce.

When Michelle and I arrived in the stands for the boys' hockey game on Wednesday night, we found Kim and Bruce together.

"Hi guys," I began. "What's new?"

"Not much," replied Bruce. "What's new with you? Do you know any more about what's happening at work?"

"Not really. It'll be weeks or perhaps months before we know for sure. But you'll be pleased to know what did happen at work."

"What's that?"

"When I was discussing the possible financial impact with some colleagues, it was immediately obvious that most were not prepared for the possibility of going months without income. And like us a few months ago, they weren't aware of any of the ideas you've helped us learn to increase our financial security – even my boss.

"To make a long story short, the discussion eventually included our human resources director. After I explained how you helped us save thousands with the $46,000

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question and consolidating all of our debts properly, she was impressed, especially since she was in the process of replacing her car. She felt that with most people being financially illiterate and the concerns caused by the merger, the whole company could benefit from your ideas. She's going to contact you about coming in to give a talk."

"That sounds good," Bruce commended. "So you've gone way past my suggestion to Teach Two, and sharing financial ideas with two people you care about."

"I guess so," I replied. "But I wasn't thinking about that. It just came up naturally.

"I was also talking to Lisa, and updated her on how we're now clients of yours. She mentioned something about a new Smart Debt strategy that you came up with a few weeks ago that allows conservative investors outperform the stock market. I don't want to seem ungrateful, but is there a reason she knows about it and we don't?"

"You know I would never withhold anything from you," Bruce assured. "As you saw from the Smart Debt Strategies chart I gave you at the last game, there are many different smart good debt concepts available. What I do try to do in educating my clients is to expose ideas in the order that makes it easier to understand and make an informed decision.

"So far, we've only discussed the fundamental investment debt approaches: Investment Acceleration and Forced Savings. There are two more key concepts about Smart Debt to fully understand before it makes sense to introduce my favourite strategy. We can discuss them now if you'd like."

"Sure."

"Alright. Let's build on the 'debt is a vehicle' analogy a little more," Bruce went on. "Let's assume that to get to your destination, you have the choice of three approaches: walking, biking, or driving. The investment equivalent of walking is fixed income investments, like GICs or bonds held to maturity. They grow in a slow, predictable manner where you're not going to get hurt.

"Biking is like investing in equities. You can go much faster than walking, perhaps five times faster. But,

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ignoring accidents with other vehicles, can you get hurt by choosing the strategy of using a bike?"

"My knees and elbows have the scars from my youth to prove it," I replied.

"Like Chris has from skateboarding," Michelle added.

"Biking allows you to go fast enough to get bloody. You can get banged and scraped up," Bruce elaborated. "But you're not likely to get killed.

"As we've discussed, investment debt is like using a vehicle. Cars can go much faster – maybe five times faster than even bikes. But because you can travel so much faster, using a vehicle can result in more serious injury or even death."

"Which is why most investors like my parents, and me, wouldn't be comfortable using investment debt," Kim jumped in.

"And we've acknowledged that, aware of the risks, almost everyone still chooses to drive a vehicle – including your parents," Bruce speculated, looking at Kim. "But while vehicles might go as fast as 200 kilometers an hour, is that the only possibility?"

"Of course not," Kim acknowledged.

"The first point that investors who aren't yet rich need to recognize is that **using investment debt is not a 'lots or none' decision**. Just like the driver has the choice of going any speed between zero and the maximum, investors have the choice of using any amount of good debt between none and the maximum they can borrow. But if you only think of driving at high speeds or using lots of investment debt, it's understandable and appropriate to be afraid and avoid it.

"So, if a vehicle can get you to your destination faster, let's think a little about what's the optimal speed to drive, and see how that can help us identify the smarter, safer amount of investment debt to consider. For discussion sake, let's say you have access to a vehicle that has a top speed of 200 kilometers an hour.

"I'll bet than none of us have driven anywhere near that speed. You probably don't even know the highest reading on your speedometer because you would never consider going that fast."

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"Because it's too dangerous," Kim stated.

"That's right. Even on freeways designed for higher speeds, the typical speed limit is 100 kilometers an hour, or about half of the maximum speed of many cars. Even though cars can go much faster than that, society has recognized that 'speed kills' and established top speed limits of about half of the car's potential. Ironically, that aligns with **one of my guidelines for smarter, safer investment debt: use less than half of the amount that you think you can financially or emotionally handle**.

"Michelle, can you remember when you were first learning to drive?" Bruce asked.

"Barely," she replied. "It's been a few years."

"And when you first started, did you immediately drive 100 kilometers an hour?"

"No, I was too nervous," Michelle admitted. "I started out slowly, on back streets where there was little traffic."

"And for the same reason, for those who have no experience or confidence using investment debt, doesn't it make sense to only consider an even smaller amount of what they could qualify for?"

"Sounds like a good idea to me," I concurred.

"So for investment debt, unless you're willing to risk going broke, lots is out of the question. We should only consider less than half of what we think we can handle, and even less than that when we're a rookie," Bruce summarized.

"But here's the important question. What's the *optimal* speed to drive?"

"Wouldn't that depend on what your objective is?" Kim inquired.

"Great point," Bruce replied. "If you can get to where you need to by walking or biking – without borrowing to invest in equities – you don't need the investment debt vehicle at all."

"But if you want to go further than that, or simply want to use the most effective strategy …" I took over.

"Then we should first answer the question: 'Is using *some* of the vehicle's potential to go faster better than *none*?'" Bruce finished. "Is it possible to drive at a speed

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where we get the some of the positive with negligible negative?”

“What if you drove at a speed that you couldn’t get hurt,” Michelle thought out loud. “Wouldn’t that be better than not using a vehicle?”

“Bingo!” an impressed Bruce exclaimed. “Recognizing that using a vehicle is much faster *and* much riskier, the best speed to consider is the one that you are confident you won’t get hurt. More specifically, if we accept that biking can cause minor injuries, the best vehicle speed to consider is the speed that results in the same downside – the same risk of non-fatal scrapes and bruises.”

“And in terms of investment debt that means?” I prompted.

“It means that **the right amount of investment debt to consider using is the small, comfortable amount that, in the worst case, would only have a minor impact on your net worth**. If markets stayed down for an extended period, it wouldn’t change your lifestyle or keep you up at night. For most people, I suggest that amount would be between ten and thirty percent of their borrowing capacity.

“Interestingly, a study by two professors, Dale Domian and Marie Racine, looked at the same issue of what amount of investment debt is best, and they came to similar conclusions.

“First, they found that high amounts of investment borrowing produced dramatic declines in long-run wealth. While some make out big, most lose lots. While it’s obvious and true that the less bad debt the better, it’s not true that the more good debt the better. So if you were apprehensive before about using lots of investment debt, now you’ve got more reason to be.

“The professors also found that a modest amount of investment debt enhances the growth of wealth in the long run. In other words, **lots of investment debt is really bad, and a little should be good – and is the only amount most investors should consider**.”

“I guess the same is true with medications as well,” Kim reflected. “With pain killers, for example, taking a little will help, but too much will kill you.”

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"That's another good analogy," Bruce complimented. "So the **second step in implementing Smart Debt is to stick to responsible amounts**. Whether it's an individual, a company, or a country, borrowing to invest can accelerate growth and increase wealth in the long run. But that's only true if the amount borrowed can comfortably be handled in the worst case."

"Is everyone onside with that?"

"I can see how that makes sense on paper," Kim agreed. "But I'm still not comfortable with the notion of investment debt. As you've said, it's not always 'good'."

"That's OK," Bruce offered. "Remember, my efforts are not to convince you to use any of the Smart Debt strategies. The focus of my education with clients and other groups I speak for, is to help everyone understand some of the Smart Debt concepts that they might benefit from. That's the only way they'll be able to make a better decision about what makes sense for them.

"And before we can introduce the other Smart Debt strategies, including the new one Lisa referred to, we need to take a closer look at the critical factor that makes Smart Debt safer. It's a big part of the evolution of Smart Debt as an improvement over my uncle's original approach."

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The Critical Factor that Makes Smart Debt Safer

"Don't drive in dangerous road conditions"

"What's changed?" I asked.

"Uncle Brian, who taught me most of what I know about financial planning and investment debt, was very careful with how clients used good debt. His fundamental approach was to use only a small, comfortable portion of the amount clients felt they could handle. Using only a small portion of the client's borrowing capacity greatly reduced financial and emotional risks. And by diversifying and holding on for the long term, it smoothed out the bumps in the road.

"That's a good, solid approach that can significantly increase wealth based on average, long-term historical results. And it made a lot of clients a lot of money. But when the financial crisis hit and the market crashed, a few clients got so stressed, they wanted out. No, they didn't sell. And yes, the markets did go on to recover.

"But that was a painful period. While most of his clients were way ahead from starting investment debt many years earlier, those who started later were underwater. My uncle, whose entire focus was to help his clients, had temporarily hurt some of them, and it really upset him."

Kim was intrigued. "So what happened then? Did the market rebound make the problem go away?"

"Yes and no," Bruce answered. "Yes, financially the problem went away because by having faith in the long-term plan, those clients who were in the red were soon in the black. But the emotional impact was not gone, and my uncle was committed to prevent it from happening again.

"That's when I worked with him to apply a simple success strategy I learned when I was growing up. Dad always told us to ask **'How can this be improved?'**, especially during a crisis or challenge."

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Kim was practically on the edge of her seat. “So, how *did* you help improve his approach to good debt?”

“Two ways. Together, we recognized that most of his clients were only using one good debt strategy. Perhaps driven by greed, they used the approach that magnified returns the most. They were only using the most powerful vehicle. Even though my uncle made sure they were driving slowly, as soon as the road conditions became dangerous, some got scared and wanted out.

“That led to us identifying the various investment debt strategies and how each had different risk levels. A few have been added over the years, including the one I conceived a few weeks ago that Lisa mentioned. Ensuring that clients understood and only implemented good debt strategies they were comfortable with became a key component of Smart Debt. As we discussed, the first dimension or step in implementing Smart Debt is to stick to responsible strategies.”

“What was the other improvement that led to Smart Debt?” Michelle prompted.

“Even if you had the safest vehicle on the road, and you never drove it over 50 kilometers an hour, would you want to be travelling at night during a snowstorm when the roads are icy?”

“That wouldn’t be prudent,” Michelle obliged.

“When considering borrowing to invest, essentially you’re deciding whether you should use some of your future cashflow to invest ‘lots now’ or invest a little slowly over time. And **if you’re borrowing to invest ‘lots now’, *when* you buy into the roller coaster of the stock market is a huge factor** in your short-term experience. And I don’t just mean financially. As some of Uncle Brian’s clients learned, the emotional impact may be even more important.

“I helped my uncle recognize that his clients that were stressed were those that ended up buying in near the top of the market. Even though his approach of only doing a little bit long term worked on paper – and most of the time in practice – it would be significantly improved if investment debt was only started or increased when markets were ‘not high’.

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“That sounds like a sensible improvement,” Kim complimented.

“Common sense, in hindsight,” Bruce affirmed. “Even a rough awareness of where the market is compared to typical market cycles, helps avoid a lot of the short-term pain to make it easier for investors to stick to the long-term commitment.

“So, in addition to sticking to responsible strategies and responsible amounts, responsible timing was added as the third step in implementing Smart Debt. **Investors should only start or increase investment debt when markets are ‘not high’.**

“As I’ve tried to make clear, investment debt is mathematically very powerful, but behaviourally very risky. That’s why all three factors are important to help minimize the financial and emotional risks, increasing the odds that investors will increase their wealth.”

“Your uncle must have been pleased with the ways you helped make good debt safer, to create Smart Debt,” I reasoned.

“I had good mentoring, and we did most of it together,” Bruce said, deferring most of the credit.

Bruce paused to watch part of the game before continuing. “Before our kids switched over to soccer in the summer, I used to coach baseball. And one of the key lessons to becoming a better hitter was to not swing at every pitch. Just because there’s a ball coming near the plate doesn’t mean you need to swing at it. Good batters wait for their pitch.

“In the same way, successful good debt investors don’t swing at every pitch. They’re low-ball hitters, who patiently ignore the temptation to swing when the market is high.

“But I have to tell you that this is not easy to do. As investors, our brains are hard-wired to do the opposite of what we know we should do. Worse than swinging at every pitch – when some of them would be low – most of us wait for high pitches, and *then* swing for the fences!”

“And most of the time strike out,” stated Kim. “But you know, I have to admit, that as much as I was very doubtful that good debt could be good, I’m starting to see

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how sticking to responsible strategies, amounts, and timing makes investment debt … smarter. I'm not convinced it's good yet, but I can see how the Smart Debt approach you've outlined so far is safer than how most borrow to invest."

"And so far we've only addressed the two fundamental Smart Debt strategies," said Bruce. "We haven't even talked about the more interesting approaches, including those more appropriate for conservative investors.

"I have an idea," Kim proposed as the game was wrapping up. "I've really appreciated learning more about the world of finances and how the rich do things differently. I was wondering what you guys thought about continuing this discussion later in a different location, say over dinner?"

"That sounds like a wonderful idea," Bruce replied, smiling warmly at Kim. "Why don't you three work out the where and when, and it's a date."

As we were driving home, Michelle was sensing what I was thinking. "Do you think there's more to Kim and Bruce than just having kids on the same hockey team?"

"I think so. I'm starting to get the impression that Kim might be interested in more than how to increase wealth like the rich do."

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Keys to a Safer Journey

"Drive to arrive alive"

When Kim found out that Bruce had never been there, she had an easy decision about the venue for dinner. She suggested Joe Kool's, a popular sports bar downtown.

Bruce was wide-eyed as the four of us were shown to a semi-quiet booth near the back of the restaurant. "This place is … different".

"I can't believe you've never been here," Michelle commented. "The three of us had many good times here during our university days."

"A few more than we should have," Kim added. "There were a couple I'd like to forget."

"And one or two you can't remember!" I laughed. "But despite our efforts to help you enjoy all of the experiences of youth, you still made it into med school."

"I take it the owner is a Detroit Tiger's fan," Bruce deduced from the sign claiming to be 'Tiger's World Headquarters'.

"At least he's not a Leaf's fan!" Kim jabbed at me.

"I'll ignore that."

Glancing at the menus, Bruce felt compelled to ask, "Why is there a disclaimer on the menu that says that management can't be held responsible for the rotten food, lousy service, or deaf bartenders? You sure it's safe to eat here?"

"The food here has never killed anybody," Michelle assured.

"Because there's two hospitals less than five minutes away!" Kim informed.

"Do you think that's an accident?" I asked.

"And the one-cent special … that can't be real is it?" Bruce inquired.

"Oh, it's real," I answered. "And it applies to the whole menu. But you have to realize this is Kool's. It's not like the specials you're used to. Everything on the menu is available for one cent – one cent *off* their regular prices!"

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"And they give that discount to *everyone*?" Bruce asked, sarcastically. "We should all order extra to take advantage of the savings!"

As we waited for appetizers to come, the three of us filled Bruce in on how the university brought us to London, and how our lives had unfolded since – the jobs, the house, the kids and their sports.

Kim shared some of the challenges of being a doctor while raising two teenagers on her own. A single father as a result of a car accident three years ago, Bruce easily empathized. Michelle and I found that it was tough enough dealing with teenagers when there were two parents. Our experience is best summed up by the fridge magnet that Kim gave us a year ago stating that 'Raising teenagers is like trying to nail jello to a tree'. While we both loved our kids very much, we confessed that there had been times that each of us had to restrain the other from killing one of them. But that would have been taking the easy way out.

After gaining a little more understanding of each other's stories, Kim shifted the conversation away from teenagers to a more positive direction. "Bruce, can you tell us more about some of the Smart Debt investment strategies? I'm particularly interested in ways that more conservative equity investors can increase returns."

"And outperform the stock market," I added, "like Lisa talked about."

"I'd love to," he replied, "but before addressing more Smart Debt strategies, we should respect Murphy's Law and clarify a few more guidelines for using investment debt safely – *before* anyone gets in a vehicle. I wouldn't want to be responsible for Kim getting all excited about how to accelerate wealth and then end up magnifying losses instead of gains."

"Don't worry," Kim assured. "Just as I don't do surgery on myself, I wouldn't try to drive any of the more powerful vehicles on my own. *If* any of the Smart Debt investment strategies are a fit for my conservative nature – and that's still an 'if' – I think I know where I can find someone to help me do it right."

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“That’s good,” said Bruce, “because my focus with Smart Debt isn’t just to help others understand additional opportunities. It’s to reduce good debt done badly. Fortunately, there are other factors that are making investment debt safer than before.”

“What do you mean?”

“For starters, just like manufacturers have made cars safer over the years, lenders and industry regulators have raised the bar and made appropriate improvements to help ensure that only those suitable end up using investment debt. And I suspect that in the future, lenders will have more innovative approaches to make it safer for investors to benefit from how the rich use good debt to build wealth.”

“And after the financial crisis – which reminded investors that occasionally the stock market can temporarily turn a dollar into fifty cents – most advisors and investors are more cautious about how they invest.

“These factors, combined with my Smart Debt Safety Checklist,” explained Bruce, “help those using any of the Smart Debt vehicles to ‘drive to arrive alive’.”

“So what’s included in your safety checklist?” Michelle asked.

“We’ve addressed some of them,” Bruce replied. “You should only use vehicles you are confident with – **only use Smart Debt strategies that suit your ability** to handle the bumps in the road.

“Always drive slowly, and **use a small, conservative portion of your financial and emotional capacity for debt**. Just as Warren Buffet advises having a ‘margin of safety’ when choosing stocks, it makes sense to have a margin of safety when using debt. In addition to reducing emotional strain, this is important to help ensure you can easily handle higher fuel prices in the form of rising interest rates, or your income is reduced resulting in less fuel available.”

“And stay off the roads when they’re dangerous,” I offered in anticipation.

“That’s right,” Bruce affirmed. “You should **only start or increase good debt when markets are ‘not high’**. If markets rarely go up more than five years in a row

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without a pullback, and we're in year four, it's not the safest time to borrow and invest lots in the markets. We shouldn't stop investing in the markets – because no one knows what the future will be – but it's not the time to step on the gas.

"Joe, did you ever own a motorcycle?"

"No, I didn't like the idea of only being on two wheels."

"And for the same safety reasons," Bruce elaborated, "it makes sense to have many wheels on the ground. When using investment debt, you want to **ensure you're properly diversified in equities**, and not invested in only one or two stocks. You're less likely to get badly hurt in an 18-wheeler than on a motorcycle.

"For most Smart Debt strategies, investors need to **commit for the long haul, and be able to invest for at least eight years**. Remember that when investing in equity markets, the longer the holding period, the lower the volatility in returns. In other words, less risk."

"Anything else investors should do to be safer when using investment debt?" asked Kim.

"Two things," Bruce said. "To ensure your lender can't confiscate your vehicle, you should **eliminate the risk of a 'margin call'**."

"What's a margin call?"

"When you deal with a broker, you can open a margin account that allows you to buy investments 'on margin' where you put up some of the money and the rest is borrowed from your brokerage company. The investments in your account are used as collateral to ensure you can always repay what you borrowed. But if the value of your portfolio drops too much, the dealer can issue a margin call that forces you to add money to the account or they will sell some of the investments."

"But selling investments when they're down isn't good," I noted.

"And it's very 'not good' when you're borrowing to invest," Bruce reiterated the obvious. "That's why when you're borrowing to invest, you don't want to be forced to sell when your investments are down. It's guaranteed to magnify losses."

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"How do you eliminate the risk of a margin call?" Kim asked.

"One way is to borrow such a small amount that even a big drop in the markets wouldn't trigger a margin call," Bruce replied. "You could also use one of the 'no margin call' investment loans that some lenders offer. Or you could borrow in a way that the investments themselves aren't used as collateral, like borrowing against your house with a home equity line of credit."

"What's the final suggestion?" Michelle inquired.

"I think it's wise to follow Kim's approach and not try to do your own surgery. Use a driving coach. Most should **use a trusted advisor to help them understand, implement, and stick to the plan**.

"Remember that success requires both an effective strategy and effective execution. If you can't confidently do both on your own, doesn't it make sense to get some understanding and guidance from someone who can help you?"

"That's what we're doing," I replied.

"The bottom line is that investors who are contemplating getting to their destination by driving instead of walking or biking should always drive safely. They should **use good debt responsibly or not at all**.

"The majority of those who have been hurt with investment debt were driving the wrong vehicle, too fast, at the wrong time. But what if you properly select the vehicle that suits you, never drive it over 30 kilometers an hour, and only drive on roads that are straight and dry when there's good visibility? Under those conditions, is it possible to be confident that you'd get where you want to safely and faster than biking?"

"That makes sense to me," I said.

Bruce looked to Kim. "What do you think?"

"I like the overall approach," she confessed, "but I need to know about the other Smart Debt strategies, especially how more cautious investors like me can outperform the stock market."

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A Commonsense Way to Beat the Market

"Only drive and increase speed when in valleys"

"Now that we've addressed the fundamentals and some of the ways to use investment debt more safely," Bruce began as our appetizers arrived, "we can discuss the more interesting Smart Debt strategies, including my favourite that enables investors to beat the market in a commonsense way and benefit from market drops."

"How can an investor benefit from drops in the stock market?" I asked, puzzled.

"As we explore how to do that, I want to make sure we're all really clear about something," Bruce replied. "Does anyone know what the stock market will do in the short term?"

"No," I answered. "You've helped us accept that it's impossible to predict the markets, no matter how intelligent and convincing someone appears. Now, I wouldn't even believe *you* if you told us where the markets would be in a year."

"Good. Then you're recognizing the difference between what's knowable and what's not. It's critical for investors to accept that **equity investing vehicles only have rear-facing lights**. But even though we can never see what lies ahead, investors can use what they've seen in the past to great benefit. As we'll discover, having a better understanding of what stock markets have done in the past under various conditions gives us a better sense of what's likely to happen in the future.

"Has anyone seen a chart of the stock market over time?"

"Yeah," I replied. "It almost looks like a mountain."

"That's right," Bruce nodded. "In fact, some in the industry refer to graphs of stock market growth over many decades as 'mountain charts'. And the experience of investing in an equity market *is* like moving up a mountain, with many peaks and valleys up the side of it.

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"And if you narrowed your focus and just looked at short periods of time, you'd see a wide range in the height of the peaks and valleys. The S&P/TSX index, which represents the Canadian stock market, has complete data all the way back to 1956. Based on monthly index values, the highest one-year return since then was a gain of 87 percent, while the lowest was a loss of 39 percent."

"That's quite a range," Michelle commented.

"Yes it is," Bruce agreed. "But while **equity returns fluctuate lots in the short term, they fluctuate very little in long run**. Over all of the possible 20-year holding periods since 1956, the compounded annual return has ranged from six percent in the worst case to a high of 14 percent.

"As most know, in the short term, investing in the stock market is very risky. But over the long term, the peaks and valleys are smoothed out so your average speed travelling through the markets is much more predictable. Equity markets historically have elevated wealth by about 10 percent a year – a much higher return than with 'safer' investments like bonds and GICs."

"So over the short term, equity markets go up and down a lot. And long term, returns tend to converge to about 10 percent," I summarized. "But how does that allow us to benefit from market drops?"

"You just answered your own question," Bruce remarked, "and identified how to outperform the market."

"How? What'd I say? I don't understand."

"You said that short-term returns fluctuate a lot, but long term they average out to about 10 percent."

"Yeah, so? I'm still not connecting the dots."

"Let me see if I can help you discover the answer on your own," Bruce responded. "I find that people understand better and remember longer when they figure something out instead of simply being told.

"Consider this: for the five years leading up to the 2008 financial crisis, the Canadian stock market index wasn't down over any one-year period, and the compounded annual return was almost 16 percent."

"So?"

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"Joe, you just said that over the long term, returns converge to the average of about 10 percent," Kim noted.

"And Bruce said that the highest annual return over any 20-year period was 14 percent," Michelle added.

"So I think what Bruce is trying to get us to realize is that when returns are way above the average, they eventually have to come down," Kim astutely concluded.

Bruce said nothing, impressed with Kim's insight.

"And that's exactly what happened," Michelle said. "The stock market returns were way above average for many years and then crashed – in a big way. Are you saying that investors could outperform the markets by knowing when they're overvalued and getting out before they fall?"

"Not at all," Bruce advised. "Remember that no one has a clue what the markets will do in the short term. I don't know of anyone who has been successful at timing the markets as an equity investor.

"But when it comes to borrowing to invest many years' worth of cashflow all at once, that's another matter. And I think that we'll all agree that *when* we borrow to invest lots has a big impact. As I've clarified as one of the keys to safer, Smart Debt, we certainly don't want to borrow to invest more when the markets are high."

"So how can we benefit from short-term market fluctuations?" I pressed.

"Every coin has two sides," Bruce hinted. "If high, short-term returns must eventually come down towards the long-term average ..."

"Then low, short-term returns must eventually move *up* towards the long-term average," I finished, partially completing the puzzle.

"Mathematicians call this behaviour 'regression to the mean'," Bruce elaborated. "But the way you said it is better. In the short term, equity markets fluctuate a lot, but eventually, returns tend to converge to the long-term average.

"So when markets are down, that's when you borrow to invest more," Kim deduced, "so you gain more when the market recovers."

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"Exactly, and then the more cautious investors will cash out completely," Bruce expounded. "In traveling through the peaks and valleys of the stock market, **the Buy More Low strategy is where you only drive and increase speed when you're in the valleys**. You invest as normal until the market is low. Then and only then do you temporarily jump into a Buy More Low vehicle – borrowing to invest more – to take advantage of the market being 'on sale'. As soon as the market rebounds, which might be six to 24 months later, you're out of the vehicle and continuing on as before, without any investment debt.

"I like the idea of only using investment debt temporarily," Kim admitted.

"And strategically waiting until the markets are down before using good debt at all," Michelle added.

"Those two factors significantly reduce financial and emotional strain," Bruce claimed, "and make the Buy More Low strategy comfortable for many who would never consider using good debt.

"Although I'm not a big risk taker, this Buy More Low concept is something I might consider," Kim asserted. "Can you walk us through a simple example to show how it works? I think I've got the general concept, but sometimes working through an illustration helps me understand it better."

"Sure," Bruce agreed. "Let's pretend that Kim's interested in the Buy More Low strategy. And for simplicity, let's pretend that she can comfortably handle an investment loan of $100,000 with negligible financial or emotional strain. For some, this would be way too much. For others, they could easily add a zero. But it's a nice, clean number to keep the discussion simple. OK?"

Kim nodded. "Since we're just pretending."

"To keep things easier for everyone, I use a simple 'two-gear' approach," Bruce explained. "When the market is down a little, you shift into first gear and invest half of your good debt total – in this case $50,000. If the market drops below a second threshold, you shift into second gear and invest the rest. In poker terms, that's when you go 'all in' and invest the full $100,000."

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"So I use a little good debt when the market is down a little, and only go 'all in' when the market is down even more," Kim affirmed. "I like that approach. It makes sense."

"And the safest, most profitable time to invest in the market is when …?" Bruce prompted.

"When it's scariest," confirmed Kim, "when markets are already down. It's common sense that we need to 'buy low, sell high'."

"But it's often not common practice," Bruce conceded. "Most investors have heard 'buy low, sell high' so many times that it has no meaning. As we've discussed, because our brains are hard wired to avoid *perceived* pain, investors tend to do the opposite of what makes sense.

"Uncle Brian used to suggest that most investors would actually be better off if they never heard of 'buy low, sell high' and their investment timing was purely random. At least that way, half of the time they would get the timing right!"

"Cute," Kim commented, "and probably true."

"In terms of understanding what it takes to be more successful at investing in the stock market," Bruce went on, "no one explains it better than Ben Graham, Warren Buffet's most influential mentor. It's a concept that every investor should be aware of.

"Graham characterized stock investing as being in business with a partner he called Mr. Market. Each day Mr. Market provided a price at which he would buy your share in the partnership – your stock – or sell you his. Most of the time, Mr. Market would quote a reasonable value for your business partnership, based on a rational assessment of future profitability and general economic conditions.

"But unfortunately for him, Mr. Market had incurable emotional problems and suffered from severe bouts of manic depression. Occasionally he would be in a jubilant mood, confident that the future of the business would only get better. At these times, he would name a very high price for fear that you would buy his share and rob him of imminent gains. Other times, he would be depressed and see nothing but darkness on the business

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horizon. Then, he would quote a very low price for fear that you would unload your stake on him.

"But like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice. **Mr. Market is only there to serve you, not provide guidance**. If he is in one of his manic-depressive moods and quotes an unreasonable price, **you are free to ignore him or take advantage of his foolishness**. But it will be disastrous if you are influenced by his emotional swings. In fact, the more manic-depressive Mr. Market's behaviour, the better for you."

"So investing in the stock market means being in partnership with a lunatic," I summarized.

"Sometimes," Bruce confirmed. "If you think it makes sense to learn how to increase wealth from those who have done it and are willing to share their ideas, Warren Buffet is a goldmine for investment wisdom. And one of Buffet's more famous insights is: 'Look at market fluctuations as your friend rather than your enemy. **Profit from folly rather than participate in it**.'"

"So how much can this Buy More Low strategy benefit investors?" I asked. "I accept that no one *knows* what will happen, but what is typical?"

"Well, this is where a little study of historical returns becomes valuable," Bruce suggested. "Let's just consider one-year returns because that's how most investors gauge performance and because a typical holding period for buying more low might be about 12 months.

"First, it's useful to know that about 26 percent of the time, the stock market loses money and the one-year returns are negative."

"But that means that **about three-quarters of the time the market goes up**," Kim, the optimist, pointed out.

"True," Bruce said. "The vast majority of the time the stock market goes up, and we'll come back to that point when we discuss the new strategy Lisa talked about.

"Based on all of the historical data available, we know that the average compounded annual return for the Canadian stock market has been about 10 percent, with

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the best one-year return of about 87 percent and a worst case of minus 39 percent."

"And?" I prompted.

"But what if we just looked at those times when the market was already down – which happened about a quarter of the time. Guess what the market did after that?"

"I'd have to say that after being down, returns were higher than the average of 10 percent," I answered, "to move in the direction of the long-term average."

"And you'd be correct," confirmed Bruce. "Historically, **after the stock market has had a negative one-year return, the following one-year return has averaged 19%** – almost double the long-term average.

"So if the only time you borrowed to invest a little more was when the market was down over the past 12 months, based on historical results, on average, your investment debt strategy would be up 19 percent a year later. But we can do better than that."

"Better?" Michelle gasped. "That sounds pretty good already."

"After the market has fallen at least 15 percent – which has happened about seven percent of the time – the average one-year return has been about 25 percent."

"That's why you use a two-gear approach," Kim reasoned. "You wait until the market is even more 'on sale' before investing the other half of the borrowed money."

"Which on average means an even bigger rebound," I concluded.

"And because the market at that point is even lower," Bruce added, "it is less likely to fall much further compared to when the market has had normal or above-average returns."

"Which makes the strategy safer," added a pleased Kim.

"So to answer Joe's question about how much a Buy More Low approach could benefit an investor," Bruce resumed, "if Kim had this strategy in place before the financial crisis temporarily caused many stock markets to drop about 50 percent, she would have done OK."

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"How OK?" I insisted.

"In that instance, the market dropped very quickly – over 30 percent in a few months," Bruce explained, "which means that all of Kim's $100,000 would have been invested in one shot."

"And when do you sell and get out of the strategy?" Kim wondered.

"Good question," Bruce acknowledged. "Most who use the Buy More Low strategy like it because it generally only involves using investment debt briefly. So some choose to pay off their loan completely when the market has rebounded the average amount it has historically. Others aim a little higher.

"In this case, after being down at least 15 percent, historically the average market rebound has been a one-year return of 25 percent. So some investors chose to eliminate the investment debt when their investments gained 25 percent, which ironically happened 13 months later."

"Which means a gain of $25,000 in about a year!" I exclaimed.

"Per $100,000 invested," Bruce clarified.

"What annual return does that equate to?" Michelle asked.

"In this example, the return on the lender's money – which you're responsible for repaying – was 25 percent," replied Bruce. "But the return on the money actually invested by the investor is … almost unbelievable."

"How unbelievable? Over 100 percent?"

"Well, at six percent interest, it would cost a little over $6,000 to rent $100,000 for a little more than a year. After deducting the interest expense, the after-tax investment might be $4,000 – less for a higher-income taxpayer like a doctor. Call it $4,000 out of pocket. A 100 percent return means a gain of $4,000 beyond the $4,000 invested."

"Which means for the investor to have a 100 percent return and double their money, the $100,000 would have to grow to only $108,000," Kim quickly calculated. "But here there was a gain of $25,000, not $8,000."

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"Which means in this case, the investor's money increased by a factor of over six," Bruce concluded, "for an annual return of over 500 percent."

"Wow!" a stunned Michelle whispered.

"And if the market doesn't rebound in a year or two?" Kim posed.

"You wait," Bruce calmly replied. "Most of the time, the market has rebounded within two years, and in the case of the market crash from the 2008 financial crisis, the market recovered from its low all the way back to its pre-crash peak two years later – a rebound of over 80 percent.

"But as we all know, that doesn't guarantee anything in the future. Even if you have to continue long term, at least you got in when the market was lower, which means your short-term experience is less likely to be stressful."

"But if you were ever going to use investment debt to magnify returns like the rich do," I spoke out loud, "the Buy More Low approach seems like a safer way to go."

"One thing I want to clarify about getting out of the strategy," Bruce announced. "If Kim's $100,000 grew to $125,000, does she need to cash in all of it to pay off the good debt?"

"She only needs to cash in amount she borrowed: $100,000," I answered.

"And a little more to cover the capital gains taxes," Bruce added. "But what about the rest of the profit? What should happen to that?"

"Whatever I want!" Kim proclaimed.

"Exactly," Bruce agreed. "And if your priority is building long-term wealth, and three-quarters of the time the market goes up, with an average annual growth of about 10 percent a year …"

"Then the best place for the profit," Kim graciously concluded, "is to keep it invested."

Bruce nodded with a gentle smile of approval. It was clear that Kim was also committed to improve how effectively her hard-earned dollars were growing.

"The other thing that makes the Buy More Low strategy one of my favourites," Bruce informed, "is that it turns a natural part of the equity market journey – the downturns which almost everyone interprets as a

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negative – into a positive, and an opportunity to increase wealth. And as a financial advisor, I can tell you it's nice to have something positive to discuss during periods when every client's portfolio is down."

"The reality is that **you can't get the higher, long-term gains of the stock market without higher, short-term volatility**. And **if we recognize that, and accept it, we can profit from it**.

"In fact, a few of my clients who initially said there was no such thing as good debt are pleased that they've profited from the strategy, and are actually looking forward to the next big drop in the market – as long as it's temporary.

"There's one final point that I like to make about this concept before I ask you regulars where the washroom is," Bruce continued. "It's one of the ideas that's easy to share with others you care about and who might also want to increase their wealth and security.

"And that is?" Michelle prompted.

"**Recognizing that the stock market will drop 20 to 50 percent at some point in the future, how are you going to react?**" Bruce paused to allow time to process the question before continuing. "How can you benefit? How are you *going to* benefit? And the most valuable question to answer is: **How are you going to benefit *automatically*?**"

I glanced at Michelle to confirm that she was in agreement. "I can't speak for others, but I know how I'm going to benefit," I declared. "Is the market down now? I think we're ready to set up a Buy More Low program so we can benefit from the next market drop – automatically. Don't you think, honey?"

"I like it," she confirmed.

"I like it too," Kim seconded. "Perhaps **the old maxim of 'buy low, sell high' should be upgraded to 'Buy More Low, Sell Some High'**. Is that the new strategy that Lisa said you just came up with a few weeks ago?"

"No. My new Debt-Opportunist Combo strategy is related though," Bruce replied. "It's like the little sister to Buy More Low, and is another commonsense way that

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investors who are even more cautious can outperform the market.

"Why don't we discuss it after I navigate to the washroom, and we order dessert."

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The Debt-Opportunist Combo

"Buy several years' worth of
nuts when they're on sale"

Bruce was chuckling and shaking his head when he returned to his seat. "Did you know that there's a letter on the wall from the office of the Queen of England?"

"Yeah," Michelle smiled. "It expresses the Queen's regrets that she was unable to attend the official opening of Joe Kool's."

"Did the owner really expect the Queen to attend opening ceremonies of a small restaurant in another continent?" a flabbergasted Bruce asked.

"You never know if you don't ask!" I counseled.

"The owner must be some kind of character," an amused Bruce remarked.

"Read a few more letters on the wall and it won't take you long to figure that out," said Michelle.

"And how did you like the meal?" Kim inquired.

"It was very good, thank you. And so far, I don't feel that I'll need the services of a doctor or a hospital! But we'll see how my stomach is after dessert," Bruce kidded. "I don't normally eat dessert, but with the one-cent special, how can I resist?"

"While we're waiting for the desserts, can you fill us in on your new Smart Debt strategy that also allows investors to beat the market returns?" I prompted.

"Sure," he replied, "and after I explain what it is, I've got a bit of a confession to make."

"So what's the strategy?"

"A couple of months ago, I was reviewing the Smart Debt investment strategies and focused on the situation of a cautious investor, perhaps higher income, who had already maxed out their RRSPs and TFSAs. If this person wasn't confident that the returns they'd get from investing in equity markets would be higher than the guaranteed return they'd get from paying down their mortgage, what would be the reasonable thing to do?"

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"Focus on paying down the mortgage," Kim quickly answered.

"Even though there are behavioural, math, and security reasons why it's better to invest ahead of paying down the mortgage, it's understandable why some would try to eliminate all debts and then save more later," Bruce acknowledged.

"And if they weren't comfortable with the Buy More Low strategy, which I rank as the lowest risk of the Level 2 Smart Debt strategies, then there was a problem."

"What was the problem?" asked Michelle.

"As the Smart Debt Coach, unless they came into some 'new money' and could do a Debt Swap, I wasn't able to offer them any Smart Debt investment strategies to help them because all of the other concepts have higher risk, and would be less suitable."

"So you came up with a new strategy with even less risk," I anticipated.

"Something that might be comfortable enough for the most cautious investor to consider benefiting from," Bruce clarified.

"So tell us about it."

"It's a new possibility for the debt versus invest dilemma that takes advantage of some of the concepts that we've already discussed," Bruce began. "As with many decisions, there are usually more options available than we consider. In deciding whether the cautious investor should pay down their mortgage or invest, it doesn't have to be an either-or decision."

"What do you mean?" I asked.

"What if there was a combination approach that was better than having *all* extra cashflow consistently invested *or* used to pay down debt?"

"You mean sometimes you invest and the rest of the time you pay down your debt?" Michelle prodded.

"Yes," Bruce affirmed, "to take advantage of those times when Mr. Market is off his rocker.

"Everyone's goal in preparing for the retirement they want is to eventually be debt free and just like the squirrels, have more than enough nuts to get through the winter of retirement.

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"If the nuts you need to accumulate occasionally go on sale for 10 to 50 percent off, does the reduced price you pay today affect their ability to feed you and grow into additional trees that can produce more nuts decades later in retirement?

"No," I reasoned.

"And if you choose to only buy when they're on sale, are your hard-earned dollars able to buy more nuts?"

"Of course."

"In the world of commerce, the stock market is truly unique in how people buy. If a grocery store puts boneless chicken breasts on sale for 50 percent off, people will buy months' worth of chicken to save less than $100. The store will impose limits of six per customer, and people will still drive to a store that's further away just to take advantage of the discount.

"But ironically, the best way to get people interested in buying equities is to *raise* the price – to charge a premium. When the price drops on stocks – something that won't get freezer burned in a few months – people stay away in droves. Worse, falling under Mr. Market's wealth-destroying, emotional spell, many are more than willing to sell at a reduced price what they recently paid a premium for."

"In other words, more backwards behaviour," I surmised. "So what's the solution?"

"After being aware of this reality," explained Bruce, "as a minimum, **the behavioural solution is to have in place a strategy or a process that prevents the negative**. In this case, that means *not* selling equities when the market is down. Even **more valuable would be to act on a strategy that turns what appears to be a negative into a positive** – to buy more equities when they're on sale."

"So how can the person focused on reducing debts do that in a way that has less risk than the Buy More Low strategy?" inquired Kim.

"Use the new Debt-Opportunist Combo strategy," came Bruce's reply. "It's a modified, lighter version of the Buy More Low approach. Let's first consider the version that uses a little unregistered good debt, which would apply to

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someone who has already maxed out their RRSPs. To illustrate, let's say you have an extra $5,000 a year that can be used to invest or pay down debt like the mortgage.

"Again, I use a fairly simple, two-gear approach based on whether the stock market's 12-month return is up, down a little, or down more than a little. When the market is up, the Debt-Opportunist investor uses their monthly investable cashflow to pay down their personal debts, producing a guaranteed, after-tax return of the interest rate charged. If the one-year market return turns negative, you shift into first gear and immediately borrow enough to invest two years' worth of cashflow – $10,000 in our example – into equity investments. You buy a few nuts when they're a little on sale.

"With the Buy More Low strategy, you make interest-only payments, and the debt is not paid off at all until you can sell at a profit. But with this strategy, when you have any investment debt, your cashflow shifts from paying down personal debt to paying off the good debt as quickly as possible. Because you also have to pay interest, even though it's tax deductible, investing two years' worth of cashflow will take a bit more than two years to pay off.

"And historically, when the stock market has had negative one-year returns, the next year's average return has been …?"

"About 19 percent," I offered.

"That's right," Bruce resumed. "By strategically shifting from paying down personal debt to accumulating nuts when they're on sale, you should benefit from higher-than-average, short-term growth on the dollars invested.

"But if Mr. Market is really depressed and is down more than 15 percent, perhaps having a once-a-decade mega-sale, he has historically averaged next-year returns of …?"

"Twenty-five percent," Michelle recalled.

"And when the Mr. Market is down a lot, would it make sense to take even more advantage of his generosity and shift into second gear to invest say three or four years' worth of cashflow?"

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“That makes sense to me,” I confirmed. “And you still pay off the loan as fast as you can.”

“That’s right, so you’re not really concerned when the market recovers because you’re not waiting until you can cash out for a profit. Your focus with the Debt-Opportunist Combo strategy is to accumulate nuts when they’re on sale and keep them long term to fuel your retirement. You focus on repaying personal, non-investment debt until you have the opportunity to cherry-pick loss leaders. In the case of the stock market, losses lead or precede the higher-than-average returns of the market rebound.”

“Which means that if you only invest then, and stick to the predictable returns of paying down the mortgage the rest of the time, the returns on your equity investments will outperform the market,” Kim summarized.

“Slightly,” Bruce confirmed. “And as a bonus, you’ll probably have a less bumpy, less stressful journey up the equity mountain along the way.”

“So what’s the confession you referred to,” asked Michelle.

“The truth is that Kim had a role in the creation of the Debt-Opportunist Combo strategy,” he declared. “When we first met in the fall and were discussing the Debt Swap concept, it was clear that some investors had done all the basics – paid off all expensive debts and took full advantage of tax sheltering with RRSPs and TFSAs – and were down to the mortgage versus taxable investing decision. And then Kim indicated that she, like many, was a cautious investor who naturally wanted the safer returns of paying down the mortgage. I recognized that if she wasn’t comfortable with the Buy More Low approach, I didn’t have any other Smart Debt strategies to help build wealth more effectively like the rich do.”

“So you created a new strategy for Kim!” Michelle announced. “That’s sweet.”

Kim looked down, blushing.

“Not just for Kim,” Bruce claimed. “But Kim was a factor in prompting me to search for a new strategy that should benefit anyone in this situation.”

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Dinner was wrapping up, and we were just waiting for the bill. Bruce insisted on paying, saying that he took two new clients to dinner, and the majority of the conversation was about financial strategies. He explained that it was clearly a business expense and a pleasurable evening.

"So what do think about the strategy, Kim?" I asked.

After some brief reflection, Kim replied. "Bruce is right, and wrong. He's right that **the Debt-Opportunist Combo strategy allows cautious investors focused on paying down debts to benefit from market downturns** when it's 'on sale'. I like the lower-risk approach of using an even smaller amount of good debt that is automatically paid off to accumulate more nuts to fuel my retirement. Even though I'd like to have no personal debt and will only ever use a little good debt, I know I need to eventually have enough investments to fund my retirement. So that all makes sense.

"But he's not right that he took two new clients to dinner tonight," Kim announced. "He now has three.

"I also really like the Buy More Low approach of temporarily stepping on the gas when in the market valleys – only briefly using a comfortable amount of good debt when it's safer and more profitable.

"It would be too stressful for me to have investment debt before a big market drop. But using some good debt *after* the market tanks, and getting out right after it rebounds – that makes sense to me. That's something I can be comfortable trying to benefit from.

"So Bruce, if you've got room for one more client, I'd like you to implement both strategies in a way that makes sense for me."

"I'd love to," Bruce smiled, appreciatively. "And I'm glad that you like the new strategy."

"And the Debt Opportunist Combo approach can also be used to buy a few years' worth of RRSP-sheltered nuts when they're on sale?" I posed. "We've got lots unused RRSP room, and we're wondering if it made sense to borrow to catch up on some of it."

"Yes, it can," he replied. "Why don't we talk about that the next time we get together."

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