Talbot's Q & A for Advisors

Common Concerns when Marketing Conservative Leverage

Question: How do I convince someone (clients and/or advisors) to leverage into equity markets when they have little confidence in unleveraged equities?

Answer: This is perhaps the key challenge for advisors and their clients who could benefit from responsible leveraging. Due to the importance of effectively addressing this common objection or hurdle, I offer multiple ways of responding, appealing to both right and left-brain thinkers.

1. We need to dispel myth #5, that returns must exceed the cost of borrowing to benefit from leveraging, and how with a 7% cost of borrowing over 10 years with 40% tax, leverage starts to benefit clients with equity returns of only 5%. In other words the "better than" return is 5% relative to a 7% cost of borrowing, not 7% as most expect.

2. Explain how the level of faith for leveraged investing is the same amount of faith required for unleveraged investing. 10-year Government of Canada bonds yield a little more than 4%. If a rational investor didn't have faith and confidence that they would get at least say 2% more (i.e. returns of at least 6%) over a 10-year time period, they wouldn't have any money outside of government guaranteed bonds. In other words, they wouldn't invest a penny in equities unleveraged. Thus, if they have enough faith in the markets to have some of their portfolio in equities unleveraged, they already have sufficient faith to leverage into the same diversified equity investments in a small responsible way.

    - Explain the fundamental reality of capitalism that in the long-term, there must be an equity premium or investors won't take any risk. In the long run, equity returns must on average exceed guaranteed returns by say 2-3%, and history certainly shows that.

3. Explain how in any responsible leveraging program — whether it is unregistered or to catch up on RRSPs — the significant benefit is not the probability that you should get higher magnified returns. The real benefit is a higher level of discipline, a higher level of forced commitment to one's financial goals. In other words, the difference between a forced savings plan and an automatic savings plan. Individuals are much more likely to complete loan payments that are comfortable and have little or no financial and emotional stress than they are with an "ad hoc" savings approach or even an automatic pay-yourself-first savings approach.

    People need to save more, as indicated by the savings rate, where on average people save and invest about 2% of their disposable income, while in the past it was 10-12%.

A responsible “forced savings” plan is a solution to that behavioural reality that people procrastinate and invest less than they know they need to. The best approach is a combination of automatic savings, and a small conservative amount of forced savings.

4. People need to focus on the appropriate time horizon. The lowest total risk investment is determined by the appropriate asset allocation. If the investor’s time horizon is short, then short-term investments — i.e. fixed income and cash — is the lowest total risk solution. If the time horizon is long term, decades or more, then a higher portion of equities in the portfolio is the lowest total risk solution.

   For retirement planning, the time horizon, is literally decades. Even someone who is 55 years old needs to have some money last until 75, 85 or even perhaps 95. That is 3 or 4 decades. So the question is: does the investor have a lack of confidence in performance of short-term equity markets or do they fundamentally have a lack of confidence that equities will not outperform over a period of over 20, 30, or 40 years?

   As mentioned and can be shown with lots of data, long term there has to be an equity return premium of 2-3+%. So the solution is to get investors who have had their confidence shaken to differentiate between the confidence in equity returns over a 20 or 30-year period, and equity performance over a 2 or 3-year period or less. Point out that 10% of women currently live beyond the age of 96, and that retirement lifespan needs require that money exists to at least age 95 and possible longer. This is decades even for someone close to retirement.

Question: If someone has say $20,000 of RRSP room available, should you recommend catching-up on RRSPs, or a small leveraging program unregistered?

Answer: While mathematically leveraging can and should be better than RRSPs, for at least equities, and it is important to diversify by strategy. The easier sell is to catch-up on RRSPs first, and then when RRSPs are maximized, suggest conservative leveraging outside of RRSPs. Because RRSPs are almost universally accepted as the best strategy to save and the industry is comfortable borrowing for RRSPs, it is best not to fight it, and do both starting with the easy strategy first. The ultimate goal should be some form of an RRSP-leverage combination plan, where tax refunds from the first strategy are productively directed into the other strategy (instead of being spent) to produce a second, additional tax refund that can be spent guilt-free.

Question: How do you address the investor’s (client and/or advisor’s) lack of comfort and confidence in the strategy of leveraging in general?

Answer: Dispel the myths, particularly good debt vs. bad debt, and explain Talbot’s Leverage Risk theory, and how there are lots of possibilities between not leveraging at all and leveraging the maximum, which is dangerous and scary. Explain how somewhere in the range of 10-20% of one’s capacity, most people would feel

comfortable that there is no emotional or financial risk or strain and that long term the behavioural benefit and the magnification benefit make sense for them.

Point 2. Suggest people consider a 2-step process. Instead of implementing the total amount that should be conservative in one step, start with a baby step of doing $10K – $20K NOW (or about 10 – 20% of their capacity for leveraging), with the intention of doing 30 to 50% of the client's capacity in a few years after their confidence, investments, and experience with leveraging has increased and thus their definition of "conservative leverage" grows.

Question: What are some of the more effective opening lines that I can use to get a client interested in meeting and discussing leveraging?

Answer:

1. I was reviewing your files and noticed some opportunities to save more taxes and increase returns as well. Do you have fifteen minutes to meet so that I can introduce you to tax-deductible investment strategies beyond RRSPs?
2. Would you like to learn of a conservative, responsible strategy to magnify returns like the rich do?
3. Are you interested in advanced wealth-building strategies that generally only the rich take advantage of?
4. Are you interested in investment strategies that benefit from today's low interest rates?