

NUMBER CRUNCHING BY TALBOT STEVENS

Leverage a double-edged sword

It can also be useful to help some clients increase returns outside RRSPs

PURELY BASED ON CRUNCHING the numbers, borrowing to invest in RRSPs benefits clients when returns match or exceed the cost of borrowing. Deciding when it makes sense to borrow to invest outside of RRSPs, however, requires a more difficult analysis.

Leverage is simply a tool that can help or hurt investors, depending on how it is used. This strategy is often used when it shouldn't be, and the perils of greed and fear combine to magnify losses.

But it could also be argued that the concept is not considered a responsible part of an integrated financial plan as often as it should. Many of the 50%-70% of advisors who do little or no leveraging say the reason is not a lack of marketing concepts but a fundamental lack of confidence and understanding of when a client benefits from leveraging responsibly. And leverage is not just a double-edged sword for clients. It can also damage an advisor's business if he or she does not take the appropriate steps to reduce both strategy and business risks.

Obviously, there are many factors beyond the numbers that should be considered and discussed with clients before leveraging. For now, let's focus on when leveraging makes sense.

Many investors and financial professionals believe that investment returns must exceed the cost of borrowing for leveraging to benefit investors, even after acknowledging that the interest expense is generally tax-deductible. This would be true if you could only purchase fixed-income investments, such as GICs, that are fully taxed annually.

When any of the return is a deferred capital gain, the minimum return needed for leveraging to increase net returns is less than the cost of borrowing. That's partly because of the interest deduction, and because capital gains are only partially taxed. But the biggest factor that lowers the return needed to benefit from leveraging is that capital gains are tax-deferred until sold by the investor or fund manager.

The interest expense is generally tax-deductible when borrowing to invest for the

Leveraged vs Unleveraged Equities

Net value after investing \$2,700/year for 10 years in 40% tax bracket

Return	No Leverage	Leverage	\$ Increase	% Increase
0%	\$27,000	0	-\$27,000	-100%
3%	30,700	14,100	-16,600	-54%
5.1%	33,650	27,000	-6,650	-20%
6.3%	35,500	35,500	0	0%
9%	40,000	58,100	18,100	45%
12%	45,700	90,100	44,400	97%
15%	52,400	130,700	78,300	149%

THE TABLE SHOWS THE NET BEFORE-TAX VALUE WHEN SOMEONE IN A 40% TAX BRACKET INVESTS \$2,700/YEAR FOR 10 YEARS. AT 9% INTEREST, THIS CASH FLOW LEVERAGES \$50,000; 30% OF EQUITY FUND RETURNS ARE TAXABLE ANNUALLY; 50% OF CAPITAL GAINS ARE TAXABLE
SOURCE: TALBOT'S LEVERAGE PROFESSIONAL SOFTWARE, WWW.TALBOTSTEVENS.COM

INVESTMENT EXECUTIVE CHART

purpose of producing income outside of RRSPs. The **Canada Customs and Revenue Agency** finally clarified that leveraging to purchase mutual funds and common shares is generally deductible as a carrying charge on line 221. Leveraging segregated funds is also deductible.

Mathematically, leveraging magnifies returns and offsets the break-even point. Until the after-tax return exceeds the after-tax cost of borrowing, leveraging produces a net loss for investors.

To illustrate the range of possible outcomes, let's consider Beth's situation. She can comfortably invest \$2,700 a year for the next 10 years without any financial or emotional stress, even during low- or no-income periods. The prime rate in Canada has averaged 7.4% over the past 64 years. To err on the high side, we'll assume an interest expense of 9%, which allows Beth to leverage \$50,000 with interest-only payments. This means she "rents" the \$50,000 and pays 9% interest every year, never reducing the loan. At the end of the 10th year, she withdraws enough to pay off the loan completely, as well as any capital gains taxes triggered. If she wanted to be more conservative, Beth could make principal and interest payments and pay off the loan over 10 years, but this also would reduce the magnification effect.

Paying 9% interest on a \$50,000 loan costs \$4,500 a year before tax, about the same as the average RRSP contribution. After deducting the interest expense, the after-tax investment is \$2,700 a year. As a long-term equity investor, Beth could simply invest her \$2,700 of annual cash flow into equity fund XYZ — or she could use it to borrow and invest

\$50,000. To be realistic, projections assume that 30% of the before-tax returns are distributed and taxable annually. Although there are funds that are very tax-efficient and keep distributions low, most funds distribute some income or gains periodically. (I have assumed that 70% of returns are deferred capital gains, 25% are capital gains that are taxed annually and 5% are dividends.)

Beth represents what I would suggest should be the minimum conditions for "conservative" leverage of equity funds. Anyone who invests longer, is in a higher tax bracket or ends up with more tax-efficient equity investments will experience higher leverage benefits than shown here.

To provide full disclosure and reduce the business risk, the net results over a range of returns are analysed.

Beth invests \$2,700 after tax for 10 years, for a total investment of \$27,000. If she averages 0% returns, not leveraging would give her \$27,000. As shown in the table, if Beth leveraged and rented \$50,000 that was worth the same \$50,000 after 10 years, she has a net gain of nothing after paying off the loan. In other words, with 0% returns, leveraging equates to flushing \$27,000 down the toilet.

The break-even point is the point at which Beth starts to net a profit — when the amount she gets out equals what she put in. In this case, Beth nets \$27,000 with a before-tax return of 5.1%, which represents the break-even return. But like all clients, Beth does not want to simply break even. What she really wants to know is what return is needed for leveraging to net more than would be produced by not leveraging, which we might call the "better than" return.

Here, leveraging and not leveraging net the same amount with before-tax returns of 6.3%, so the “better than” return is a little more than two-thirds of the cost of borrowing. This is number is key to dispelling one of the common myths of leveraging.

The “better than” return determines the advisor’s and the client’s level of confidence in benefiting from leveraging. Assuming that all the other leveraging issues and risks have been addressed, Beth and her advisor simply need to determine how confident they are in averaging diversified equity fund returns of at least 6.3% over a 10-year period. If they are not reasonably sure they can clear this hurdle, the discussion is over. Unfortunately, many people mistakenly

think that the investment hurdle is the 9% cost of borrowing, which is tougher to clear.

When returns match the 9% interest expense, leveraging is about 45% better than not leveraging. If returns match the long-term global equity fund average of 12%, leveraging is 97% better, effectively doubling the investment produced without leveraging.

As a comparison, if Beth was in a 50% tax bracket and invested for 20 years, leveraging would be about 76% better with 9% returns, and 139% better with 12% returns. The “better than” return drops to 5.3%, less than two-thirds of the interest expense.

In rough terms, we could say that when leveraging equity funds over at least 10 years:

- the minimum “better than” return for leveraging to benefit clients is about two-thirds of the interest expense;
- when returns match the cost of borrowing, leverage increases investments by about 50%;
- when borrowing at 9% and averaging 12% returns, leverage is about 100% better than not leveraging.

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