NUMBER CRUNCHING BY TALBOT STEVENS

Borrowing money to invest

New "no margin call" loans greatly reduce the risk of leveraged investments

WITH INTEREST RATES dropping to 40-year lows, industry interest in leveraging, or borrowing to invest, has never been greater. Indeed, one bank is running TV spots saying, "There has never been a better time to borrow to invest."

As a researcher and consultant to the financial industry, I have seen a great increase in the popularity of leveraging in the past year or so. Much of the reason is the significant decline in interest rates. With the prime rate dropping to 3.75%, many people have never seen rates this low.

Certainly part of the movement to explore leveraging is a desire to reverse sagging sales as down markets put a damper on clients' enthusiasm for investing, particularly in equities. A more significant industry trend is the growing number of advisors who, while very conservative with their clients' money, are recognizing that responsible leveraging can make sense as a part of a client's financial plan. Investors are asking about leveraging and ways to reduce taxes. Professional advisors need to be knowledgeable about the strategy, and take steps to protect their clients and themselves from competitors who may try to pry away clients with the enticing potential of borrowing to invest.

As another example of the shifting tide toward leveraging, an industry "first" occurred last summer when **AIC Ltd.** launched its "upvesting" program. This was the first fund company to align itself publicly with the controversial strategy and the associated risks to the client, advisor and itself. Others will soon bring their own leveraging programs to the market.

"No margin call" loan programs

Company	Loan limits ($000)*	Interest rate (%)*	Loan types**	Eligible investments
AIC	$5-$250	P + 0.75-1.0	100%	own funds, own segs
AGF Trust	$15-$250	P + 1.25-2.0	100%	own funds
B2B Trust	$5-250	P + 0.75-1.75	2:1, 100%	many funds
Clarington	$10-$250	P + 0.75-1.0	100%	own funds
Dynamic	$10-$250	P + 0.75-1.0	100%	own funds
Empire Life, Maritime Life, Transamerica	$15-$100	P + 0.5-0.75	1:1	own segs
Manulife Bank***	$10-$250+	P + 1.0-1.25	4:1, 3:1, 2:1, 100%	own segs, many funds
MRS Trust	$10-$250	P + 0.75-2.0	2:1, 100%	many funds, packaged funds
SunLife Financial	$5-$250	P + 0.75-1.0	2:1	own segs
TD Canada Trust	$15-$100	P + 0.5-0.75	1:1	many segs, many funds
All lenders' home line of credit	75% of home value	Prime	100%, interest only	anything

*DIFFERENT LIMITS AND RATES APPLY FOR DIFFERENT LOAN TYPES. **LOAN TYPES: 100%: NO COLLATERAL OR DEPOSIT REQUIRED, BUT REQUIRES PRINCIPAL AND INTEREST PAYMENTS; 3:1: CLIENT RECEIVES LOAN OF $3 FOR EACH $1 OF COLLATERAL PLEDGED (SIMILAR FORMULA FOR 2:1 AND 1:1 LOANS). ***MANULIFE'S 4:1 PROGRAM AVAILABLE FOR A LIMITED TIME

SOURCE: TALBOT STEVENS INVESTMENT EXECUTIVE CHART

Conservative leverage checklist

- Stay conservative on cash flow, collateral, emotions
- Eliminate the risk of a margin call
- Invest long-term, minimum of eight to 10 years
- Diversify in several (global) equity funds
- As a trusted advisor, help clients to understand all pros and cons, and urge them to stick to their plan

■ **NEW "NO MARGIN CALL" LOANS.** The most significant industry development that will forever change leveraging in Canada is the recent introduction of "no margin call" loans. In the past year, several lenders have started to offer loan programs for which there is no possibility of a margin call.

This is great news for investors, advisors and the industry, as these programs make it easier for everyone involved to avoid the downside of leveraging. Previously, the industry's publicly sanctioned approach for borrowing to invest was to use margin accounts. However, there is a night-and-day difference in terms of risk between borrowing to buy a single stock on margin and long-term leveraging into several diversified funds if there is no possibility of the lender forcing your client to sell at the worst time.

A margin call occurs when leveraged investments are used as collateral for the loan and the value of those investments drops enough to cause the lender to demand more collateral. Clients who receive a margin call are forced to deal with the reality that their investments — purchased with borrowed money — are down significantly. Worse, they have only a few days to provide more collateral or some of their leveraged investments will be sold at the worst possible time. Margin calls cause most clients to fear the worst and they bail out of the program. For this reason, one of my guidelines for conservative leverage is to eliminate the risk of a margin call.

Manulife Bank was the first lender to provide a "no margin call" loan program. In 1997, **Manulife Financial Corp.** introduced its leveraged GIF program. Its guaranteed income funds allowed investors to choose from a suite of brand-name fund managers under one segregated fund umbrella.

In 2001, **B2B Trust**, **MRS Trust**, **AGF Trust**, Manulife Bank and AIC all introduced "no margin call" investment loans allowing clients to leverage into mutual funds, which generally charge lower MERs due to the absence of seg fund guarantees. Some, such as AIC and AGF Trust, offer loans for investments in their own fund company. Others, such as B2B Trust (owned by Laurentian Bank of Canada), MRS Trust (owned by Mackenzie Financial Corp.) and Manulife Bank allow leveraged invest-

ments into many funds from different companies. Last fall, several life insurance companies introduced "no margin call" leverage programs for their seg funds. Most of these use loans through **TD Canada Trust**, which also offers its own TD GIF II, an umbrella program offering several insurers' segs to compete with Manulife's leveraged GIF program.

Competition among investment lenders has produced innovations beyond the introduction of "no margin call" loans. For example, most of MRS Trust's investment loans are structured as lines of credit, allowing advisors the flexibility to control the timing and amounts borrowed. This feature enables clients to invest all at once, as traditional loans do, or use dollar-cost averaging, which might be attractive to some during these turbulent times.

AGF Trust offers 100% financing of its "no margin call" loan with two payment options. Clients can pay off the loan over as much as 20 years with principal and interest payments, or pay interest only and invest additional funds (1/20th of the amount borrowed each year for 20 years).

The table on this page compares some of the "no margin call" loan programs available.

Clarington Funds Inc.'s program launches in April, and others will have similar programs coming soon, including **Standard Life Assurance Co.** In addition to these offerings, several planning firms have recently partnered with lenders to provide clients with investment loans, including "no margin call" options. **Investment Planning Counsel of Canada** (IPC) has teamed up with **Bank of Montreal**, and **Investors Group Inc.** is launching its investment loan programs in conjunction with **CIBC**.

Of course, all lenders offer personal loans, which if secured with collateral other than the leveraged investments can be used to eliminate the risk of a margin call. One of my preferred methods of securing investment loans is the use of home equity lines of credit. This approach not only eliminates the possibility of a margin call, it is usually the cheapest way to borrow and allows interest-only payments, resulting in the most efficient leverage from a client's available cash flow. Perhaps more important, this method serves as a rough qualifier of leverage suitability. If a client does not have sufficient equity in his home to borrow against, he probably should not be leveraging.

It should be noted that while they often cause clients to react negatively to down markets, margin calls can benefit a client who is leveraging responsibly. The lender's margin call forces the client to invest more when the markets are down. A well-counselled client would have the necessary collateral and cash flow to handle the margin call, and recognizes that being forced to "buy low" only increases his long-term returns after his diversified investments recover.

■ **BEWARE OF THE "INTEREST RATE TRAP."** Yes, borrowing is more attractive when rates are at 40-year lows. But we need to understand what that means and be careful not to fall into an "interest rate trap." If an investor (or consumer) makes a commitment to borrow when rates are at 40-year lows, he should be prepared to handle the payments when interest rates return to normal levels. Over the past 64 years, the prime borrowing rate in Canada has averaged 7.4% — effectively double prime, which is around 3.75%.

The real reason that now should be a "safer" time to consider leveraging is not because borrowing has never been cheaper. It is because most stock markets around the world are still well below their previous highs. At the 7600 level, the TSE 300 composite index is about 30% below its previous high of more than 11000. Although many will argue the markets are still overvalued, it is clearly safer to invest when the market is significantly below its peak, leveraged or unleveraged.

■ **CONSIDER ONLY CONSERVATIVE LEVERAGE.** The interest rate risk can be addressed by following the first guideline of the conservative leverage checklist, above. By using only a conservative portion — say, less than half — of a client's available cash flow for leveraging, he or she should be able to handle the loan payments even if interest rates double.

Note that my second point on the checklist is to eliminate the risk of a margin call. Any of the "no margin call" loan programs can be used to eliminate this risk to both client and advisor.

The fourth guideline is to diversify into several (global) equity funds. For most investors, mutual funds may be sufficient; however, business owners and, more important, older clients should be introduced to the pros and cons of the seg fund alternative, especially when leveraging.

The death guarantee could avoid discussions with beneficiaries who challenge the idea of leveraging with older investors. Others might financially justify the emotional peace of mind that the market guarantee provides, enabling them to know the worst case up front.

Every leveraging horror story I have heard over the past 10 years has acknowledged that one or more of these guidelines has been ignored. Following them and fulfilling your role to ensure that clients understand the downside for their unique situation will go a long way toward making leverage help — instead of hurt — both you and your clients. **IE**

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