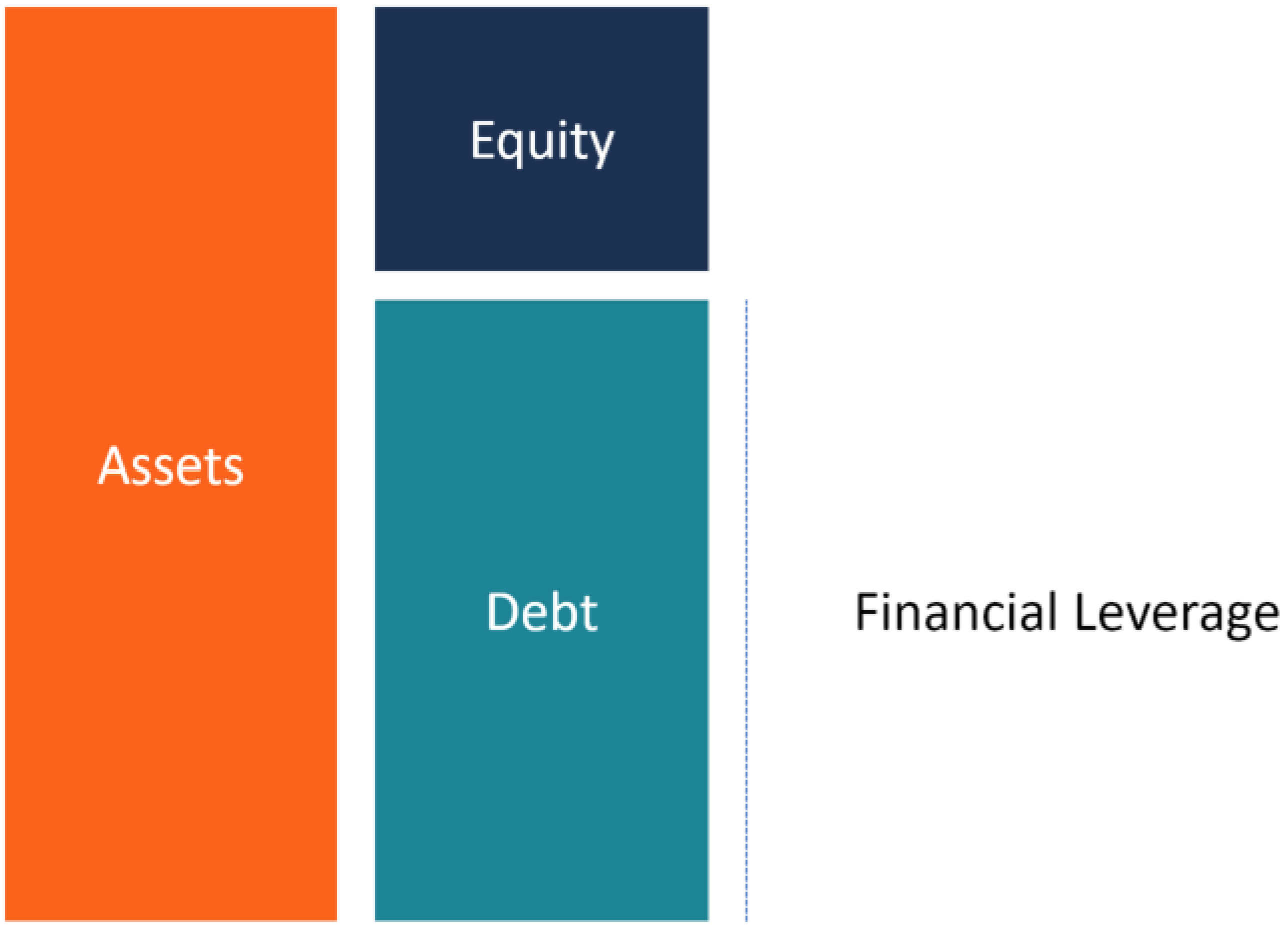
ALASKA HIGHWAY NEWS

Smart Money: Using leverage to help reach your financial objectives

Jul 28, 2021 1:17 PM By: Brad Brain / Smart Money



To be totally clear, this is a column that will be fun to contemplate, but it will only be suitable for a very select number of situations. This is a high-risk, high payoff idea. If you are reckless with this you may cause permanent and irreparable financial damage. Everyone likes fireworks until someone loses a few fingers.

Leverage. In other words, borrowing to invest.

Used properly, leverage is like a chainsaw. You can cut a lot of wood in a short period of time. Used improperly, leverage is still like a chainsaw. You can cut your foot off.

Leverage will magnify your results. Leverage will turn a good investment into an amazing investment. But leverage doesn't turn a bad investment into a good one. Leverage turns a bad investment into a nightmare.

The use of financial leverage is actually fairly common. Anyone who takes out a mortgage to buy a house is leveraging. Anyone that takes out an RRSP loan is borrowing to invest. But these are plain vanilla applications, and they are relatively low risk.

Today we aren't going to be talking about plain vanilla leverage. Today we are getting spicy. And, to reiterate, spicy is not for everyone.

Given that, how would you like to make your mortgage tax deducible? And unlock the equity in your house to potentially grow at an enhanced rate? Well, then, let me introduce you to the Smith Manoeuvre.

In a nutshell, the Smith Manoeuvre involves taking equity out of your house and investing the proceeds. Why, you might ask, would anyone want to do this?

Well, let's say for sake of discussion that the long-term growth rate for real estate is about five per cent and the long-term growth rate for the stock market is about 10 per cent. If you can double your long-term rate of return on your investment you can accomplish magnificent things.

But it's not just getting a bigger return on your own money. By borrowing you can buy in with a bigger stake than if you just put up your own money, and now you can make money on other people's money too.

And then what makes the idea even more appealing is the tax treatment. You can't write off your mortgage, but you can write off the interest expense on an investment loan. So, by using a home equity line of credit to fund the purchase of a non-registered investment, you can turn your mortgage into a tax deduction.

At this point it is vital to point out a few things. First, this is a 600-word article and important information is beyond its scope. If you ever consider leveraging in real life, make sure you do your due diligence.

But, perhaps more importantly, leveraging illustrations will always look good when you assume everything works out. And in the real-world things don't always work out. So here are some important things to consider.

Buy high quality, diversified investments. The use of leverage is already jacking the risk profile, you don't need to purchase speculative investments on top.

Have a long time frame. This is not a get rich quick scheme. You will need time to recover if things go sideways.

Don’t buy at the top. The time to leverage, if there ever is one, is when investments are cheap to buy.

Don’t take it to the limit. Have a margin of safety in case there is a change in interest rates, or in your ability to service the loan.

Don’t get greedy. You don’t have to literally bet your whole house.

Understand what a margin call is. Also, understand how unforgiving and ruthless a margin call is.

Implement only on the advice of a knowledgeable professional.

Ask yourself, “how will this help me reach my goals?” If you can’t articulate why it makes sense, then it doesn’t make sense. If it doesn’t make sense, then don’t do it.

Used wisely, leverage can help you reach your financial objectives. But you do want to make sure the idea fits your situation, and that you understand the entirety of the strategy, including what could be daunting levels of risk.

Certainly, you can cut a lot of wood in a short period of time with a chainsaw. Then again, nobody ever accidentally cut their foot off with a handsaw.

Brad Brain. CFP, R.F.P., CIM, TEP is a Certified Financial Planner in Fort St John, BC. This material is prepared for general circulation and may not reflect your individual financial circumstances. Brad can be reached at www.bradbrainfinancial.com.

Comments (0)