

## **Borrowing to invest makes sense**

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Hal had been in the hospital recently. He had been slipping in and out of a coma for several months, yet his wife stayed by his bedside every single day. When Hal came to, he motioned for her to come nearer.

As she sat by him, he said, "Dear, you have been with me all through the bad times. When I got fired, you were there to support me. When my business failed, you were there. When we lost the house, you were by my side. When I got shot, you gave me support. When my health started failing, you were still by my side. You know what? I think you bring me bad luck!"

How's your luck? You see, some people are of the opinion that borrowing money to invest makes sense only when you're lucky. If this were true, I'd advise Hal to stay away from leveraged investing like the plague. Borrowing to invest, however, is not like that. You don't need luck -- you just need some common sense and a few rules to follow. Recapping briefly

This article is really a sequel to my article last week where I introduced a strategy called the "RRSP meltdown," which makes use of leveraged investing. The RRSP meltdown involves borrowing money to invest, which creates an interest deduction for tax purposes. If the interest deduction were, say, \$12,000, then you could withdraw \$12,000 from your registered retirement savings plan and effectively pay no tax on that withdrawal thanks to the offsetting interest deduction.

Why make RRSP withdrawals like this? The theory is that it's possible to have too much in an RRSP. Last week, I used the example of Jack who has built up more than enough in his RRSP already. By moving some of those assets out of his RRSP on a tax-free basis and investing outside his plan, he'll likely pay less tax in the long run thanks to the low rate of tax applicable to capital gains.

Don't forget, withdrawals from an RRSP are fully taxable, whereas capital gains realized on investments outside of a registered plan are just 50-per-cent taxable for gains after Oct. 17, 2000. Risks and rewards

Now, the RRSP meltdown, and leveraged investing in general, is not for everyone. Borrowing to invest does come with risks. I like to compare leveraged investing with using electricity.

We'd all agree that electricity is an invaluable resource when used properly. But you're not about to lick your finger and stick it in a light socket. If you abuse electricity, you can get hurt. Leveraged investing is no different. When it's used prudently, it can dramatically improve your financial picture. If you abuse it, you could end up in serious trouble.

Borrowing to invest will magnify your returns when your investments are appreciating in value. But watch out. If your investments start to drop in value, your losses are even more magnified. Rules to follow! Here are *five rules to keep in mind if you're borrowing to invest*: **1.** Borrow no more than 30 per cent of your net worth. Sure, I'm a bean counter who could be labeled as too conservative. When it comes to leveraged investing, however, conservative is good. Limit your borrowing to 30 per cent of your net worth and you're less likely to run into problems. **2.** Ensure you've got cash flow to make payments. If you're borrowing to invest, make sure you've got a source of cash flow (apart from income earned on that borrowed money) sufficient to pay at least the interest on the debt. **3.** Invest in conservative equities. While equities make more sense than fixed income or money market investments based on historical rates of return, forget about investing in that high-flying tech story your brother-in-law told you about. Borrowed money belongs in conservative equities. Blue-chip equity mutual funds can make a good choice. You might even choose segregated funds. After all, seg funds come with a capital guarantee over a 10-year period -- a good complement to leveraged investing when declines in value can hurt you. **4.** Invest for the long term. Your investments have got to appreciate in value for leverage to work. This is more likely to happen over the long term -- say five to seven years or more. If you're borrowing to invest for a shorter period, here's my advice: Don't bother. **5.** Keep your interest tax deductible. The tax collector will trace your borrowed money to its current use. If you had originally invested the borrowed money but subsequently liquidated those investments to travel the world, renovate your home, or pay off some debt, for example, you'll lose all or a portion of your interest deduction.

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