Manulife Investments

WealthStyles



Borrowing to invest A tax-deductible alternative

Many Canadians, particularly those who use all or most of their RRSP contribution room, are seeking tax-deductible investment options beyond their RRSPs. One investment strategy that is complimentary to your RRSP has been used by wealthy investors for hundreds of years – leverage.

WHAT IS LEVERAGE?

Leverage is simply borrowing money to invest. Investment loans are similar to borrowing money for any large purchase. Rather than saving and waiting, a loan provides the purchasing power you need, today.

When you borrow to buy an item such as a car, your money is going toward something that will depreciate over time. When you borrow to invest, the expectation is that your investment will grow over time, and be worth more when you are ready to sell it.

There are two primary benefits to investing with a leverage strategy. First, leverage allows you to make a large lump-sum contribution at the start of the investment period. This allows the entire investment to benefit from the power of compounding for the full investment period.

Second, in most cases the interest paid on loans for investment purposes are tax-deductible[1]. This effectively lowers the cost of borrowing, and reduces the 'break-even' return that you must achieve to make leverage investing worthwhile. In many cases the 'break even point' – the rate of return at which you're better off borrowing than simply investing the money you would have paid in interest and taxes on annual investment income – is actually lower than the interest rate you're paying on the loan!

Based on average historical returns, leveraging has the potential to produce much more wealth than would be possible without a loan, allowing you to substantially increase the value of your investment portfolio over time.


THE STORY OF MIKE AND LIZ

This story illustrates how borrowing to invest may produce better results than traditional investing.

Liz and Mike both need to finance a large expense 10 years from now. Each has selected a different investment strategy to ensure they have sufficient funds for that future date. Liz's approach involved diligently making lump sum deposits at the end of each year, whereas, Mike has chosen to borrow $30,000 from Manulife Bank to invest immediately. Mike's cost of borrowing is 7.00% annually, and that expense is 100% deductible. At the end of each year, Liz makes contributions that are equivalent to Mike's net cost of borrowing. For both of them, the annual taxable portion of fund return is 33%, the tax rate on income allocations from funds is 35%, and the marginal tax rate is 40%.

After 10 years, their cost of investing has been the same, but Mike ends up with almost 50% more money than Liz. Even though both investors realized an 8% annual return, Mike's strategy put him in a better position to harness that growth by utilizing the tax deductibility and compounding power of his investment loan.

	Liz: Annual Investment Contribution	**Mike: $30,000 Investment Loan**
Initial Contribution	Nothing	$30,000
Annual Gain	8.0%	8.0%
Total Amount Contributed after 10 Years	$16,616	$0
Net Cost of Borrowing after 10 Years*	$0	$16,616
Portfolio Value after 10 Years	$22,804	$64,768
Less Loan Repayment	$0	($30,000)
Less Capital Gain Tax on sale of Investment	($938)	($4,659)
Net Equity after 10 Years	**$21,866**	**$30,109**
Internal after-tax rate of return	6.2%	13.0%

*Net cost of borrowing includes the after tax investment cost plus annual taxes paid on the taxable portion of investment income.

The example above is for illustration purposes only and assumes an investment in segregated funds with a constant rate of return over the 10 year period. Results will vary depending on actual performance. Investment returns of segregated funds will fluctuate and are not guaranteed.

  

HOW DOES LEVERAGED INVESTING WORK?

Instead of making regular contributions to build up an investment position over time, leveraged investors borrow money, invest all of it right away, and then make regular interest payments on the loan. At the end of the investment period, after interest, taxes, and loan repayment, the investor keeps any remaining investment gains.

WHAT TYPES OF LOANS ARE AVAILABLE?

There are a number of different options to consider when borrowing to invest. Traditionally investors had to put up some of their own money in order to get an investment loan. For example, if they put up $25,000 of their own money, they could borrow $50,000 (2:1 loan), $75,000 (3:1 loan), or even $100,000 (4:1 loan). These options are still available and popular, but recently a new loan option has been gaining in popularity: 100% loans. With a 100% loan, the investor puts up none of their own money. Rather, the financial institution lends the investor 100% of the value of the investment. While 100% loans typically charge a slightly higher interest rate than more traditional options, they have the advantage of allowing investors to rapidly build an investment portfolio even if they have no money of their own to invest.

WHAT IF THE INVESTMENT FALLS IN VALUE?

Normally with an investment loan, the lender requires the value of the loan to be no more than a specified percentage of the investment. For example, at the start of a 2:1 leveraged investment worth $30,000, the loan is worth $20,000, or 2/3 of the investment, and your deposit is worth $10,000, or 1/3 of the investment. If the investment drops in value, for example, to $25,000, the loan is still $20,000, but now represents a larger percentage of the investment – 80% in this case. If this happens, the lender will make a 'margin call', which is simply a request for you to deposit more money into the account to bring the loan back to the appropriate ratio. In this example, you would be required to deposit $5,000 in order to bring the investment back to $30,000, so the loan again represents only 2/3 of the total $30,000 investment. If you don't have the $5,000, you will be required to surrender the investment and pay off the loan. Investors concerned about their ability to contribute more money into the account in the event of a decline in investment value should look for an investment loan that guarantees NO margin calls. For example, ALL Manulife Bank loans for Guaranteed Investment Fund loans offer no margin calls, as do Manulife Bank loans for mutual funds of $50,000 or less.

DO I NEED TO PUT UP CASH UP FRONT?

Many loan types require an initial deposit in order to qualify for the loan. This initial deposit generally means that the loan will be offered at a lower interest rate. However investors who do not have the cash available can still take advantage of leveraged investing in at least two ways. First – a few financial institutions, including Manulife Bank, offer 100% loans that require no initial deposit from the investor. Second, if the investor has qualifying alternative equity, such as specified mutual funds, segregated funds, GICs, or insurance policies, they can potentially use these investments as the 'client



WealthStyles

equity' portion of their loan – so again, no 'cash' would be needed from the investor.

WHEN DO I NEED TO PAY BACK THE LOAN?

With many types of loans, the borrower is only required to pay interest on the loan, and can choose to pay off the principal amount of the loan at any time. Some types of loan require the borrower to make principal and interest payments, such that the loan is paid off over a predetermined period of time.

IS THIS A RISKY INVESTING STRATEGY?

As with any investment program, leveraged investing involves an element of risk. Leveraging increases an investor's potential for additional losses as well as additional gains, depending on how the investment performs. This strategy is not for everyone. Before you borrow money for any investment, it is important to consult your advisor to ensure that the benefits and risks associated with leveraged investing are fully understood.

Borrowing to invest with Manulife Bank may be right for you if:

- You believe that funds are an important part of your portfolio.
- You understand the increased opportunities and risks of borrowing to invest.
- You have a long-term investment horizon to maximize the power of compounding.
- You have adequate income to comfortably pay loan interest and applicable investment taxes.
- You are interested in building non-registered assets.

Borrowing to invest is a proven investment strategy that can accelerate the growth of non-registered investments for clients who are comfortable taking on additional risk. If you are interested in learning how borrowing to invest with Manulife Bank can help grow your non-registered savings, speak to your financial advisor.

1 Tax deductibility of loan interest depends upon a number of factors, with the Income Tax Act providing the framework for determining deductibility. It is advisable to enlist the services of an independent professional tax advisor to consider these factors.

Borrowing to invest is suitable only for investors with higher risk tolerance. You should be fully aware of the risks and benefits associated with investment loans since losses as well as gains may be magnified. Fund values will fluctuate and are not guaranteed. You must meet your loan and income tax obligations and repay your loan in full. Please read the terms of your loan agreement and the information folder or prospectus for important information and discuss with your financial advisor before deciding to borrow.

Compliments of:

www.manulife.ca/investments

Manulife Investments

With you every step of the way!™