

## Should I borrow to invest?

Grace makes regular RRSP deposits and has been using up all her contribution room for several years. She also makes regular deposits to a non-RRSP account to build up her retirement savings. Grace is wondering if there is a better way to build wealth.

Grace's investments can be made with cash or a combination of cash and borrowed money. If only cash is used, her gains or losses on the investment are equal to the percentage increase or decrease in value over time. However, when money is borrowed to invest, the gain or loss on her cash invested is magnified. This effect is called leveraging.

Let's say that Grace has \$25,000 of her own money to invest and she borrows \$75,000 so that a total of \$100,000 is invested. If the value of her investments drops by \$10,000 after one year, her return on equity (her original \$25,000) is a loss of 40%. However, if her investments increase by \$10,000, her return on equity is a gain of 40%.

It is important for investors to be aware of the terms of their investment loan. Some lenders may require additional funds invested, more collateral or investments sold in the event of a drop in value to keep the loan within a certain percentage relationship. This is called a margin call.

Grace must be able to meet the ongoing costs of the loan. She can arrange to pay interest only for a certain number of years and sell her investments to pay off the loan, or principal and interest so that the loan is fully paid off at the end of the chosen term.

The Canada Revenue Agency (CRA) currently allows the deduction of interest expenses incurred to invest in securities or investment funds that have the potential to generate an investment return. Investments that generate capital gains and dividend returns over time are well suited for this type of strategy. Capital gains and dividends also receive preferential tax treatment.

Leveraging to invest is not a good idea on a short-term basis. The risk of this strategy is greatly reduced if it is done over at least 8 to 10 years or more. A well balanced portfolio or investment fund may be a good choice for this strategy.

When using leveraging as a wealth building strategy, it is wise to use conservative investments and to diversify. After watching friends get very high returns on high-tech stocks in the late 1990's, Carl decided to borrow and invest. His investments promptly lost over 40% in one year, magnifying his losses because of the leveraging.

Let's say that Grace can save an additional \$3,000 per year. Ignoring taxes along the way, she could accumulate about \$42,441 in 10 years at 7.50% compounded annually. The same \$3,000 per year can support an interest only loan of \$60,000 at 5.00%. If the \$60,000 is invested for 10 years at 7.50%, it will accumulate to about \$123,662. Grace then pays off the loan from the investment and is left with about \$66,662, some \$21,221 more than making annual deposits. She can also save about \$1,200 per year (40% tax bracket) by deducting the loan interest.

**Want to know more about borrowing to invest? Call today!**

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