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Leveraging on nerve

Should you borrow money to invest for the long term?

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Money is cheap. If you can secure a loan, the cost of borrowing is minimal. This week the prime rate dropped to 3.0%.

Factor in inflation, and money on deposit may be worth less tomorrow than it is today. Yet, despite its low return, investors will settle for the paltry return of cash or bonds over anything the stock market has to offer.

So, rather than lend money to the banks for next to nothing, consider the opposite strategy: Borrow money from the bank to invest for the long term.

High-yielding bank shares in the near term may be alluring. The iShares CDN Financial Sector Index Fund (TSX: XFN), for example, has a current dividend yield in excess of 7% that would easily fund the cost of a loan.

Terry Shaunessy, portfolio manager at Shaunessy Investment Counsel in Calgary, says that "the numbers definitely add up," but it comes down to a "gut check" for investors because of the high market volatility.

The risk is that dividends could be cut, rates go up, or both. Mr. Shaunessy says he "has a high confidence in the banks common dividends," but a better idea is a more diversified investment fund.

Professor Moshe Milevksy of the Schulich School of Business says the right question to ask when considering leverage is not whether money is cheap, but whether you can afford it.

"Your total amount of leverage, if any, should depend on the structure of your personal balance sheet and, in particular, the nature of what I call your human capital — your job, career, salary," Prof. Milevsky says.

Indeed, mindless borrowing en masse is the reason our financial system is in its current state of disarray.

Jonathan Kirshblum, a financial advisor at Blackmont Capital in Toronto counsels caution.

"When borrowing money to invest, you are introducing the risk of losing more than your initial invested capital," he says.

"Investors who act on the allure of borrowing cheap money often pay dearly when 'sure bets' deliver far from guaranteed returns."

One point that is lost on the buy-and-hold community is that when you invest greatly matters in your total return, even over the long run. Rather than averaging out over time, there is a high variability in long-term returns that is affected by an investor's base year period of investing.

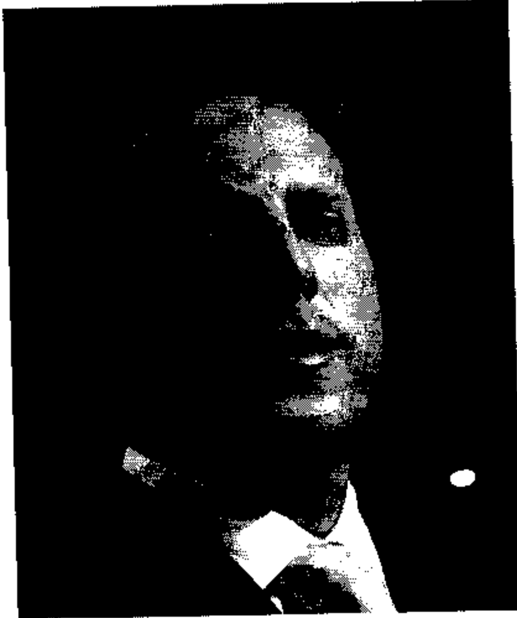
In other words, there are better times to invest than others, and now may be one those better times.

"With the benefit of hindsight" it is possible to identify "critical times" that were either really good or really bad from the perspective of the long-term investor, write Andrew Smithers and Stephen Wright in their approachable and insightful book on investing, Valuing Wall Street.

Hindsight always works best when looking backward. Mr. Smithers and Mr. Wright have something to say about the predictability of stock returns, too. Long-term investors (more than 20 years) will be interested to know that the 10 best years to have bought stocks over the past century "were invariably years that seemed at the time to be either pretty bad or more often downright terrible."

The single best year to have purchased equities in the 20th century was, surprisingly, 1932, the height of the Great Depression. Between 1931-1933, real gross national product in the United States fell a back-breaking 19%. Yet, in the midst of the national pain, the stock market was unequivocally cheap.

The worst year to have bought stocks was 1929, just before the market crash that precipitated the Great Depression. Similarly, in 20 years time, 2007 will likely register as one of the worst years, even for long-term investors, to have invested in the stock market.



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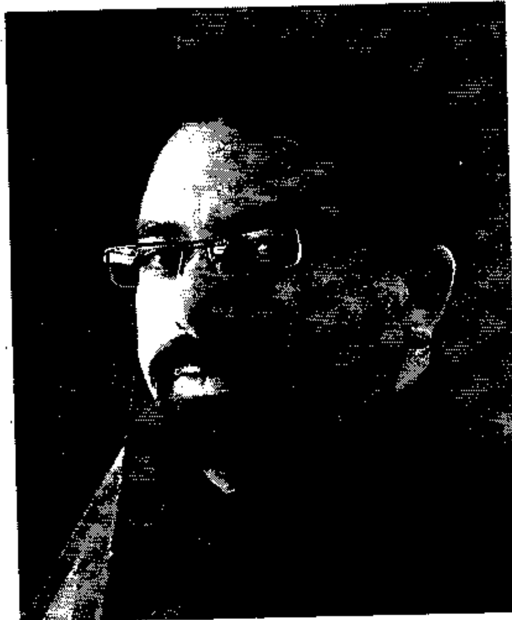

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Jonathan Kirshblum, left, and Moshe Milevksy. The question to ask when considering leverage is not whether money is cheap, but can you afford it, Milevksy says.

History says that the probability of earning an above-average return in the stock market is higher after having earned a below-average return. Despite that fact, Mr. Smithers and Mr. Wright's measure of market valuation, called "q" (www.smithers.co.uk/), suggests that the U.S. stock market is close to fair value but not overly cheap. In contrast, in 1932, the market was roughly 40% undervalued.

> *The risk is that dividends could be cut, rates go up, or both*

Just because the market has fallen heavily doesn't mean investing today is a sure thing, says Marc Dalpe, portfolio manager with advisors Dalpe Milette Group at Desjardins Securities. Odds may favour leverage, says Mr. Dalpe, but you never know if we are on the cusp of another Depression.

That said, the stock market is actually very consistent over the long run at delivering consistent returns, which lends more support to the idea that now may be a good time to borrow to invest over the long term.

Professor Jeremy Siegel of the Wharton School of Business, discovered that, looking at data for the S&P 500 all the way back to 1800, stocks exhibited a trend return of 6.75%.

Through two centuries of upheaval, innovation, wars, that trend return has not changed and currently the market is nearly 40% below trend, according to research by Charles Dumas of Lombard Street Research.

And, if there is one thing that is for certain, there is no telling where stock market returns will be over the next year.

Still, according to Mr. Dumas, the notion that stock market gains are below trend suggests "fair returns, even if future downward lurches recur.

Yes, money is cheap today and stock prices are down, which makes leverage an interesting proposition for long term investors. You have to have to a clean balance sheet to finance the loan to make sure you can carry the investment over the next couple decades.

One other thing you will need in the current tumultuous market is a healthy dose of nerve.

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FREE MONEY FROM CHEAP MONEY OR THE RISKIEST STRATEGY OF 2009

STEP 1: BORROW

Borrow $100,000 on a line of credit that is at Prime less 50 basis points, or 2.5% (A pre-crisis negotiated line of credit)

Annual borrowing costs = **$2,500**

STEP 2: INVEST

Higher risk ETF
iShares CDN S&P/TSX capped financials index fund yielding 6.55% for eligible dividend income of $6,550 earned in a non-registered account.

STEP 3: REDUCE TAXES

Write off borrowing costs from your income, which at the top marginal tax rate of 46.41%, equates to a tax savings of $1,160.25

STEP 4: PAY TAX

Pay tax on dividend income

$6,550 x 23.96% = **$1,569.38**

STEP 5: ADD UP WHAT YOU EARN ON THE CHEAP MONEY

($3,750 + $1,160.25 - $2,500 - $898.50)
Profit = **$1,511.75**

Interest income + tax savings - interest paid - tax paid = profit.

($6,550 + $1,160.25 - $2,500 - $1,569.38)
Profit = **$3,640.87**

Upside:
Stocks go up in price
Dividend yields go up
Borrowing costs fall further

Downside:
Stocks go down in price
Dividend yields are cut
Bank asks for money back

CALCULATIONS DONE BY KARKHECK BLOOMBERG LLP, CHARTERED ACCOUNTANTS.
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