INVESTMENT LOANS

Understanding Investment Leverage

Manulife Bank

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Leverage is simply borrowing money to purchase investments with the goal of achieving greater wealth. Many Canadians are taking advantage of a simple, yet powerful, wealth-creation strategy – investment leverage. For those unfamiliar with investment leverage, this strategy may sound a bit intimidating but it's actually quite simple. This guide explains, in easy-to-understand language, what investment leverage is and how it works. And, at the end, there are some questions to help you determine if investment leverage is right for you.

What is investment leverage?

Investment leverage is borrowing to invest. That is, it is using someone else's money to achieve your investment goals. Whether you know it or not, you may have already taken advantage of this strategy. For example, if you've had a mortgage, a student loan or an RRSP loan, you've used someone else's money to achieve your goal of home ownership, higher education or a more comfortable retirement.

Investment leverage is similar to the examples above. Leverage is simply borrowing money to purchase investments with the goal of achieving greater wealth.

Now, it's probably easy for you to see how a mortgage can help you achieve the goal of home ownership. However, it may be less clear how taking out a loan to buy an investment can help you achieve the goal of greater wealth.

How does investment leverage work?

With traditional investing, you set aside a portion of your income each month or each year to purchase investments. Gradually, those investments grow over a long period of time.

With leveraged investing, you take out a loan and make a single large investment purchase on day one. Then, you set aside a portion of your income each month to make interest payments on the loan.

The amount you pay for loan interest may be the same as the amount you would normally contribute to a traditional investment plan. But, while your "out of pocket" costs may be the same under both strategies, leveraged investing has the potential to generate far greater returns. Here's why:

1. **Compound returns.** Compound returns refers to the fact that investment growth accelerates over time as the growth from one year is added to your initial investment to create a larger investment that can grow the next year and so on. The key to successful compounding is having the largest possible amount growing for the longest possible time.

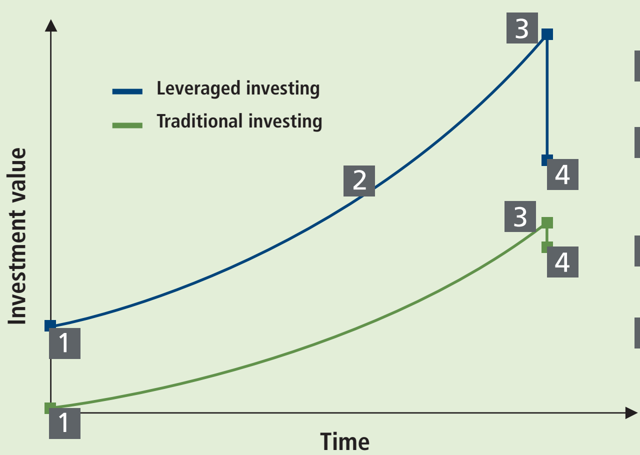
   While traditional investing benefits from compound returns, it fails to take full advantage of them. Assume you have 15 years to invest and plan to make regular contributions each year. Only the contribution you make today will grow for the full 15 years. The contribution you make one year from now will only have 14 years to grow and so on. With leveraged investing, you contribute a much larger amount on day one and the whole amount can grow for the full amount of time, say 15 years. The effect of compound returns is much stronger with leverage, which can result in better investment results over the long term.

2. **Tax deductibility.*** Since the interest you pay on a loan reduces your investment return, it's important that you pay as little interest as possible. However, the interest you pay on an investment loan is generally tax deductible. This reduces the overall cost of this strategy.

* Tax-deductibility depends on a number of factors, with the Income Tax Act providing the framework for determining tax-deductibility. Readers should consult their own tax and legal advisors with respect to their particular circumstance.

With leveraged investing, a larger initial investment can result in greater overall growth of the investment

Even though the out-of-pocket costs are the same, compounding can help provide a greater value at the end of the investment period, even after the loan is repaid.



1. Leverage allows you to start with a larger initial investment.
2. Because a larger amount is growing, compounding allows a leveraged investment to grow faster.
3. Value before taxes are paid (on both types of investing) and loan is repaid (leverage only).
4. Final investment value returned to the investor after taxes are paid and loan is repaid.

The story of Paul and Jennifer

Together, the effects of compound returns and tax deductibility could greatly increase the likelihood that a leveraged investing strategy will outperform a traditional investing strategy. To illustrate this, let's look at an example.

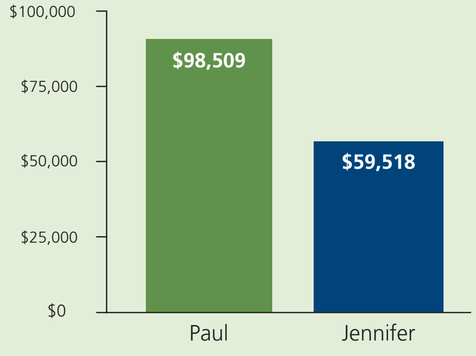
Paul and Jennifer both want to invest to save for a down payment on a vacation property in 10 years. Jennifer diligently makes a lump sum deposit at the end of each year. Paul borrows $100,000 at an average interest rate of 6% to invest immediately. During the next 10 years, Jennifer contributes a total of $44,692 to her investment plan. Paul makes annual interest payments which, after tax deductions, cost him the same, $44,692. Both investors earn an annual return of 8% on their investment. After 10 years, they sell their investments, pay their taxes and Paul repays his loan.

They compare their results and discover that even though the cost of investing has been the same, Paul ends up with an additional $38,991 to spend on his vacation property.

Is leverage always better?

In this example, Paul's investment leverage strategy outperformed Jennifer's traditional investing strategy. Does this mean that leverage will always outperform? Unfortunately, no. Leverage offers the potential for increased growth in good times, but it also carries the risk of increased loss during bad times. So, we need to ask, under what circumstances would Jennifer, with her traditional investing strategy, end up better off than Paul with his leveraged investing strategy?

After-tax investment value 10 years after Paul loan is repaid[1]



[1] Assumptions: Jennifer makes end-of-year contributions equivalent to Paul's net cost of borrowing. Cost of borrowing for Paul is 6% annually and his loan interest is 100% deductible. Both clients: A taxable portion of fund return is 25%, tax rate on investment income is 30% and marginal tax rate is 40%. All assumptions are for illustration purposes only. This illustration assumes that a specific percentage of loan interest is tax deductible. However, actual tax deductibility of loan interest depends on a number of factors. Individual tax situations and tax deductibility will vary. Tax laws are subject to change and therefore, tax treatment of illustrated figures cannot be guaranteed. Results for Quebec residents may differ due to different deductibility rules. Clients should consult their own tax and legal advisors with respect to their particular circumstance.

Leverage and break-even returns

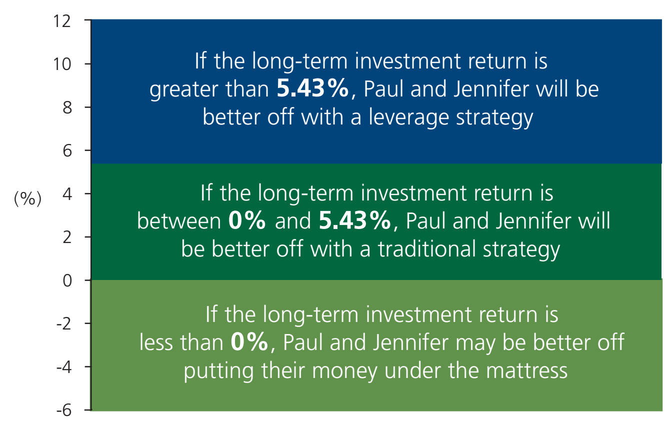
To answer the question of when traditional investing would be more advantageous than leveraged investing, we need to look at the concept of break-even returns.

Let's assume that prior to starting her investment program, Jennifer had two choices: traditional investing or putting her money under the mattress. The concept of "break-even return" attempts to answer the question, "What rate of return does Jennifer's investment need to earn so that she is better off than if she had simply put her money under her mattress?" In this case, the answer is fairly simple. If her investment earns more than 0% return, she's better off with the strategy she chose. If her investment earns less than 0% return, she would have been better off with the mattress strategy. So Jennifer's break-even return is 0%.*

Now, let's assume Paul is also choosing from between two strategies: traditional investing or leveraged investing. Determining Paul's break-even between these strategies is not quite as straightforward because the leverage strategy includes interest payments on the loan that need to be factored in. The question we need to answer is, "What return would Paul's investment need to earn to make him better off with a leveraged investing strategy than with a traditional investing strategy?"

This break-even return depends on factors such as tax rate and interest costs. In Paul's case, the break-even return is 5.43%. That is, if Paul's investment earns more than 5.43% per year, he's better off with a leverage strategy.

Now, because we used all of the same assumptions for Paul as we did for Jennifer, we can state the following:



The break-even return will vary from investor to investor. Your financial advisor can help you determine your own personal break-even return. But the point to remember is that you generally don't need huge returns for leverage to work.

* For simplicity, inflation has not been included in this analysis.

Your financial advisor can help you determine your own personal break-even return.

If you purchase an investment using borrowed money, the gain or loss you experience will be magnified relative to the performance of the investment.

Understanding the risk of investment leverage

Before deciding to invest with leverage, it's important to understand that this strategy involves a greater degree of risk than traditional investing. If you use your own cash to purchase an investment, the gain or loss you experience will equal the gain or loss of the investment. However, if you use borrowed money to purchase an investment, the gain or loss you experience will be greater, relative to the performance of the investment.

For example, if you invest $50,000 of your own money and the investment declines in value to $40,000 over 10 years, you will have lost $10,000. However, if you borrow $50,000 at an interest rate of 6% and invest this amount and the value declines to $40,000 over 10 years, you will be in a worse financial position. To repay the loan, you must come up with an additional $10,000 to supplement the $40,000 raised from the sale of the investment. In addition, you will have paid $30,000 in loan interest over the 10 years. In other words, you will have lost $40,000 with this investment strategy.

In addition, regardless of how your investment is performing, you're still obligated to pay the interest on your loan. Investment leverage can be a powerful tool for accelerating investment growth. But be sure you understand and are comfortable with the potential downside before you decide to use this strategy.

Leveraged investing – keys to success

Leveraged investing involves more risk than traditional investing. There are a number of things you can do, however, to reduce the risk of this strategy:

1. Invest for the long term

The amount of risk involved decreases as your investment horizon (the length of time the money is invested) increases. This is because the return of stocks and stock-based investment funds can vary widely from year to year. But these fluctuations tend to even out over the longer term. Plan to borrow to invest for 10 years or more to reduce the impact of short-term market movements.

2. Commit to the strategy

Even for long-term investors, short-term market volatility carries the risk of emotional decision-making – i.e. selling at the first sign of trouble. Emotional decision-making can derail an investment strategy before it has time to work. Ensure that you are in this for the long term. Start your investment plan with the expectation that the value of your investment may rise in some years and may fall in others. Keeping your eyes on the long-term results will reduce the risk that you will get cold feet and lock in short-term losses.

3. Borrow less than you can afford

Since a long-term horizon is key to the success of this strategy, the last thing you want to worry about is being forced to cash out early because of an unforeseen change in your ability to make interest payments. Start by borrowing less than you can afford so that you can comfortably absorb the bumps that life may throw your way, without abandoning your investment strategy.

4. Consider a "no-margin-call" loan

When you take out an investment loan, the lending institution holds the investment you purchase for the loan. If the value of your investment falls below a predetermined level, you will be asked to make an additional deposit to the account. This is a margin call. Some investment loans offer a "no-margincall" feature (sometimes at a slightly higher interest rate). Unless you could easily come up with cash to cover a margin call, choose a loan with a no-margin-call feature.

5. Diversify your investments

Investing in a single investment or in a high-risk investment will increase your risk. While the goal of leverage is to accelerate investment growth, it works best with a diversified portfolio of long-term investments.

6. Make principal payments

If you're particularly concerned about the amount of risk involved, you can reduce the risk by repaying the loan gradually over time. This may reduce the magnification of potential losses but it may also reduce the magnification of potential gains.

> Investment leverage can be a powerful strategy for accelerating your investment growth and helping you achieve your financial goals sooner. While this strategy involves an increased level of risk, much of the risk could be reduced with careful planning.

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Is leverage right for *me*?

Leverage isn't right for everyone. The best way to decide if it's right for you is by discussing the strategy with your financial advisor.

Here are some of the things you need to ask yourself and discuss with your advisor:

Do I have a specific financial goal in mind? Ensure you have a specific goal you're trying to achieve before starting this (or any) investment strategy.

For how long am I planning to invest? Leverage may be appropriate if you have a long-term horizon of 10 years or more.

How much other debt am I carrying? Ensure you have your current debt load under control before assuming further debt through leverage. A good rule of thumb is that your total borrowing cost each month, including the interest you pay on an investment loan, should not exceed 35% of your before-tax income.

How stable is my income? A stable and predictable income stream will make it easier to make the required interest payments each month.

What is my tolerance for risk? Are you comfortable seeing the value of your investment move up and down? Are you comfortable with the possibility that leverage may not outperform traditional investing?

How do I get started?

If this sounds like a strategy that you might be interested in, speak to your financial advisor who can determine if it's right for you.

Manulife Bank Investment Loans

Manulife Bank's Investment Loan program allows you to access additional cash to invest. 100% Loans feature 100% financing, no risk of margin calls due to market volatility and interest-only[1] or principal and interest payments. You can also choose to repay part of or your entire loan at any time with no penalty. Multiplier loans feature a 3:1 loan-to-deposit ratio financing for more sophisticated investors who wish to borrow higher amounts. Speak to your advisor to determine which option is right for you.

[1]If you choose interest-only payments and the loan-to-value becomes higher than 125%, we may require you to change to principal and interest payments.

Important notes

Borrowing to invest may be appropriate only for investors with higher risk tolerance. You should be fully aware of the risks and benefits associated with investment loans because losses as well as gains may be magnified. Preferred candidates are those willing to invest for the long term and not averse to increased risk. The value of your investment will vary and is not guaranteed, however you must meet your loan and income tax obligations and repay the loan in full.

Please ensure you read the terms of your loan agreement and the investment details for important information. Manulife Bank of Canada solely acts in the capacity of lender and loan administrator and does not provide investment advice of any nature to individuals or advisors. The dealer and advisor are responsible for determining the appropriateness of investments for their clients and informing them of the risks associated with borrowing to invest.

About Manulife Bank

Manulife Bank is a wholly owned subsidiary of Manulife Financial, one of Canada's largest and most respected financial institutions. Established in 1993, Manulife Bank offers a broad range of innovative banking solutions and competitive rates across Canada.

We believe that effective management of savings and debt is essential to long-term financial success. By working with a financial advisor and incorporating our innovative, integrated banking solutions into your financial plan, you could make your money work harder, enjoy financial flexibility and become debt-free sooner.

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