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Insight

Don't Let Leverage Derail Your Investment Plan

-Stuart Birdt, CFA, Wealth Manager

When interest rates are low and markets are rising, one is tempted to increase portfolio returns through borrowing or leverage. One option is to take out a home equity loan and use the proceeds to invest in the stock market. Another is to use the stocks in a brokerage account as collateral for a margin loan.

In a rising market, leverage increases the return on a portfolio. Without leverage, if you invest $100,000 in the stock market which increases 10%, your portfolio will increase by 10%. At your tennis club your friend Norbert brags he can increase his portfolio's return through leverage. Norbert plans to invest a $100,000 inheritance in the stock market and take out a home equity loan for $100,000 at a 5% interest rate to enable him to invest a total of $200,000. If the market increases 10%, at the end of one year, Norbert's portfolio would be worth $220,000. He could pay back the $100,000 loan plus one year of interest of $5,000. This would leave him with $115,000, equivalent to a 15% pre-tax return.

This works great if the stock market goes up. But what happens if the stock market goes down by 20%?

Your $100,000 portfolio declines 20% to $80,000. As an experienced investor with a long-term time horizon, you believe in the long-term investment potential of stocks. As such, you maintain your portfolio after the 20% decline and the market increases 25% the following year, bringing your portfolio value back to $100,000. Although a zero return over two years, it is not a disaster. You remain confident your portfolio is well positioned to grow.

Norbert's $200,000 portfolio declines to $160,000, he pays back the $100,000 loan plus $5,000 in interest. He is left with $55,000, equivalent to a negative 45% return. Norbert sees his inheritance decline from $100,000 to $55,000 and gets nervous. After too many sleepless nights, he sells his $55,000 stock portfolio. As a result, he misses out on the following year's market recovery.

Although Norbert was not forced to sell his portfolio, the psychological impact of seeing his inheritance decline by 45% caused him to panic and get out of the market at the wrong time. With a less severe decline in your portfolio and fewer sleepless nights, you were able to stay committed to your long-term investment plan and benefit from the recovery in the market. Experience has shown that the psychological impact of large losses makes sticking with a long-term investment plan more difficult, which reduces the likelihood of reaching one's financial goals.

Over the next few years, Norbert saves $45,000. He now has $100,000 and decides it is time to get back into the market. Unfortunately, the value of his home has fallen so he is unable to take out another home equity loan. As an alternative, he sets up a margin line on his brokerage account.

His broker informs him that his $100,000 of cash combined with $100,000 of margin debt can be used to buy $200,000 of stock. As such, Norbert decides to invest a total of $200,000 in the market. The margin agreement discloses that if the portfolio value declines, he will be required to put up more collateral or else the broker will be forced to sell some of the portfolio and use the proceeds to reduce the margin debt.

Unfortunately, Norbert's market timing was poor and the market falls 20% causing his portfolio to decline to $160,000. As he expected this market correction to be short-lived and was confident in the long-term investment potential of his stock portfolio, he did not want to sell. Sadly, due to unforeseen medical expenses, he did not have any additional cash to put up as collateral. This forced his broker to sell $40,000 of stocks to pay down debt leaving him with a portfolio of $120,000 and margin debt of $60,000.

> *"The market can remain irrational longer than you can remain solvent."*
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> *-John Maynard Keynes*

Although Norbert did not panic and did not want to sell, the decline in the value of his portfolio forced his broker to sell in order to reduce margin debt. This deprived him of the opportunity to benefit from the market recovery a few months later. Norbert's use of leverage caused him to lose control over his investment decisions and portfolio. If he had not used margin, he would have remained in control.

Although leverage has the potential to increase returns during rising markets, it can be very destructive when markets decline either by causing one to panic and make emotional decisions or to lose control over investment decisions. Rather than try to increase portfolio returns through leverage, we recommend maintaining an appropriate long-term investment strategy and asset allocation plan that can perform during good markets and weather bad markets. This should help your portfolio achieve its objectives and allow you to remain solvent until the market becomes rational and to sleep better at night.