A GUIDE FOR INVESTORS

Borrowing to invest

Is it the right strategy for you?

OSC
ONTARIO SECURITIES COMMISSION

Contents

Borrowing to buy mutual funds or other investments can be an effective way to boost your potential returns, but it involves more risk than paying for an investment outright with cash.

Investing with borrowed money is also known as “leveraging”. As long as your investment increases at a rate that is higher than your borrowing costs, you can make money.

However, whether your investment makes money or not, you still have to pay back the loan plus interest. If you rely solely on your investment returns to cover your borrowing costs and your investment falls in value, you could end up defaulting on the loan.

Topping up your RRSP

Many investors borrow so they can make a larger contribution to their RRSP and get a bigger tax refund. A common strategy is to use the tax refund to pay off or pay down the loan to reduce the amount of interest payable.

If you don't pay the loan off as scheduled, you could end up paying more in interest than what you get back in a tax refund.

Using your home to buy investments

People who have built up equity or paid off their mortgage may be tempted to "unlock" some of this value by borrowing against their home and investing the money in mutual funds or stocks. They may refinance their existing mortgage, take out a new mortgage or get a line of credit secured by their home.

The hope is that the investment will not only cover the loan and related borrowing costs, but also generate extra income. The downside is that you could be putting your equity, and possibly your home, at risk.

The risks of borrowing against your home

Like many retired couples, John and Jane Smith have paid off their house, but are concerned about having enough income to cover their living expenses.

They decide to tap into the value of their home by taking out a new mortgage of $100,000 at 5% and putting the money in a mutual fund. Their goal is to make more than 5% on their investment—enough to cover the monthly mortgage payments and give them some extra income.

The Smiths invest in a mutual fund that has earned an average of 10% over the past five years. But instead of going up, the mutual fund falls in value. After one year, their investment is worth just $85,000. They were counting on this mutual fund to pay the mortgage and they have no other assets.

The Smiths are now faced with a tough choice: sell some of their investment at a loss to make the mortgage payments, or sell their house and hope that what they get will be enough to pay off the mortgage, pay the real estate commissions and provide for somewhere else to live. Either way, they run the risk of losing money—and their home.

Borrowing to invest can be an effective strategy, but it's not for everyone. The following are some things to consider before you take on this kind of debt.

Before you invest

Ask:

- Are you comfortable going into debt for an investment that may fluctuate in value?
- Can you afford to lose the collateral you put up for the loan? Any asset used as collateral, including your home, can be taken by the creditor to satisfy the loan.
- How will you pay for the mortgage or loan if your investment falls in value? Do you have a secure salary, a cash reserve or other sources of income?
- What are the terms for repaying the loan and interest?
- Are there any other fees associated with the loan?
- Are the investments you buy with borrowed money suitable for your goals and risk tolerance?
- What fees do you have to pay to buy, hold and sell these investments?
- What are the tax consequences? You may be able to deduct the interest you pay on money you borrow to invest, but any profit you realize may be taxed.

Make sure you:

- Take your time when making investment decisions. Never sign documents you have not read carefully.
- Don't invest in anything you don't fully understand. If you have any questions or concerns about borrowing to invest, get a second opinion from a financial adviser, lawyer or accountant.
- Contact the Ontario Securities Commission (OSC) at 1-877-785-1555, or go to checkbeforeyouinvest.ca, to find out if the person or firm offering you the investment is registered.

Contact the OSC

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