Borrowing against your home poses some risks

Possibility of financial disaster exists in attempts to expand personal net worth

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MONTREAL - U.S. housing foreclosures may spook some Canadian homeowners, but borrowing against your home to fund the purchase of market investments remains a potentially lucrative way to expand personal net worth over the long-term, advisers say.

But it's not for the faint of heart.

Along with the potential for great rewards is the possibility of disaster for those who aren't properly suited for the risks.

Leveraged borrowing to invest reflects the belief that in the long run a diversified portfolio of equities should outperform the cost of borrowing. As an added benefit, interest costs incurred are tax-deductible.

On a 25-year, $150,000 mortgage, this strategy could increase after-tax net worth by more than $75,000 compared to just paying down a mortgage, the Investors Group says of its home equity diversification plan.

Similar programs are offered across the country by various financial and lending institutions.

"It's really suitable for those that are investing for the long-term, a minimum of six years and are able to ride out market fluctuations," Jack Courtney, an assistant vice-president of the Winnipeg-based company, said in an interview.

The ideal candidate is an investor who is comfortable with risk, is in a high income tax bracket, is a long-term investor, and has a sustainable cash flow, he said.

With most share prices floundering, dollar cost averaging may make this an ideal time to invest.

"Over time, the return on equities and the reduced after-tax cost of borrowing from deductibility of the interest should improve your net worth over time versus just paying down your mortgage," Courtney said.

Since borrowing can magnify gains as well as losses, it's not for everyone, Courtney concedes.

Having a steady income with consistent cash flow is key. It's not for those who struggle to make their monthly mortgage payments.

Leveraged investors must have the stamina to weather short-term fluctuations in the market since much of the gains come at the end of the investment horizon.

Financial author Gordon Pape warns against leveraged borrowing.

"I see leveraging as the financial equivalent of a loaded gun," he wrote in his book Sleep-Easy Investing.

"People who are knowledgeable can use it effectively; everyone else will probably shoot themselves in the foot."

He said some financial advisers aggressively encourage clients to use leveraging because of the significant fees and commissions they earn.

Their arguments can be compelling in bull markets, when stock prices are soaring.

But as the Ontario Superior Court of Justice ruled in 2005, investors that borrow take a risk in addition to the investment risk.

The court rejected a lawsuit by 22 elderly investors who suffered heavy losses from leveraged investments who had claimed their advisers made "negligent representations."

"What all this boils down to is that if you decide to go into debt in order to get rich quick, you're on your own. The cavalry isn't going to charge in to save you if you run into trouble."

The Investment Funds Institute of Canada has warned that the practice of using borrowing to finance mutual fund purchases is on the rise and is potentially destabilizing for the mutual fund industry.

In a 2005 advisory, it offered several tips to investors, including the need to keep a sufficient financial cushion to see withstand market declines.

The Ontario Securities Commission published a booklet in 2006 warning that the downside of using a line of credit to invest is "that you could be putting your equity, and possibly your home, at risk."

Adrian Mastracci, portfolio manager of KCM Wealth Management, estimates that less than one quarter of homeowners with mortgages borrow on their equity, but mostly to purchase a second residence or fund renovations.

The strategy can be successful and boost an investor's net worth. But he cautions people to be careful.

"Just make sure you can protect yourself in the very worst situation," he said in an interview from Vancouver. "If you can do that, then borrowing for you is not as big a deal as it could be."

But if you would have a problem making a payment if the investment floundered, he said, investors should think twice about it.

"When everything is going positive, leverage is wonderful. However, when things turn against you then of course you get clobbered to death."

Since mortgage interest is not tax deductible in Canada, the best risk-free investment is paying off ones house, he said.