3 Rules to Follow When Borrowing to Invest

Description

There have been plenty of articles recently about an idea that many investors would find too risky. It involves borrowing money, often by using a house as collateral, and investing those funds in the stock market. Such a strategy can certainly enhance returns during the good times, and likely would have worked out very well over the past five years.

But at the same time, borrowing to invest can be extremely risky, especially if done improperly. Below are some rules you should follow before taking that leap.

1. Dividends are king

Short-term stock price movements are impossible to predict, and can move against you in a hurry. So when borrowing to invest, relying on capital gains is a dangerous game. A better alternative is to find dividend-paying stocks that yield enough to cover your interest payments. That way it becomes much easier to invest for the long term.

Otherwise it's best to keep borrowing to a minimum. Just remember what happened in 2008, when markets fell 50% before recovering. Some investors were squeezed into selling their leveraged investments after suffering big losses, and missed out on the rebound. You don't want to leave yourself vulnerable to this kind of scenario.

2. Don't get greedy

The whole point of dividend investing is to lower risk, not increase it. This is especially the case if you're buying stocks with borrowed money. For this very reason, it would be very dangerous to buy lower-quality companies in an effort to get a higher yield.

You would be much better off going for companies with a strong competitive position and stable earnings, such as **Bank of Nova Scotia** (TSX: BNS)(NYSE: BNS) or **TD Bank** (TSX: TD)(NYSE: TD). The two companies yield 4.0% and 3.7%, respectively.

Meanwhile, companies like **Torstar** (TSX: TS.B) and **AGF Management** (TSX: AGF.B) pay much higher-yielding dividends (8.1% and 8.8%, respectively), but both businesses are in decline, and pay out dividends that are higher than earnings. While either one could turn around, the dividend is not nearly as safe. So borrowing to invest in these companies is a very dangerous game.

3. Know your tax rates

In Canada, domestic dividends are subject to a gross-up of 38%, but then receive a federal tax credit of 15%. There is also a provincial tax credit, which varies by province. And the impact of these rates depends on your annual income. Meanwhile any interest you pay on an investment loan is tax-deductible – once again, how this affects you depends on your annual income.

Foolish bottom line
Even though borrowing rates remain low, now is not a great time for borrowing to invest. Equity markets have been on a wonderful run over the past five years, and are arguably due for a correction. Even worse, high dividends are difficult to find, and usually require taking substantial risk.

The phrase “if you don’t play, you can’t lose” isn’t heard very often. But in this context, it might be the best advice you can receive.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:BNS (The Bank of Nova Scotia)
2. NYSE:TD (The Toronto-Dominion Bank)
3. TSX:AGF.B (AGF Management Limited)
4. TSX:BNS (Bank Of Nova Scotia)
5. TSX:TD (The Toronto-Dominion Bank)
6. TSX:TS.B (Torstar)

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