3 Reasons Why Now Is the Time to Boost Your Returns With Margin Leverage

Description

I am not generally one to encourage taking on excessive leverage. This philosophy applies generally both to my personal life as well as my preferences in companies. But there are times when leverage can be used to your advantage. Right now, we have a perfect storm of interest rates and dividends that may help you to use leverage in a relatively safe and effective way.

With rates already on the way up, you may be wondering why now is such a great time to use leverage. After all, margin leverage is tied to the prime rate, which will go up with rising rates. While this is indeed true, there are a few reasons why now, even with higher rates, it might be a good time for you to use margin to increase your returns.

Rising rates are driving down dividend stock prices

Take a look at companies like **Enbridge** (TSX:ENB)(NYSE:ENB), **BCE** (TSX:BCE)(NYSE:BCE), and **Emera** (TSX:EMA). These companies' stock prices have been driven down significantly over the course of this year, driving yields higher. These companies pay dividends in excess of, or close to, 6% at current market prices. Their stock prices are also approaching or exceeding their 52-week lows, limiting further potential downside.

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If you can get margin at a rate of 5% or lower in your trading account, a rate that is very common in most accounts, at the moment, you will earn a free spread of 0.5-1% on the margin in your account. Over time, that cash will help you pay down the debt, leaving you with assets for which you did not have to pay a dime of your own money. Real estate investors use this strategy all the time.

Make sure the companies you buy are also dividend growers. Enbridge, BCE, and Emera have all grown their dividends consistently in the single- to double-digit percentages and are committed to continuing to do so for the foreseeable future. Enbridge alone has committed to increasing its payout by 10% annually at least until 2020.

Capital gains can speed the process

Don't forget that some of these companies may appreciate significantly in a short period of time. If one rises by 10-20% in a relatively short period of time, such as less than a year, you may want to lock in the capital gain instead of waiting on the dividend. At least you have the option to take the early payout and collect some dividends along the way.

GIC rates are rising

Now for the big caveat. Because of my conservative nature, I suggest that you use margin equal to the stocks you intend to buy. If you want to borrow $10,000 in a margin account, you should have $10,000 cash to back it up. Do not over-leverage.

So, what do you do with your cash that backs the margin purchases? I suggest a 20-80 ratio. Put 20%

of your cash in a liquid high-interest savings account. There are plenty of accounts that offer interest rates of 1.3-2%.

The remaining 80% should be put into a ladder of year-duration GICs. It is possible to find GIC offerings of 2.4% for a year, and those yields are rising with interest rates. The GICs serve two purposes. They allow you to squeeze a little extra yield out of your cash, but also keep you from laying your greedy, little paws on the cash protecting your leverage. The yield from this cash also goes straight to paying down your debt. That is an approximately 3% yield paying down your investment leverage.

The bottom line

With the current state of things, using leverage can significantly increase your returns over time. Your stocks can pay for themselves, with your cash sitting there in case of an emergency to pay down that debt if you have the need. But do not borrow more than you have and put yourself at risk. While this can be tempting, excessive leverage can destroy your account rather quickly.

Focus on stocks that have yields in excess of the margin interest rate and that grow over time. Choose companies that have long histories of steady business and dividend growth. And, if possible, use any large capital gains to pay down your debt as quickly as possible if you so choose.

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