

# PITFALLS OF LEVERAGING

## ADVISORS NEED TO LEARN FROM THE CONSEQUENCES OF MARKET HISTORY.

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This is the first of two parts

**T**he notion of borrowing money to invest likely isn't first and foremost on most people's minds in a down market. But I've come across yet another study touting the benefits of leveraging retirement savings.

The release of the June 2008 working paper, *Life-Cycle Investing and Leverage: Buying Stock on Margin Can Reduce Retirement Risk*, written by Ian Ayres and Barry Nalebuff, both from the Yale School of Management, claims that historically equities have returned about 9%, while the cost of margin was 5%; the difference of 4% is the equity premium and serves as the source of additional returns.

Ayres and Nalebuff then use Monte Carlo simulations to support their dubious claim that young people should borrow against their retirement savings to obtain better returns.

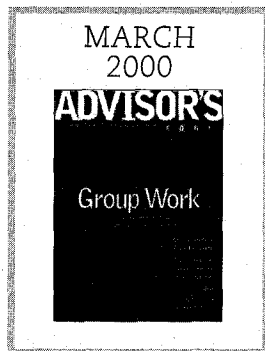
Recent business collapses prove academic theory doesn't always translate well into reality, but my main concern is to show how advisors can protect clients from bad bets using leveraging.

When we borrow money to invest, there are as many as six participants in this transaction:

- › The investor, or client;
- › The lender, be it a bank, brokerage or another financial institution;
- › The seller, the advisor or broker;
- › The dealer, the organization the advisor works for;
- › The manufacturer, the fund company; and
- › The overhead in the form of taxes.

When borrowed money supports investments that do well, everyone on this list wins. When things turn sour, only two participants lose. The first is the tax department (no gain, no tax). The second is the investor, your client. All other participants either still make money, or lose nothing. So the first question you should be asking is: Are you comfortable with this? The second is whether or not this strategy, based on market history, will really benefit your client.

When a client borrows to invest there's an implied declaration that either the client, or the advisor, is confident about beating the market. In order to appreciate **continued on page 24**



"Leverage: It Cuts Both Ways," page 53

