# Why do the wealthy borrow?

## So they can grow their wealth in strategically tax-efficient ways.

More than any other segment of the population, the wealthy understand the power of leverage in today's low interest rate environment. Ready access to cash allows investors to seize opportunities to make major purchases at discounted prices and to smooth out cash flow and handle emergencies without disrupting their portfolios.

In addition, in an era where increasing personal income and capital gains tax are anticipated, borrowing against a portfolio allows access to cash in a tax-efficient method. Capital gains are not triggered in order to access cash as they would be if the underlying appreciated investment asset itself was sold. In addition, borrowing can also be used for diversification purposes and to potentially enhance returns.

Two effective ways to borrow are a line of credit secured by an investment portfolio and margin loans against a brokerage account.

Before using debt, however, investors must carefully consider how much leverage they can comfortably take on, from both a balance sheet and cash flow perspective. The degree of volatility of their portfolio, cash flow and net worth, as well as overall liquidity and risk tolerance should also be factors in deciding whether — and how much — to borrow.

## Line of credit

For a fast and flexible source of funds, many investors choose to establish a line of credit secured by their marketable securities portfolio (sometimes called a "non-purpose line of credit" or "NPL"). This line of credit differs from conventional margin loans against a brokerage account by offering better pricing and better advance rates. While they can be used for nearly any purpose, regulations prohibit the use of an NPL for buying publicly-traded equities.

Wealthy clients are the most likely to maintain NPLs as a standby source of liquidity. Ready access to cash allows investors to seize opportunities and handle emergencies without disrupting their portfolios or triggering taxable events.

NPLs offer quick access to cash, making them a good source of bridge financing to facilitate the purchase of big-ticket items like real estate, artwork and aircraft before securing permanent financing. NPLs provide all the advantages of cash acquisitions — more favorable pricing and terms — while allowing investors to remain fully invested and not sacrificing potential portfolio appreciation.

NPLs provide a convenient, low-cost source of capital with rates that may be well below expected investment returns. In today's low interest rate environment, investors have an excellent opportunity to take advantage of this expected return differential. Interest rates tend to be far lower than for both HELOCs and margin loans — typically below Prime.

### Advantages of line of credit to smooth out cash flow

Many wealthy clients have incomes that are irregular, often in the form of lump-sum payments that are less frequent and reliable than those earned by salaried employees. Private equity investors, for example, typically receive periodic distributions. NPLs allow the wealthy to smooth out cash flow and meet short-term liquidity needs without being forced to sell at an inopportune time or incur the tax consequences that may arise from the sale of securities. They can be particularly useful for those who have a portfolio full of low-basis stocks or concentrated investment positions.

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### Use of NPLs for diversification

Another use of NPLs is for investors with concentrated investment positions. NPLs can provide an effective means of portfolio diversification. By leveraging the concentrated asset, investors can reinvest the proceeds into fixed income and/or alternative assets in order to diversify their holdings while slowly unwinding their concentrated positions over time.

### NPLs are easy to establish and implement

Unlike alternative sources of standby liquidity such as home equity lines of credit, NPLs can usually be set up quickly, with minimal paperwork and no closing or maintenance fees. What's more, advance rates are higher than margin, with investors generally able to borrow 65% to 85% of the market value of their portfolio, depending on the asset mix.

## Margin loans: optimal for buying publicly-traded equities

If the purpose of borrowing is to purchase publicly-traded stocks, then margin is the appropriate source of financing. When used prudently, margin can be an effective way to potentially enhance portfolio returns.

A margin line allows investors to borrow up to 50% against the value of marketable securities held in their investment portfolio. The line can be used for any purpose, including buying margin-eligible securities such as publicly-traded stocks and convertible bonds.

Bear in mind that leveraged investing can magnify both gains and losses. If the portfolio balance falls below a certain point, investors may be required to deposit additional funds or pay down their line of credit. Therefore, it's best to lower the overall volatility of the portfolio where possible. One way to keep volatility in check is to ensure that any purchased assets have low correlation with the current portfolio; the higher the correlation among assets within a portfolio, the more volatile the returns are likely to be. Ideally investors should choose assets that increase diversification and therefore lower the expected volatility of the overall portfolio. When considering leverage to help enhance portfolio returns, it's important that the expected return on the purchased assets exceeds the cost of the debt. Investors should not take outsized risk in pursuit of only moderately higher returns.

## Tax deductibility of interest

If used for investment purposes the interest paid may be used to offset investment income for tax purposes. For example, interest paid on debt used to invest in private equity or to purchase of investment real estate may be deductible. Interest paid may also be deductible as business interest if it is used for a business investment, or to fund capital needs. These tax advantages allow investors to enjoy potential returns that potentially far exceed the cost of borrowing.

Note that the amount of the investment interest expense that may be deducted when the loan proceeds are used to purchase investments is limited to the net investment income for the year. When the loan proceeds are used to meet business capital needs, the business expense deductions are limited to 30% of adjusted taxable income with an exception for small businesses and real estate companies.

## Bottom line

Whenever using leverage, there is a risk that the asset used as collateral will decline in value and the cost of borrowing could exceed the potential return of the acquired asset. While securities-based lines don't typically have fixed repayment schedules, investors may be required to deposit funds or pay down their line of credit if the value of their portfolio drops below a certain point. For that reason, it's important to keep leverage to a manageable amount and maintain sufficient liquidity elsewhere as a cushion.

However, the prudent use of debt can enhance an investor's wealth by allowing the investor to take advantage of opportunities. Work with an experienced lending professional to evaluate whether this option is right for you.

BMO Wealth Management