What is Investment Leverage?

Leverage is simply borrowing money to purchase investments with the goal of achieving greater wealth.

Investment leverage, simply put, is borrowing to invest. That is, it is using someone else's money to achieve your investment goals. Whether you know it or not, you may have already taken advantage of this strategy. For example, if you've had a mortgage, a student loan or an RRSP loan, you've used someone else's money to achieve your goal of home ownership, higher education or a more comfortable retirement.

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Now it's probably easy for you to see how a mortgage can help you achieve the goal of home ownership. However, it may be less clear how taking out a loan to buy an investment can help you achieve the goal of greater wealth.

How Does Investment Leverage Work?

With traditional investing, you set aside a portion of your income each month to purchase investments and your investments gradually grow over a long period of time. With leveraged investing, you take out a loan and make a single large investment purchase on day one. Then you set aside a portion of your income each month to make interest payments on the loan. The amount you pay for loan interest may be the same as the amount you would normally contribute to a traditional investment plan. But while your "out of pocket" costs may be the same under both strategies, leveraged investing has the potential to generate far greater returns. Here's why:

1. **Compound Returns:** Compound returns refers to the fact that investment growth accelerates over time as the growth from one year is added to your initial investment to create a larger investment that can grow the next year, and so on. The key to successful compounding is having the largest possible amount growing for the longest possible time.

While traditional investing benefits from compound returns, it fails to fully take advantage of them. Assume you have 15 years to invest and plan to make regular contributions each year. Only the contribution you make today will grow for the full 15 years. The contribution you make one year from now will only have 14 years to grow, and so on.

With leveraged investing, you contribute a much larger amount on day one and the whole amount can grow for the full amount of time, say 15 years. The effect of compound returns is much stronger with leverage, which can result in better investment results over the long term.

2. **Tax Deductibility**: Since the interest you pay on a loan reduces your investment return, it's important that you pay as little interest as possible. Luckily, the interest you pay on an investment loan is generally tax deductible. This reduces the overall cost of this strategy.

*Not all investments are tax deductible. Please review your situation with your tax professional.