Risk and the Retail Investor

What does risk mean to the average investor? For most of us, “risk” brings to mind two things: the likelihood of a loss and the size of that loss. In these times, when markets are down, some investors are considering borrowing money to invest.

When is it a good time to borrow to invest?

True, the markets are down but if we were to glance at a chart of either the TSX 60 or S&P 500 index from 2000-2003 or 2007-2009 you would see that either could drop and have dropped another 15% - 20% (or more) in short order from where they currently stand. Unfortunately, we cannot know what the low-point is until it has passed.

Who benefits from you borrowing to invest?

If you are a client of a financial advisor who recommends that you borrow to invest, ask yourself, “who stands to benefit?”

- You ***may*** benefit, but only if the investment rises in value by more than the interest rate on the loan and the fees you pay to invest this “new” money.
- The lender benefits to the extent of the interest on the loan.
- The advisor benefits from the fees on the added transactions that can now be made (now that there is additional money to invest) or the increase in the assets in the account (again now that there is additional money that is being invested).

The investors are the ones taking on the risk and the lender and advisor gains are a sure thing.

Is there another way?

Yes, and your advisor should bring these to your attention and provide you with a full analysis of their associated risks. One such example is leveraged ETFs (although if you don’t already know what these are, now is likely not the time to invest in them). Used correctly, they can reduce the interest cost (they borrow at a lower rate than you can) and investment risk (they can diversify better than you can, and at lower cost), but they are very, very risky.

Did your advisor recommend leverage, or borrowing to invest?

If your professional advisor recommends borrowing to invest, you should get a second opinion from another professional advisor. If your advisor recommended that you borrow to invest and you lost money as a result, then you should both seek a second opinion and consult a lawyer who is familiar with these types of cases.