Leverage, Baby!

It Might Seem Crazy, but There Has Never Been A Better Time For Disciplined Investors to Take on Debt to Boost Their Portfolios

By Jane Kim and Jeff Opdyke

Wall Street Journal
June 12, 2010

It would be the height of foolishness to load up on debt now, right?

Just look at the news these days. Homeowners are being foreclosed on at a record clip. Governments around the world are lurching toward insolvency. Job growth in the U.S. remains feeble at best. And at the center of the global economic storm are bad loans, which promise to weigh on consumers, businesses and governments for years if not decades to come.

And yet—and yet!—the cold clarity of financial analysis points to an inescapable conclusion: There has never been a better time for people to borrow money, whether to buy financial assets or boost cash reserves.

For sophisticated, disciplined investors who have lived and invested within their means—and perhaps decried the bailouts being lavished on those who haven't—this is your time to take advantage. Not only are interest rates just about as low as they can get, but future inflation could erode the paper value of loans, making debt even cheaper over the long run.

The first step involves making peace with the idea of taking on new debt at this perilous moment in global economic history.

It isn't an easy concept to embrace. While the inflation scenario seems likely over the long term, there is a small but growing chance that the global economy could suffer from the opposite problem, deflation. Japan could be the template for the kinds of problems facing the U.S. and other advanced economies: years of tepid growth and falling asset values and prices.

That would make new debt more expensive over time, not less so. It would also mean that the job market is headed for a longer slump than even the direst estimates now suggest.

Then again, the moments that seem the bleakest often turn out to be inflection points. Alan Greenspan has famously said that the worst of loans are made at the best of times. The opposite holds true as well.

Most important, "there's nothing inherently wrong with leverage," or borrowed money, says Christopher Jones, a New York financial planner working with high-net-worth clients. For people with the capacity to take on debt, who understand it and can tolerate the risk, "now is an ideal time to leverage cheap dollars to buy into areas that can produce much higher returns over the longer term," he says.

Mr. Jones is advising clients who can afford to pay cash for a home to take out a mortgage instead and invest the funds in a diversified portfolio. "If you look at where the market is now and where it could be five to 10 years from now, the return potential is significant," he says. Ideally, investors would want to borrow at rates below 5% and invest the money in a well-diversified portfolio aiming to return 8% a year over 10 to 15 years.

"You don't want to be borrowing money and going to Vegas with it," Mr. Jones says.

There are many ways to exploit leverage smartly right now, from simple and safe to complex and risky, on loans big and small, for consumers and investors alike. Here are a few.

MORTGAGES

Nationwide, loans on 30-year fixed-rate mortgages were about 4.9% on June 10, down from 5.3% in January and within a few hundredths of a percentage point of a 50-year low, according to HSH Associates, a financial publisher in Pompton Plains, N.J.

Moving out on the risk curve can yield even bigger savings. Amy and John Rydland of North Pole, Alaska, used a riskier adjustable-rate mortgage, or ARM, to upgrade to a bigger home in Colorado Springs, Colo., a city to which they are in the process of relocating. Last month, the Rydlands locked in a 3.875% rate with no points on a 5/5 ARM with Pentagon Federal Credit Union in Alexandria, Va., which serves military members.

But unlike typical ARMs, whose rates can reset every year, the Rylands' loan adjusts only every five years, with each adjustment capped at two percentage points and a lifetime cap of five points. The low rate "gave us more choices with the houses we had to choose from," says Ms. Rydland, a 41-year-old housewife with three kids whose husband, John, is a lieutenant colonel in the U.S. Air Force. "Being military, we don't stay in one place very long, but this is a move that we're hoping to maybe stay a little bit longer."

Ms. Rydland says she was careful to find a mortgage that would limit her interest rate risk. Because the mortgage has a lifetime cap, the highest her rate could jump would be 8.875%, and that couldn't happen for at least 15 years.

Wealthier homeowners also are getting a break on so-called jumbo mortgages—or first mortgages that exceed $417,000, the limit in most of the country for mortgages to qualify for government backing. Rates have been falling steadily in recent months after having jumped significantly during the financial crisis.

Average rates on 30-year jumbo loans are now 5.7%, compared with 6.14% in early January, says Keith Gumbinger of HSH Associates. "The competition is starting to show again," he says.

The savings can be significant: On a $500,000 30-year fixed-rate jumbo loan, a one-percentage-point decline in mortgage rates to 5.7% from 6.7% a year ago can cut $324 off the monthly payment, Mr. Gumbinger calculates.

INVESTING THE PROCEEDS

Wealthier investors who already have built up considerable equity in their homes might even consider—gasp—a cash-out refinance. Yes, this sort of behavior is what got so many people in trouble during the housing bubble. And, yes, leveraging a home to the hilt can be dangerous because if home prices continue to slide, you could owe more on the house than it is worth.

But people who have a potentially profitable use for that money—preferably an investment—could come out ahead using this strategy. A borrower who takes out a mortgage at 4.5% is essentially borrowing money for free on an after-tax, after-inflation basis, assuming he or she is in the 33% marginal tax bracket and inflation returns to its long-term average 3% or more, says Greg McBride, a senior financial analyst at Bankrate.com. "That's probably the best example of how those who are well positioned can utilize the low-rate environment and leverage up their financial return prospects," he says.

If that hypothetical investor were to take out a $400,000 loan at 4.5%, he would come out ahead if his portfolio makes more than 3.015% a year after taxes, says Terry Siman, a wealth adviser in Spring House, Pa. If you assume 2% a year is lost to taxes, such as capital gains, dividends and interest income, then the portfolio needs to return 5.015% annually to break even. "Anything better than that and you're in a winning situation," says Mr. Siman.

Skip Fiore is a Waretown, N.J., director of a digital print-manufacturing company nearing retirement who is looking to rebuild a nest egg devastated by the stock-market collapse. He has no mortgage on his $1 million home, so he is in the process of taking out a $300,000 mortgage at a fixed rate of 4.75%, and plans to use the money to invest in his portfolio. "Fundamentally, it was cheap money," he says. "And it was cheap money that could be used to supplement a depressed retirement portfolio."

The risk, of course, is that the investment returns will be lower than the new mortgage interest rate. Investing in bonds probably wouldn't make sense, says Mr. Jones, the financial planner, because Treasurys or high-quality corporate bonds aren't yielding enough to offset the cost of carrying the debt.

Also, investors who are borrowing against their home can't invest the money in municipal bonds and get both an interest-tax deduction for the home-equity loan and the tax-free income from the municipal bonds. "There's no double dipping," says Mr. Siman, who is working with Mr. Fiore to rebuild his nest egg.

Mr. Jones suggests using home-equity money only in a well-diversified equity portfolio split among U.S. and international markets.

Within the U.S. portion, he suggests buying equal amounts of U.S. large growth, U.S. large value, U.S. small growth and U.S. small-value and real-estate investment trusts. On the international side, he suggests equal helpings of large growth, large value, small growth, small value and emerging markets.

Marc Schindler, a certified financial planner in Bellaire, Texas, is encouraging clients to consider "pulling equity from their home with the idea they can invest and generate better returns."

MARGIN LOANS

Investors also can lever up their investment portfolio through a margin loan from a brokerage firm. These are loans in which investors buy stocks by borrowing up to 50% of the value of the securities in their brokerage portfolio. Margin balances at E*Trade Financial Corp., which charges between 3.9% and 8.1%, have jumped to about $4 billion at the end of the first quarter, from $2.44 billion a year earlier.

The money is getting cheaper: Fidelity Investments offers a rate of just 3.75% for margin loans over $500,000, down from 4% last year.

But be warned: Margin loans can be hard to understand. They also pose the risk of a "margin call." That is when the value of your holdings falls so far that the firm demands you raise the level of cash in the account.

A margin call can be particularly problematic on extremely volatile days like the "flash crash" session of May 6. If your account value falls far enough, fast enough, your brokerage firm could forcibly sell your shares to raise capital in the account, or require you to deposit money immediately.

CARS

Rates on auto loans are near all-time lows. Big banks, such as Bank of America Corp. and J.P. Morgan Chase & Co., are offering both new and used car loans with rates below 5%. Typically those types of rock-bottom rates are usually only offered by dealers or manufacturers' financing arms, says Bankrate.com's Mr. McBride.

Car makers have been emphasizing 0% and low-APR loans instead of cash-back incentives in recent months, prompted in part by Toyota Motor Co.'s big push in March to offer 0% financing, says Jessica Caldwell, senior analyst at Edmunds.com, who notes that average APRs in May were 4.65%, compared with 5.87% a year earlier.

Mr. Schindler, the Bellaire, Texas, planner, has gotten into the leverage game himself. Though he routinely pays cash for used, late-model high-end cars at as much as 50% off the original sticker price, he recently borrowed money to buy a new Honda Odyssey minivan for his wife because the 1.9% interest rate "is really cheap and lets me put my cash to work" in the markets.

CREDIT CARDS

Credit-card companies are still figuring out ways to get around new legislation that aims, among other things, to rein in abusive lending practices by forcing companies to limit their interest-rate increases on existing balances.

Meanwhile, issuers are quietly ramping up their 0% financing offers to woo new customers. Direct-mail offers to consumers are up 83% in the first quarter, according to Mintel Comperemedia, a market-research firm. Terms are getting longer, with an estimated 40% of offers during the second quarter promoting an introductory rate for balance transfers of 13 months or longer, up from 20% at the end of last year.

About six months ago, Richard Eisenberger of Lakewood, N.Y., took advantage of a 0% balance-transfer offer for 12 months and parked the borrowed funds in a savings account that now is yielding about 2%. While the 40-year-old information-technology professional says he isn't making much at current rates—probably a couple of hundred dollars—"I didn't have to do much for it."

Mr. Eisenberger, who doesn't have any other debt except for a mortgage, plans to pay off the balance in full at the end of the introductory period. "It works for me," he says. "I figured it's worth at least trying."