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Something borrowed

New stock-investment product appeals to high rollers – if they can stomach a loan with '80s-era interest rates

Commercial lawyer Eric Carmona understands the concepts of risk and leverage better than most investors. That's why he needed little convincing when his investment adviser came to him with a leveraged stock-investment program bred Down Under.

Pioneered and sold in Australia for more than a decade, the Equity Plus product from Macquarie Global Investments allows high net worth investors to borrow $100,000 or more to buy a basket of TSX 60 blue chip stocks or exchange traded funds. Any stock losses are covered by Macquarie, and the loan is tax deductible.

Macquarie charges interest on the loan - an average of about 15 per cent a year - and the investor keeps his or her returns. The benefit for Macquarie comes in the form of charging high interest - just how high depends on the risk of an investor's portfolio. In effect, the financial firm is placing its bets alongside those of its clients.

Investors typically need to be well off to buy into the product not because of any risk - Macquarie covers losses, after all - but because the loan is expensive and the tax benefits make sense only for those in the top tax bracket.

A big selling point is that investors do not need to put up the capital, just pay the interest on the loan.

Mr. Carmona, a lawyer at a well-known firm, took out a $250,000 loan from Macquarie to buy a basket of six stocks from a pool of nine securities that were suggested by Mike Newton, his adviser at Macquarie. In the end, he went with BCE Inc., Loblaw Cos. Ltd., Bank of Nova Scotia, Toronto-Dominion Bank, Teck Resources and Crescent Point Energy for the five year program, which he started three months ago.

"A couple of stocks were high on yield. Loblaw and Teck were lower yield, but I liked the growth potential there. The financials were both in around 3.6 [per cent]," said Mr. Carmona.

Macquarie's "get the gains, don't worry about the losers" program can take a bit of explaining even to sophisticated investors, but Mr. Carmona required little of that. "I'm a commercial real estate lawyer. I understand diversification and leverage. It was one of the prime attributes to which I was attracted, the leverage, and of course the backstop, the financial strength of Macquarie and the fact that they had launched this already in Australia."

While Mr. Carmona's loan with Macquarie carries a 1980s-era interest rate of 15.7 per cent, he calculates that the final cost will be only 5.73 per cent because of dividends he will receive from the stocks and the tax deductibility of the loan. He stressed that he is a conservative investor who was attracted to this investment because the leverage was covered by the downside program, and the interest payments are tax deductible.

John DeGoey, a certified financial planner and vice-president with Burgeonvest Bick Securities Ltd. of Toronto, is familiar with the Macquarie product because his firm is considering offering it to its clients. Mr. DeGoey views it as an option for about 30 per cent of his clients who fit the high net worth profile (earning more than $150,000 a year and maximizing their RRSP contributions), but he added that it has some significant caveats.

He estimates that an investor in the top tax bracket (46.4 per cent) needs the investment to grow by more than 8 per cent just to break even.

"It works, but the spread is not great," he said. "Eight per cent is doable. Historically returns on equities have been about seven per cent real, seven per cent above inflation."

He expects that he will advise clients to select securities carefully. "If you are going to hold these things for three or five years I think there is a better chance in participating on the upside if you are buying at a bit of a valley in the stock's mountain chart," he said.

Mr. DeGoey said that he has never recommended that clients borrow to invest but that he will if and when he begins offering the investment program.

There are plenty of variables to consider when picking securities for the product.

Clients can swing for the fences and pick just one or two stocks. Some investors have decided "to roll the dice with aggressive, non dividend-paying companies - after all, you have the protection," noted Mr. Newton. His preferred mix is "two value stocks, two higher-yielding blue chips and two more aggressive names," which is essentially what Mr. Carmona selected.

Stuart McClure, an Australian who moved to Canada just over a year ago to run Macquarie in Canada and launch the Equity Plus product as the firm's managing director, has found take-up is highest among people with a background in real estate investing. He calls the program "unique in the Canadian market."

Mr. Carmona, who is extremely optimistic about Equity Plus, has for his part refrained from touting it to his circle of friends and family with one notable exception. "I want my Mom and Dad to get into it."

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