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The Krygier Report

An exclusive newsletter from Mark J. Krygier, Senior Portfolio Manager | May 2024 www.krygierwealthmanagement.ca

Mark J. Krygier
Senior Portfolio Manager
& Wealth Advisor
416-733-5750
mark.krygier@rbc.com

Avital Pearlston
Associate Wealth Advisor
416-733-5751
avital.pearlston@rbc.com

Irene Hama
Associate
416-733-5752
irene.hama@rbc.com

Jacky Mai
Associate
416-733-5749
jacky.mai@rbc.com

Leverage – the good, the bad, and the ugly!

A few years ago, I started to consider how much money I will personally need in retirement, and I concluded that, in an increasingly more expensive world, it is pretty hard to have "too much" money set aside. After all, at the point in one's life when one is no longer earning an income, one's savings or investments will have to be sufficiently large enough to be able to provide an alternative source of income. Barring having such other sources it is quite clear that it will be impossible to maintain one's lifestyle in one's retirement years. For families that own rental properties or business interests that spin-off free cash flow, those can be a reliable source of income beyond one's earning years. For those few who work for companies that still provide a pension, that too can be a source of retirement income. So, I thought about how I can raise cheap capital to be able to invest, grow the capital over time, and eventually pay off that loan. The goal was to eventually have this paid-up pool of capital as a source from which I could draw income for myself in my eventual retirement. The most obvious choice as a source of cheap capital, as a homeowner in Toronto, was my own house. By virtue of simply owning property in Toronto, and not through any particularly brilliant investing strategy, every homeowner in Toronto is a "millionaire," or several times that number, depending on location. So, I proceeded to contact a banker and I set up a loan or "credit facility" against my house, and I borrowed capital at what were the ridiculously cheap interest rates available prior to the Covid crisis.

While some may view the idea of borrowing as "risky", those in the world of real estate and business know very well that without borrowing they would not have been able to turn the small amounts of capital they had personally generated into large amounts of capital. Like in every business, success when borrowing is found when creating a "positive spread" – the difference between the costs of borrowing and the return on the money invested. If one can borrow at 2% and earn 6% with that borrowed money, that positive spread is a winning formula. As long as the underlying investment maintains its value, and the debt can be paid off, the investor will earn a positive return. If the investment itself also grows in value, while the loan is being paid off, then the investor wins both by paying off the loan and thereby owning the capital outright, as well as by the increase in value of the underlying investment. I have had many clients over the years, who had bought a piece of property 20, 30 or 40 years ago at a low price and, after the debt used to purchase the property was paid off, used the investment property as a source of income. Eventually, unless the family is in the business of owning real estate, many of them forgo the nuisance of managing the properties and at the same time simplify their estate planning by selling the investment property at a healthy gain. So, with the thought that what is "good for the goose is good for the gander" I decided to join the party…

When borrowing, one ought to have an opinion as to the direction of interest rates, unless one can lock in the rate of borrowing for very lengthy periods of time. In the U.S. for instance, borrowers can lock in mortgage rates for as long as 30 years or more. Within that time frame one should be able to pay off most if not all of one's borrowed funds. However, in

Canada, one can generally lock in a mortgage to a maximum of five years. So, for Canadian investors, the risk of borrowing is amplified by the brief period for which one can lock in the rates of one's borrowed debt or "leverage". To make matters worse, historically for the past 30+ years, interest rates had been declining, so the prevailing mindset of mortgage holders was to hold "variable rate" mortgages to be able to take advantage of what were a declining interest rate environment. So how did my plan work out? In the first two years everything was going great. The investments (the same high yielding stock portfolios which I manage for clients requiring income) were rising, the income being produced from the investments was steady, and the debt was gradually being paid down – all according to plan!

That was then and this is now… in the spring of 2022, interest rates began to rise to counter inflation. Most economists suggested rates were being raised "too little and too late" as inflationary pressures in wages, goods and services were rapidly rising. While many assumed it would be a temporary measure to fight temporary inflation, I should have recalled the teachings of Dennis Gartman, a now retired portfolio strategist and former prolific investment newsletter writer, who often described the policies of the US. Central Bank (the "Fed") as always going too far in whichever direction they took. If they started to lower interest rates to stimulate the economy, they would lower them too far to the point where money was too easily available and encourage excessive risk-taking. On the other hand, when they raised rates, they would raise them too high to the point where they would crush borrowing and consumer spending. How prophetic were Mr. Gartman's statements! Today, rates have remained stubbornly high, which has negatively impacted borrowing, investing and consumer spending. In light of persistently high interest rates, investments which thrive on low rates have not fared well, including real estate and high-yielding stocks. If one is investing one's own capital, this means suffering with mediocre investment returns, but still maintaining steady income to support one's lifestyle. However, for those borrowing to invest, higher rates created "negative spread". So, what would you do? Last year I sold a portion of the investment, and recently I sold the rest of it, eked out a small profit and paid off the borrowed funds. Lesson learned, experience gained, and poised to do it all over again when the conditions are right.

Bottom line

Leverage is a double-edged sword! When rates are low, it can make a lot of sense to take some "risk" and borrow to invest, whether in stocks, real estate, or some other business opportunity. However, unless rates are in a secular decline, to make this successful one has to be sure to have a "positive spread" and to lock in the borrowing costs as long as possible. On the flip side, there is no need to be a "hero". When the facts change, so should your opinion!

Global benchmarks

As of April 30, 2024 (Canadian $ Returns – except where noted)

Asset class	YTD	1 year	3 years
S&P/TSX Composite T/R (Canada)	4.7%	8.7%	7.6%
S&P 500 TR - **US$**	6.0%	22.7%	8.1%
NASDAQ Composite - **US$**	4.3%	28.1%	3.9%
MSCI Europe Index Price Return	6.2%	6.3%	5.2%
MSCI Emerging Markets	6.3%	8.8%	-4.5%
China S.E Shanghai A Price Return	6.4%	-9.3%	-3.3%
MSCI World Index Price Return	8.5%	18.5%	8.0%

Asset class	YTD	1 year	3 years
30-year U.S. T-Bond - **US$**	-10.6%	-13.9%	-11.8%
10-year U.S. T-Bond - **US$**	-5.0%	-6.1%	-5.7%
Long GOC Bond (2053)	-11.9%	-11.8%	-8.4%
10-year GOC Bond	-4.7%	-4.6%	-3.5%
5-year GOC Bond	-2.0%	-0.8%	-1.8%
3-month CDN T-bill	1.7%	5.0%	2.6%
US$/CDN$ (1.3777)	4.0%	1.7%	3.9%

Source: RBC Capital Markets Quantitative Research

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