

Insights

Evaluating Leveraged Investments

In recent periods, the low cost of borrowing in many markets has led a number of investors to decide to leverage their assets. Borrowing at low rates to invest in an opportunity with high growth potential often leads to significant benefits in an up market although, conversely, it can also multiply losses and reduce an investor's ability to ride out a down market.

In general, the closer the investment's expected return is to the cost of funding, the less the incentive for investors to use leverage to increase performance. Conversely, the larger the difference, the greater the incentive is to use leverage.

However, this is a simplistic view that only tells part of the story because it ignores the extra risk the investor is taking on. The decision to use leverage should include an analysis of whether the anticipated extra return is worth the additional risk.

Analyzing Return Versus Risk

With your own leveraged investments, if the expected volatility (as measured by standard deviation) is determined as higher than the anticipated extra return, you might want to consider slowly paying off the loan and de-leveraging your position by reducing your investment holdings at a measured pace. If you do so, consider re-balancing your positions within a diversified asset allocation structure, and in a disciplined manner, with the help of your Private Banker and Investment Advisor.

However, if the investment's volatility is equal to, or lower than, the extra expected return, then the leveraged structure is advantageous, particularly if there is a strong expectation that interest rates will rise faster than the investment's expected return. In this scenario, the borrowing should be positioned over a longer time horizon.

Consider the Cost

What's the bottom line? Leveraging your investments — on the surface — might look like a sure-fire way to gain incremental return. However, a deeper analysis of the true cost, when you factor in risk, can help you make a better decision and one that may be more aligned with your goals.

Review Current Positions

During a time of significant market movements and rising interest rates, it may be worthwhile to review your leveraged positions. Contact your Private Banker who, together with your Investment Advisor, can conduct a review of your positions.

When considering leveraging your investments, keep in mind that there is a risk that a position may have to be closed if losses consume the margin.

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