Financial Leveraging and Wealth Creation

Other People's Money

Most people will have heard of the expression OPM. It's a commonly used abbreviation for the phrase, "Other People's Money." If you have ever had occasion to take out a loan from the bank then you have already had some experience and benefited from the use of someone else's money. OPM is the key ingredient when it comes to leveraged investing.

A bank is usually willing to lend out money as long as the borrower meets the bank's lending criteria and agrees to pay back the loan plus specific interest charges over a set period of time. A loan can be secured or unsecured depending on it's use, the size of the loan, and the banks assessment of the borrowers ability to repay the loan.

If a loan is being used to fund a private business venture it is called a business loan. When a loan is used to purchase a home or property it is called a mortgage loan. If a loan is used for investment purposes it is called an investment loan.

Business Loans

Business loans are used primarily to cover the capital cost of starting up new businesses. The loan might be used for the purchase of equipment or machinery, put toward leasehold improvements, the hiring and training of staff, paying for franchising fees, etc.

A business loan could also be used to purchase inventory and to maintain cash flows for companies during slower selling seasons. A lender will usually require a down payment of between 10% to 30% along with a detailed business plan before considering a loan application.

A business person who understands the concept of leveraging realizes that ten pairs of hands can accomplish much more than a single pair of hands. The employee working with two hands has limited earning potential while the business owner multiplies that earning power by hiring ten employees to help run the business. The business person has learned how to leverage both resources and manpower.

Mortgage Loans

A mortgage loan is only necessary if the buyer doesn't have enough cash to cover the full selling price. If the selling price happens to be $400,000 then the purchaser has 4 different options.

1.) Withdraw the $400,000 from a savings account and pay cash.

2.) Wait until there is enough money in the savings account and then pay cash.

3.) Convince a rich relative to purchase the property on their behalf.

4.) Give the bank a down payment and take out a mortgage for the remaining balance.

The first scenario is unlikely because the average Canadian doesn't have $400,000 sitting in a savings account. The second is just as unlikely because even if one managed to squirrel away $20,000 a year, it would take 20 years to come up with the $400,000.

If that same property was even listed on the market at that time it's value would have probably doubled to at least $800,000. And the rich relative scenario well……..if you have one then go for it.

The reality is that most Canadians are going to walk into a bank and apply for a mortgage loan. The bank will require a minimum down payment of 5%, so on a $400,000 property the buyer will need to come up with a minimum of $20,000 and the bank will finance the rest. In effect what the buyer is doing is leveraging the $20,000 into $400,000.

"Leverage by definition is using the proceeds of a loan to invest with the intent of earning a greater rate of return than the interest cost on the loan itself. "

If the real estate prices were to rise every year by an average rate of 7%, then in 10 years time the value of the property will have increased to **$786,860.**

At a 5% mortgage rate monthly payments on the property would be about $2200 per month, so the total cost of servicing the mortgage over 10 years would have been ($2200 X 12) x 10 = **$264,000.**

Lastly the amount left owing on the mortgage would be **$280,425.**

If the homeowner was to sell the property after the 10 years the following scenario would unfold.

	$786,860	New Appraised Value
subtract	**$264,000**	10 years of Mortgage Payments
subtract	**$280,425**	Outstanding Mortgage Balance
subtract	**$ 20,000**	Initial Down Payment
	$222,435	Total Capital Gain

That represents a **78%** return on the investment using other peoples' money and the power of leverage.

Investment Loans

The rationale behind an investment loan is really no different than for a mortgage loan. It provides the investor an opportunity to maximize profits by taking a small amount of money and leveraging it into a much larger amount of money. Let's take a look at an example of 2 different investment strategies:

1.) Mr. Smith withdraws $5000 out of his personal savings account and invests it in a mutual fund. He is hoping for a return of at least 10% on his investment and is willing to take some risk. He chooses an aggressive stock fund, the market does well and he realizes his gain of 10%.

$5000.00 invested with a 10% return =	**$5500**
subtract the initial investment	**- $5000**
Investor earns a profit of =	**$500**

2.) Mr. Jones decides to use OPM as his investment strategy and takes out an investment loan for $100,000. He calculates that the borrowing cost of the loan will be $4000. Because Mr. Jones is a much more conservative investor he wants to minimize his level of risk. So the investment he selects is a balanced growth segregated fund which earns him a modest return of 6%.

$100,000 investment loan earning 6% =	**$106,000**
subtract the initial investment	**- $100,000**
subtract the cost of borrowing	**- $4,000**
Investor earns a profit of =	**$2,000**

Conclusion:

Mr. Smith invested **$5000** of his own money in a riskier fund than Mr. Jones and made a profit of **$500.**

Mr. Jones spends **$4000** to leverage $100,000 at lesser risk than Mr. Smith and made a profit of **$2000.**

Mr. Jones realized an overall return of **400%** more than Mr. Smith.

That is the power of leveraging an investment by using other peoples money. Oh, and did we forget to mention that Mr. Jones can also write off the **$4000** cost of borrowing against personal income taxes? The **$4000** write off would reduce Mr. Jones income taxes in exactly the same way as if the $4000 was contributed to an RRSP!

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