Should You Borrow Money in Order to Invest?

The stock market keeps going up and anyone not invested is losing out. Right? We have commonly preached about having a cash reserve for living expenses and paying off credit cards before investing in the stock market. But interest rates are low and the S&P 500 gas gone up 70% in the last five years. If you simply traded on margin, bought an ETF that tracks the S&P 500 you would have paid around 8% a year on your investment capital. So, should you borrow money in order to invest in stocks? How about other investments like your home?

How to Borrow in Order to Invest

Canadian Business discusses **borrowing to invest**.

> *It's often said that fortunes are built with other people's money. Like many business clichés, there's a lot of truth to that maxim. There's nary an empire around that didn't get started with borrowed money. Individual investors can take the same approach. Borrowing money to invest, also known as margin or leveraged investing, is an increasingly common strategy in Canada. The appeal is that borrowing allows you to buy more securities than you'd otherwise be able to, magnifying your returns. The downside is just as obvious. If your investment goes south, not only could you lose your principal, but you'll end up owing more money on top of that.*

How does investing on margin work? *Investopedia* discusses **buying on margin**.

> *Buying on margin is borrowing money from a broker to purchase stock. You can think of it as a loan from your brokerage. Margin trading allows you to buy more stock than you'd be able to normally. To trade on margin, you need a margin account. This is different from a regular cash account, in which you trade using the money in the account. By law, your broker is required to obtain your signature to open a margin account. The margin account may be part of your standard account opening agreement or may be a completely separate agreement. An initial investment of at least $2,000 is required for a margin account, though some brokerages require more. This deposit is known as the minimum margin.*

So, should you borrow money in order to invest? The best time to get into the market is when it is going up and the worst time is just before it corrects, crashes or simply heads down. If you are going to borrow money to invest you need a clear plan of action. Successful investors use the concept of **intrinsic stock value** to determine if a stock is likely to be a winner or not. An investor investigates a stock to determine if it is likely to generate returns over the years and if its price reflects that promise. When a stock is underpriced compared to its intrinsic value the investor buys the stock. In this case it might be wise to borrow money in order to invest. However, the wise approach is to sell stocks after a run up in order to reduce or pay off the margin. Thus the remaining stock generates dividends and appreciation without causing you to pay interest on the outstanding margin. Over the long haul paying on margin costs around 8% so you need be invested during a strong market upswing in order for this to work.

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