When Does it Make Sense to Borrow for Investing?

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Is borrowing to invest ever a good idea - or is it insanely risky?

The answer depends on these factors:

- Investment returns
- Borrowing costs
- Risk tolerance

Some of us are well-positioned to borrow money to invest, while others should probably avoid this practice. Here's how to evaluate potential investments and sources of funds to make a smart decision.

See personal loan interest rates

Why Borrow for Investment?

Borrowing can increase your investment returns because you can apply leverage. "Leverage" is the ability to purchase a larger investment than you could by paying cash, and it allows you to potentially increase your earnings.

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For instance, suppose that you can buy $10,000 of stock by purchasing it outright. But by borrowing another $90,000, you'd control $100,000 of stock.

If you pay 4% to finance the $90,000 ($3,600) for a year, and your portfolio increases by 10% (to $110,000), you'll have earned $6,400, or 64%.

Instead, if you only invested your $10,000, you'd earn $1,000 (10%) during the same time period. The additional $5,400 in earnings illustrates the power of leverage.

Investment Returns

Individual investments can have wildly different returns, especially in the short term.

But you don't have to invest blindly. Analysts have tracked the average earnings of investments over the long term. Here are some of the most popular:

Investment Type	*Low ROI	*High ROI	Period
Rental Real Estate	8%	10%	Per Year
Stocks and Mutual Funds (S & P Index)	9.80%	9.80%	20 Years
Bond Funds (last 10 years)	5%	8%	10 Years
Certificates of Deposit (since 1990)	3.31%	3.31%	30 Years
Tax-exempt Municipal Bonds (since 1990)	5.66%	5.66%	30 Years

*Gross ROI, prior to taxes and expenses

Understand that, while average returns can be impressively high for many investments, you could lose money if you sell too soon. And you are more likely to have to cash out early when the economy is poor. It's easier to invest for the long term when you have enough emergency savings to get through the economic downturns.

You'll also want a mix of high-earning, riskier investments, and safer vehicles that deliver more consistent results.

Tax consequences

Finally, you'll factor in the effects of taxes on your returns. Depending on your income tax bracket, a tax-exempt investment can be the better choice even if its interest rate is lower. Check with your financial advisor about the tax consequences before buying.

2020 Tax Brackets and Federal Income Tax Rates

Borrowing Costs

An important factor in your return on investment, if you finance it, is interest rate.

Current interest rates impact the cost of your investment loan and also what you might earn in a no- to low-risk vehicle like a certificate of deposit (CD) or Treasury bond.

In general, the higher interest rates are, the larger the hurdle your investment must clear to make borrowing worthwhile.

In the 1980s, investors were getting on average 18.3% returns with CDs and 11.6% in the stock market - the safe CD investment outperformed stocks by a long shot.

If you can borrow cheaply, your chances of making money increase.

Tax consequences

When you calculate the cost of borrowing, you'll want to consider the tax consequences of that aspect too.

When you pay interest to finance an investment, it's often tax deductible (check again with your financial advisor).

There are limits to deductibility, however. You must itemize your tax deductions to take advantage of them, and you can only deduct investment loan expenses to the extent of your investment income - not against the ordinary income you earn from your job.

Risk Tolerance

The biggest drawback to financing your investments is that you may take on more risk than you expect, and it can cascade in spectacular fashion if your luck runs out.

Home equity financing, for example, is one of the cheapest ways to borrow for investment. But if you can't repay the loan, you could lose your home to foreclosure. If you can't pay off your credit card balance, your interest rate can easily eclipse the earnings of your investment.

When markets head south, leverage can be your worst enemy.

If you finance 90% of a $100,000 stock portfolio at 4% interest and put in $10,000 of your own money, look what happens if the price falls 10% during the next year:

Your stock is worth $90,000 and your entire $10,000 investment is wiped out - plus you paid $3,600 in financing costs at 4%.

You are now -$13,600 (-136%) after one year.

Had you purchased just $10,000 in stock without borrowing, you'd only have lost 10%, or $1,000.

Not everyone can weather a loss over the short term or wants to deal with the stress of monitoring a leveraged portfolio.

Low Risk Investments to Keep Your Money Safe

Types of Investment Loans

There are many ways to finance an investment. Here are some of the most popular.

(Interest rates shown are available to those with excellent credit as of this writing. If a type of investment loan could potentially work even for investors with fair credit, it's noted below.)

Personal loans (3.5% to 6.5%)

Personal loans are generally unsecured by collateral, which means the lender can't repossess any of your property if you fail to repay. If your credit score and borrower profile are excellent, you may qualify for interest rates that allow you to earn a good return on investment.

Home equity line of credit (2.5% to 5%)

Home equity lines of credit, or HELOCs, are mortgages. They are secured by real estate and very safe for lenders. Because of this, they carry some of the lowest financing costs.

These loans have variable interest rates, though, so your borrowing costs can rise over time. Because the lender can foreclose on your home if you default on a HELOC, your credit rating affects your interest rate less than it does with unsecured financing like personal loans.

Second mortgages, fixed rate (3.5% to 5%)

Home equity loans take longer and cost more to get then HELOCs, but their interest rates are fixed. They are a good option when you have good credit and want a lump sum with a fairly large loan amount. And because the loan is backed by real estate, you may be able to obtain a workable interest rate even if your credit is fair - as long as you have a lot of home equity.

Credit cards (0% to 13%)

Credit cards are unsecured, and the interest rate is highly dependent on your credit rating. In general, only an applicant with stellar credit seeking a low- to no-interest introductory rate could make credit cards work for financing investments.

The idea is to make your investment with a zero-interest credit card (this rate usually applies for six to 24 months) and cash out before the higher credit card interest kicks in. If your investment value falls, however, this strategy could backfire.

Margin account from brokerage (4% to 8%)

Margin accounts allow you to double your buying power. You get the financing from your stockbroker, so you can take care of your borrowing and your investing at the same time.

However, buying on margin can be tricky. Suppose that you purchase $10,000 of stock, $5,000 with cash and $5,000 on margin. If the stock value increases by $3,000 and it cost $400 to borrow, you make $2,600 on your $5,000 investment. That's a 52% return!

But what if your investment falls by $3,000?

The value of your stock drops from $5,000 to $2,000, and you owe $5,000 plus interest. When the value of margin accounts falls too low (brokerages often set limits at 30% of the purchase price), investors receive margin calls.

In this example, 30% of $10,000 is $3,000, and the value of the stock you own is just $2,000. So you'll get a margin call to deposit $1,000. If you don't, the brokerage can liquidate your stock. Your $10,000 stock purchase is worth only $7,000, and your ownership, once you pay the $400 in interest, is $1,600. Your loss is 68%.

Borrowing against a 401(k) account (0%)

If you have a 401(k) account, you might be tempted to take an investment loan against it. There are advantages, but the risks loom large:

First, you're borrowing from yourself, so the interest you pay goes to your own account. Your credit is not an issue when you borrow from yourself. However, using retirement money to leverage an investment purchase can put your future at risk.

Financing some or all of your investment purchase gets you the advantages and disadvantages of leverage. But using your 401(k) brings in additional risks:

- As long as you have an outstanding 401(k) loan, you cannot make contributions. The wealth management advantages of the 401(k) are off limits until you repay the loan. If your company matches contributions, you could be foregoing a lot of low-risk gains.
- If your investment funds, stocks or other vehicles fall in value, you may not be able to repay the 401(k) loan. If you leave or lose your job, the outstanding loan balance becomes taxable and probably subject to 10% penalty as well. If you're in the 25% bracket, you could pay 35% of the loan balance in tax and penalties. You'd have to generate an incredible rate of return on your investment to make up the cost of financing it.

How to Invest for Retirement With Mutual Funds

Who Shouldn't Borrow for Investment?

Borrowing to fund an investment is not right for everyone. If you are carrying high-interest debts, your best investment is paying them off.

Your credit card company might be charging you 30%. Paying that off is a risk-free way to "earn" 30%. Any investment with a possible 30% payoff is probably too risky for all but the most sophisticated and well-capitalized investor.

The other investor who should probably avoid borrowing is the investor who cannot afford to lose money. If your investment has to be successful in order for you to afford the loan against it, it's probably too risky for you.

There are safer ways to invest for those without high net worth or income (yet):

- Pay off high-interest debt first
- Establish an emergency fund (enough to cover two to six months of expenses)
- Fully fund your retirement account, especially if your company matches your contributions
- Choose an amount to invest for every paycheck into a portfolio of diversified funds. A good financial advisor can help you choose them, or subscribe to a service like Morningstar, which rates funds

The main thing to remember about investing is to do it regularly and to allow your investment to grow. Investment professionals like to say that time *in* the market is much more important than *timing* the market.

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