Smith Manoeuvre

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SPEAKERS
Sabiha Mukadam, Pat Bolland

Pat Bolland 00:05
For most Canadians, their biggest investment is their house. But what if you could use that biggest investment to fund your retirement? It's a kind of a strategy called the Smith Manoeuver, and we're going to discuss it with Sabiha Mukadam ... Sabia, a real pleasure to meet you.

Sabiha Mukadam 00:32
Hi, Pat. Nice to be on the podcast with you.

Pat Bolland 00:36
Sabia, you're a senior financial planner. It's interesting ... at Sage Collaborative Financial Planning ... and it's interesting. Frazier Smith is an actual individual. He was a financial planner, I think, on Vancouver Island, and he saw an advantage, if you will, that Americans had that Canadians don't have when it comes to their house and, in particular, their mortgages. What was he looking at?

Sabiha Mukadam 01:02
I think the way Fraser was thinking about it is like the Canadian homeowners can have an enormous amount of wealth just sitting in their homes, but and it's one of the biggest liability as well they have. But their mortgage interest was not deductible. U.S. people can deduct principal residence mortgage, but Canadians cannot. So he was looking at how can we make this work that we can use the Canadian tax rules and make the interest deductible, and also grow investments. So I think that was he was looking at. He was trying to gradually replace non-deductible mortgage with a deductible investment debt, and and the foundation is what the Smith Manoa is basically all about. You are just not making your existing mortgage deductible magically. You are paying it down and then borrowing it back, and changing the debt over time.

Pat Bolland 02:01
Yeah, but when I think of when I was growing up, for sure, and even until very recently, you were always taught to pay down your mortgage, pay down your home as fast as you could. But at the same

time, a lot of Canadians, myself included, said, "Hey, listen, if I'm paying down my mortgage, I'm not investing, and the retirement's standing still, if you will. What do you do to get around that?

Sabiha Mukadam 02:26
So, first of all, paying your mortgage down off is not a bad thing. The problem is when paying off your mortgage is just your entire financial plan. Like all your money is just going into paying down that mortgage. I've seen people do everything they thought they are supposed to do, work hard, make the extra mortgage payments, but they avoided investing because all they were trying to do is get rid of the debt first. And yeah, 2025 years later, they may have a million dollar home paid off, but very little investments outside. So on paper they are wealthy, and in reality they are cash poor. So I call them house rich cash per, like they have a big asset. But the and this is what I tell my clients: you cannot eat bricks and mortars. You need money, buy food. So the house rich cash per is a very common thing you get to see if you ever go to Toronto and all like $2 million homes, $3 million homes, but they're living on CPP and OS. No, so you can still live in a home and have a bigger nest egg to utilize it. That's what Smith Manoa actually helps you do. So when clients ask me, should I pay down my mortgage or should I invest? I say you can do both if you actually bring in a strategy where you actually pay down your mortgage, which is a non-deductible debt, borrow money, which becomes a deductible debt, and invest it at the same time.

Pat Bolland 03:50
Okay, now you're starting to get more complicated. Let's go through a very simple exercise, if you will, and and I'm going to use a million dollars. I mean, the average house in Canada is probably closer to half a million. But let's use a million-dollar home as an example of how you use this smooth maneuver. And a million dollars is just to make the numbers easy.

Sabiha Mukadam 04:12
Yeah. So let's assume you have a million-dollar home. The max you can, in Canada, the max you can qualify for borrowing on that home, depending on, of course, income and everything is 800,000. That's the max borrowing you can do. Let's say you did buy the home for million dollars, put a down payment of 200, and your mortgage to start with was 800 ... $800,000. Now you're paying down that mortgage every month. So when you're making the payment, your normal payment probably is, I would assume about $6000 to $7000 right now at today's rates. Now, when you're making that $7,000 payment monthly, you're paying about 60% of it is interest. So let's say from 7000 $5,000 or 440-500 is interest, and you're paying down to. $2,500 of principal. Now the product you need for this is a readvanceable mortgage product. Any readvanceable mortgage, simple readvanceable mortgage, can work for this. So when you make that mortgage payment, your mortgage goes down by 2500, and there's available room so in the associated credit line of 2500. So that 2500, which becomes available, you can take that money out of the credit line and put it into an investment. So what you borrow from the credit line is a deductible debt now. And then next month the same thing happens. So every time you make a mortgage payment, there's 2500 becoming available in the credit line, and you can like obviously there's a little bit more mechanics to it, but this is like a simple example. You can take the whole 2500 and invest it.

Pat Bolland 05:49

Okay, I get it. So you're not really yeah you're paying down your principal on your mortgage, but at the same time you're taking out more loans, aren't you? Yeah.

Sabiha Mukadam 06:02
So what is happening is your personal mortgage is shrinking, your investment loan is increasing, and your investment portfolio is growing.

Pat Bolland 06:10
Oh, okay. So that loan is critical. So how do you fund that loan? How do you get that extra loan on the 2500 we're talking about?

Sabiha Mukadam 06:19
So that's already available. So when you go for a readvanceable mortgage, it is like a total limit. They'll give you a total limit. So a readvanceable mortgage would be a total limit, and that will have a mortgage component and then HELOC component. It's called a credit line. People know it very commonly by HELOC. So for a classic Smith Manure, we use a read advancable mortgage, which has these two components: a credit line and a mortgage. The mortgage starts with the maximum number, 800,000, and it keeps going down slowly. By the $2,500 a month, you're making a principal payment. Smith Manure strategy then goes in and borrows that $2,500 every month to invest. So, overall limit always is the same. What is changing is from deductible to non-deduct. Non-deductible is going down. Deductible is going up.

Pat Bolland 07:10
Right. So it's still 800,000 in debt, but the debt is part mortgage, part HELOC, as you say. So does the bank provide me that HELOC?

Sabiha Mukadam 07:19
Yes, it is automatically provided when you go for that product, readvanceable mortgage product.

Pat Bolland 07:26
Okay, so now I've got this HELOC in place. What do I do with it?

Sabiha Mukadam 07:30
iWhat you do with it is you is so, math usually comes in here, whatever becomes available, you have two options. You can take the whole thing and start investing, but the way we want to run the Smith Manoa strategy is it should be cashless for your actual cash flow, like no burden on your actual cash flow. The only thing you need to do is make your mortgage payment. That's the only cash flow line you need to worry about. So, how do we make this so that we don't have to borrow more money or use more money from your cash flow? Simply, we have $2500 available. Instead of taking the whole 2500 and starting investing every month under two 500, I will go with 2200 a month. I will take 2200 from the credit line and start investing it into the investment account. That leaves with that $300 because you need to pay interest on this credit line as well. So you are going to borrow from the credit line to make the interest payment as well. We we use the same money to invest and pay the debt interest as well.

Pat Bolland 07:31
Okay, so let's go back to basics again. So we got an $800,000 loan, part of its mortgage, part of its HELOC. But of the HELOC of that loan, we don't use the whole of the loan. We use enough to invest, but we also need to save and put some aside to pay the interest on the loan, right? Yeah. So we leave some room available in the. So it's called the capitalization strategy. So we take 2200 invested. So next month, standard HELOC is prime plus point five. So let's say it's 4.95% right now. So 20 we borrowed to 2200. We are going to pay $25 of interest on that next month. So basically, you borrow 25, take 25 out, put it into a bank account, and bank goes and takes that interest and pays. So then, for next month, your total borrowing is 2200 plus another 2200 plus 25. So 4425. So your next month's interest is going to be say about $32. You borrow this, so like that's how it goes like a snowball effect. And the reason we leave that $300 buffer is like you don't have to make changes very often as to what is going in investment and what is staying in the account because this this can go for like 18 months. To two years without making any changes. Then, when you hit that mark where there's not enough available in the credit line to cover it, we can then go switch. Okay, instead of 2200, now let's just do a $2,000 investment.

Sabiha Mukadam 08:22
Yeah. So we leave some room available in the. So it's called the capitalization strategy. So we take 2200 invested. So next month, standard HELOC is prime plus point five. So let's say it's 4.95% right now. So we borrowed to 2200. We are going to pay $25 of interest on that next month. So basically, you borrow 25, take 25 out, put it into a bank account, and bank goes and takes that interest and pays. So then, for next month, your total borrowing is 2200 plus another 2200 plus 25. So 4425. So your next month's interest is going to be say about $32. You borrow this, so like that's how it goes like a snowball effect. And the reason we leave that $300 buffer is like you don't have to make changes very often as to what is going in investment and what is staying in the account because this this can go for like 18 months to two years without making any changes. Then, when you hit that mark where there's not enough available in the credit line to cover it, we can then go switch. Okay, instead of 2200, now let's just do a $2,000 investment.

Pat Bolland 10:12
Right,

Sabiha Mukadam 10:13
And that's how it rolls.

Pat Bolland 10:14
I got it. I got it. I see how that works. But what? Okay, so now what do I do with the? Now I've got the loan. I've got the HELOC set up. I've got a way to pay the interest on that, but what do I do with it? How do I invest it? What's the best way to invest it so I'm making money for my ... Because the whole plan is to have more money for your retirement.

Sabiha Mukadam 10:32
Yeah. So that is the most critical part of Smith Manure investments. Like the two major benefits of Smith Manure is growing wealth, and growing wealth means you have to make sure it is growing at the rate

more than what you're borrowing it at. Right. So let's say I'm borrowing at I'm borrowing money at 5% I cannot put it in an investment which is only going to give me 4% return. So I have to choose an investment which is going to be giving me more than what I'm borrowing. Usually, Smith Manoeuvre works really well when you have equity investments, so growth style investments. You could use a growth fund or just invest in any kind of equity investments, ETFs, mutual funds, whatever whatever your style of investing is, what you like investing. But try and make it equity because Smith Manoeurve is also not a short-term strategy. If you if you do simple Smith Manoeuvre, simple Smith Manoeuvre, it's a 25-year strategy because your mortgage is going to take 25 years to pay it off, right? So your borrowing should be right. So it's a 25-year strategy at least to start with, even if you're doing it the simplest way of doing it. So you have a long time on horizon. So going growth really is the best way to do it. Also, it is usually a retirement strategy, supplementing your retirement income. So you have the time frame, you have the risk appetite. So going through equities makes it the best form. You make the most out of it. That's one benefit. The other benefit, obviously, is the tax benefit you get from the strategy. So there are two different benefits you get. So usually, when people are talking to me and they are very new to Smith Manoeuvre, they're like, "Oh, so I'm borrowing at four or 5% and I'm getting 7% Not big of a deal, right? I'm like, "Your actual cost is not 5% because all the interest you pay is tax deductible. So for simple question, if I am paying total $10,000 in interest on that investment side of the credit line, that 10,000 is directly deductible from my income. So if my tax bracket is 30% I will get 30% in refunds, so $3,000 in refunds for that 10,000. If I net it off, I didn't pay $10,000 in interest. I only paid $7,000 in interest. So, at a 30% or a 40% tax bracket, my interest cost was not 5% it was only three and a half percent.

Pat Bolland 12:59
Okay.

Sabiha Mukadam 13:00
So now the difference is quite large.

Pat Bolland 13:04
Yeah, it adds up over time. Okay, I'm getting the picture now. So I have a couple of questions. First off, you're investing. You're hoping to get more than 5% and equity returns have averaged somewhere between eight and 10% over the last few decades. So I see how that works. But stock markets can go down. What happens if the investment you make, and even if it's a broad equity fund of some descript, what happens if that investment goes down?

Sabiha Mukadam 13:32
Now, even if it goes down, the main question to ask is, and this is true for all the kind of investment, but for especially for Smith Manoeuvre, if I have invested, let's say by the time you invest $200,000, and you know the it probably has grown. Say 10 years from now, it probably has grown, and it's at half a million dollars. So investment going down, how much down is it? 30% 40% 50% If I borrowed 200. My investments are down 50% I still have $250,000 in that investment account, but net net, I'm not at a loss one layer. The actual debt is on the house, not on the investment, right? So my house is still there. My house value is still there. If I have to sell and pay off the debt, I'm still going to be able to do it, so I see this. I call this when I'm explaining Smith-Manoeuvre as you have one debt and two assets. One

debt is that credit line, and the two assets against it is the house itself, which is appreciating in value at three to 4% a year, and the investments. So when I add it all together. I'm never going to be at a stage where I'm going to be at a loss. Secondly, the investment going 50% down. What do I need from that investment? I'm like, if I'm in the middle of my accumulation stage, I'm not even touching that money. It's just going to stay invested. So yes, it's down right now. But eventually, it's going to come back up and go back, keep going back up. So, it's the discipline, like

Pat Bolland 15:06
Right.

Sabiha Mukadam 15:07
Discipline is very important here.

Pat Bolland 15:09
Yeah, obviously, and time. But the other question I had is, with those investments, could I put those into, for instance, a self-directed RSP and get that deduction as well.

Sabiha Mukadam 15:22
No, so that's the big CRA. The biggest thing about Smith Manoa is making sure you keep clean records. So money borrowed can only be invested in a non-registered portfolio. It cannot be put into any kind of registered portfolio because then it is double dipping, right? You're already getting the tax benefit for RSP or TFSA, and then on top of that, you want deductions as well. So no, that's a big no-no.

Pat Bolland 15:50
I I had to try. I had to try.

Sabiha Mukadam 15:51
That's a big no-no. It's a leverage investment has to go in a non-registered account.

Pat Bolland 15:57
Okay, so then down the road, how does this all unwind? Or if I move, like what happens to this investment if things change?

Sabiha Mukadam 16:06
You can absolutely do the move, no problem. So there are different ways of looking at it. So if you move from a small home to a bigger home, and you have, let's say you you we were good and we did a lot of different strategies and we completely made your home totally deductible, not proud. You still have a mortgage on it. You can sell the property, take the equity out, the mortgage which was already on there. You can just take that portion and move it on your new home. So you know, like say you had a million dollar home and now you bought a $1.5 million home. You had an 800 original mortgage, which is all you know, non converted completely from deductible to non deduct, like non deductible to deductible. So now you have $800,000 mortgage which is deductible. You sell the house, you sell it, let's say for 1.2, you have 400,000. Take that 400,000, buy the new $1.5 million home. Now your mortgage on this

new $1.5 million home is 900,800. was already paid off, so you just move that 800 as is as a deductible mortgage because you already have the investments against this. Your new additional mortgage will be a separate $100,000 mortgage, which is non-deductible, and that's how you run it. So you're still the same. You have a paid off 800,000 mortgage, which is deductible, and a new 100,000 non-deductible mortgage.

Pat Bolland 17:28
Wow, cool. Okay, it sounds a little bit complicated. Number one, and it looks as though, or it sounds as though, it takes time. Who should move into this? Who should consider this? And who should avoid it?

Sabiha Mukadam 17:43
I think when the avoidance comes with people who are not comfortable with debt itself, because there are a lot of people who just find debt very, very stressful. Any kind of debt that basically is a no-no. Someone who borrows money and invests conservatively definitely a no-no. Like if you are not going to be able to take the equity style of investing or a growth style of investing, it's probably not going to, you know, give you the same benefit in the long run. So definitely no-no. Someone who watches the investment markets volatility quite a lot and panics when the markets go down. No, you need to have the steady behavior of markets will go up and down. It will come back up. I'm not going to make any decisions right now, like sell when it's down and buy when it's high. Definitely no, no. This is more for someone who is comfortable with debt, is comfortable with having growth style equities, does not watch the markets like a hawk, and is comfortable managing the downs and ups of the market. So these are the three major pluses and minuses. One of the things that people tend to forget, a lot of people do Smith Manu on their own, and I have seen this when clients come to me. The major time they goof up or make errors is not keeping clean records of it. So that is a big thing in Smith Manoa, and a lot of times people can do all this. They can invest, they can keep, but when CRA comes knocking on their door and asks them to show me proof that this is invested money from borrowed money, and if they are not able to give them the clean records, they could, especially for tax, all the deductions they had claimed could go away. So, keeping clean records is also one of the biggest things about Smith Manoa.

Pat Bolland 19:39
How many people actually do this, and and what happens if the rules on mortgages change?

Sabiha Mukadam 19:48
How many people do it? Like I, I don't have a Canadian stat, but I think it's becoming more and more common, especially because people are realizing that the houses are getting more and more expensive and. The only way to make investments for retirement would be using the equity in the home. In our portfolio itself, like we are known for Smith Manoeuvre, a lot of clients just come to us for Smith Manoeuvre. So leverage investing. I think we have 70 to 80% of our clients do leverage investing. That's what they come to us for mostly. Long term horizon is very big on it, and the younger you start, the more money you make. I have seen some of my clients come to me five, six years, and markets have done really well in the last seven to eight years time frame. So that is one of the bigger factor. Like they come to me and they say we are never going to sell this home. This is my forever home, 1.5 million dollar home. Then they have kids and stuff, and then, like from a 1.5 million dollar home, they go to a 2.5 million dollar home, which they would never have been able to afford the down payment on if

we would not have done Smith Manoeuvre strategy for them, because then they can liquidate some of the investments when they sell the home, pick a bigger down payment on the new home, buy the home, and still be not be like you know bigger mortgage. Like they still be at the same mortgage level. So from a strategy perspective, that is becoming common as well. I see that coming up. I think there's no specific age for Smith Manoeuvre. I can tell you that as well. I have older clients who start Smith Manoeuvre later on in life. Their goal is not to grow wealth for themselves. Sometimes it's an estate plan. Their goal is to grow wealth for the next generation, and you know all their liquid cash is used for their lifestyle. So they want to. The only big asset they have is the house. So this way they grow their estate bigger by borrowing money and investing it. Then there's a estate, real estate, and an investment portfolio at the end of their life to leave it as an estate. So like I don't know. Can I say, oh, you can't do this after this age, or you can't do this after this age. It's not true. It depends on what you want the money to do for you.

Pat Bolland 24:02
Sabia, very interesting. Thank you so much for your time in explaining it.

Sabiha Mukadam 24:09
You're welcome. You're welcome.

Pat Bolland 24:10
Sabia Mukadam is the senior financial planner at Sage Collaborative Financial Planning.