Khaleej Times

Should you borrow money to invest?

Suneeti Ahuja Kohli /Dubai

Should you borrow money to invest? While this may go against the grain of established financial wisdom suggesting that debt is usually bad, some people are keen on using it to create wealth.

Dave R., for instance, made some intellectually rational arguments at the start of this year to gain from low interest rates and use debt to create wealth. He reverse-mortgaged his fully paid house and invested some $200,000 in Bitcoin.

The price of the cryptocurrency has since plummeted to almost half — from the highs of $58,000 to around $34,000 now.

“I lost my job in March this year and have been unemployed since then. I have a bit of cash reserve to sustain myself and service my bank commitments for at least six months, but I understand that if I don’t secure a job by September this year, this bet can go horribly wrong,” said Dave.

The lure of low interest rates

Generally, it is better to invest in US dollar assets if the investor is taking a loan from the UAE, said Vijay Valecha, chief investment officer at Century Financial.

"Interest rates in the UAE are low since the currency is pegged to the US dollar, and many might be tempted to take a loan from here and invest in high-yielding assets back home. However, practically, it is a dangerous strategy," he warned.

Investors taking a UAE dirham loan and investing in another currency asset should remember that they are selling US dollar and buying another currency. Therefore, investing in the same currency of the loan will help reduce exchange risk.

Nevertheless, there are a lot of risks with this strategy. Investors who are at the risk of a liquidity crunch should never take leverage.

Investing in home countries

This is not a great idea, Valecha said. "The UAE dirham is pegged against the dollar, so from a currency perspective, the loan's dollar value will be stable. This is not true of emerging markets. If their currency depreciates, the value of the asset bought with a loan comes down. This doesn't make economic sense. This is especially true in the current scenario where the US Federal Reserve is withdrawing monetary stimulus and is forecast to raise interest rate in 2023. These developments are likely to lead to a strong US dollar, and it is not advisable to invest in EM assets with a UAE loan."

Vishal Dhawan, CEO of Plan Ahead, added: "Leverage helps when returns from assets are headed upwards but can significantly work against you when asset prices correct, as one has seen at multiple points in the past. In addition, when you are investing in a different currency from the currency you are borrowing in, you could also be exposed to the risk of currency movements working against you. Therefore, it is ideal to avoid using leverage to invest."

Leverage doesn't only help you on the way up but it certainly compounds pain on the way down.

"Using personal loans in a situation where job uncertainty is high needs to be avoided as there is the additional risk of a loan needing to be repaid against an asset that may have seen a price correction. We need to remember that very often, at times of major asset corrections, job uncertainty also gets heightened," Dhawan said.

How to assess risk

Personal debt is a very real source of stress, and if not managed well, it could spiral out of control. One of the best ways to gauge your repaying ability is to take a stress test — something on the lines of a Bank Stress Test.

A bank stress test is an analysis conducted under hypothetical scenarios to determine whether a bank has enough capital to withstand a negative economic shock.

At an individual level, it could mean assessing your capacity to repay or honour financial commitments in case of a job loss or decrease in income level. If you can continue to service your loan with ease if the costs were doubled or tripled, then you are probably fine. But if the doubling of your debt service cost would cause you hardships then you got to be cautious.

Piling on more debt to build assets can leave vulnerable to several shocks, interest rates, and dropping incomes.

"Understand the characteristics of the asset class you are investing in, for example, equity as an asset class generates returns over longer periods of time and therefore using short term upward movements to invest may expose you to a recency bias that can create damage to your financial health. Also, borrow only if you have surpluses available to repay if your investments don't work in the way that you had planned, and do not have to sell in panic just to repay the loan," Dhawan said.

TAKE NOTE

Debt is no shortcut to wealth and should not be seen as one. Yet, we are taking on more and more at a fast pace through loans, credit cards, phone contracts, buy now pay later schemes, and in many cases personal loans for investments in stocks or real estate.

Dealing with the fallout on debt can be very challenging. So even if lenders are prepared to offer you more money, it doesn't mean you should take it. Stay clear of excessive leverage.