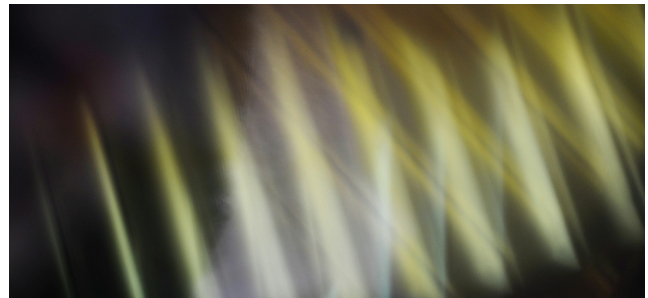


# Strategic: Optimize your leverage

## Optimize your leverage

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**Why?** 1) Borrowing strategies can mitigate tax drags, potentially improve returns, and enhance diversification when carefully managed. 2) Some borrowing capacity can be reserved to build resilience against emergency situations, including market downturns, without locking in losses. 3) The unique risks of borrowing, including the potential requirement to sell assets to meet a margin call or repay debt, should be carefully managed as part of a well-diversified investment approach.



Source: Liana S\_Unsplash

Borrowing is risky, but we believe that proactive, prudent, and strategic borrowing can enhance an investor's financial plan. Investors may be initially more reluctant to look at lending given the repricing in both interest rate expectations and government bond yields on fears that the Iran war and reduced oil supply may push up inflation.

While we believe long-dated bonds may remain vulnerable to further rises given long-term fiscal sustainability concerns, our sense is that the direction of travel for short-dated debt is for lower yields. We expect high-quality bond yields and US interest rates to fall toward the end of 2026 and into early 2027, especially as US growth and labor market activity moderate. If volatility picks up again on a prolonged Middle East conflict, borrowing to fund short-term investment or spending while letting asset prices recover may be a preferable strategy to selling assets at a loss, subject to careful consideration of the risks and one's own financial plan.

Borrowing can help with:

- **Managing liquidity:** A flexible line of credit can provide immediate access to funds without the need to sell assets, reducing the necessity of holding excess cash, money-market funds, or fixed-term deposits. This may be beneficial for handling tax bills, capital calls, or retaining the flexibility to make larger investments. If an investor needs funds but finds a part of the portfolio has sustained losses, it may be more prudent to borrow against a more resilient part of one's holdings, than to sell the assets whose price has fallen and lock in losses.

- **Improving diversification:** Borrowing against existing assets to invest in less correlated assets may help smooth portfolio fluctuations and broaden return sources, with future cash flows used to gradually reduce debt.
- **Currency management:** Borrowing in foreign currencies can help manage exchange rate risks associated with future foreign income and offer additional funds for domestic investments. It may also be more cost-effective to borrow in a foreign currency with a lower funding cost. However, this approach requires careful risk management, including tools to limit adverse impacts from an appreciation in the funding currency. Borrowing in a foreign currency should also align with long-term currency management and the wider financial plan for one's needs today, over one's lifetime, and beyond.
- **Boosting return potential:** For those with a high risk-tolerance, borrowing could potentially lead to higher long-term gains if returns exceed borrowing costs, particularly as interest rates decline. However, this strategy is risky, as leverage can amplify both losses and gains.

Before engaging in borrowing, investors should carefully consider both the cost and robustness of any loan.

Costs involve comparing loan rates with expected returns for the investments in which borrowed funds are put to work.

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If the expected return of the intended asset is lower than the borrowing cost, borrowing does not make financial sense. If the expected return is higher than the borrowing cost, taking on debt could make sense.

It is important to remember that short-term returns often deviate significantly from long-term expected returns. As a result, cost should not be the only criterion for deciding when to use liabilities.

Robustness checks include considering refinancing and interest rate risks, being aware of the potential for margin calls during market fluctuations (including in periods of heightened geopolitical volatility), and understanding the impact of spending plans on the ability to service or repay a loan. If a family or investor expects to tap a portfolio for large expenditures, such as university tuition for children or a home purchase, an important consideration would be how long the portfolio could take to recover (the “time underwater”) and the impact that spending might have on a projected loan-to-value ratio.

In today's uncertain environment, it is especially important to explore borrowing plans in terms of potential interest rate scenarios, with flexibility to adjust plans in the event of either adverse or more favorable growth and rate scenarios.

If, after making such planned expenses, the investor's assets still hold enough value to avoid a margin call in a worst-case scenario, a borrowing plan can be considered robust. If, however, the plan leaves little margin for error—or if there is a projected shortfall—it may be necessary to reduce leverage.

Whatever the objective of a borrowing strategy, it's vital to develop a specific plan for paying off the loan:

**Identify a specific source of funds.** This could be the sale of an asset, or projected cash inflows from a business or salary.

**Formalize a specific timeline.** While it's fine to reassess financial plans as things change, setting out a formal schedule for repayment can stop borrowers from procrastinating and help them stay focused on managing the risk and cost of their debt.

**Develop a “plan B.”** It can be advantageous to identify an alternative source of funds to repay debt in case the asset sale or cash inflow initially expected doesn't occur or is delayed. Setting specific criteria for triggering this backup strategy may also be prudent, especially if the liability grows over time.

**Stress test plans.** Borrowers would do well to consider how they might deal with unexpected expenses, or with market stresses that impair the asset side of their balance sheet. It is crucial to account for the risk of a margin call and act

proactively to keep a buffer against that scenario.

For any investor planning to use leverage as a part of their strategy, we recommend following these three guiding principles:

1. Use debt to diversify and build resilience.
2. Avoid a mismatch between the duration of liabilities and the duration of assets.
3. Manage liabilities proactively.

Investors should be able and willing to bear the unique risks of borrowing and build a flexible financial plan that can adapt to multiple economic scenarios without compromising their long-term financial goals.

### Global asset class preferences definitions

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**Attractive:** We consider this asset class to be attractive. Consider opportunities in this asset class.

**Neutral:** We do not expect outsized returns or losses. Hold longer-term exposure.

**Unattractive:** We consider this asset class to be unattractive. Consider alternative opportunities

**Note: For equities, we have a five-tier rating system with two additional preferences**

**Most Attractive:** We consider this asset class to be among the most attractive. Investors should seek opportunities to add exposure.

**Least Attractive:** We consider this asset class to be among the least attractive. Seek more favorable alternatives opportunities.

When equities are included with the other asset classes in the three-tier rating system, we collapse "Most Attractive" with "Attractive" and "Least Attractive" with "Unattractive."

## Appendix

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Version B/2026. CIO82652744

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