Report Completion Date
23 October 2026, 10:24 UTC
Chief Investment Office GWM
Investment Research

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 instead of holding excess cash that is vulnerable to inflation. 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.



Prudent borrowing can enhance liquidity and portfolio flexibility, provided leverage remains aligned with repayment capacity and carefully managed risks. Source: Jason Leung_Unsplash

Borrowing is risky, but we believe that proactive, prudent, and strategic borrowing can enhance an investor's financial plan. While central banks have turned more hawkish and many major government bond yields have risen to multi-year highs, borrowing can still make sense as part of a robust and risk-controlled financial plan.

US and Eurozone: rates to rise

Recently CIO revised its outlook for the Federal Reserve to reflect a combination of higher-than-expected September inflation data and recent Fed commentary. We now expect two further US interest rate hikes of 0.25 percentage points in December and March 2027, taking the target range for the fed funds rate to 4.25-4.50%. In the euro area, the European Central Bank has already raised its deposit rate to 2.5%, with another quarter-point increase now expected in December. As such, borrowers with floating-rate facilities should prepare for rising costs.

Swiss franc: low rates, not low risk

Switzerland remains relatively sheltered, rather than untouched: Swiss bond yields have risen only moderately, and CIO expects inflation to average 0.6% both this year and next. We forecast the Swiss National Bank to hold rates for now before raising its policy rate to 0.25% around the middle of next year.

The Swiss franc outlook is less straightforward. Higher euro and dollar interest rates may weigh on it initially, while we anticipate Swiss franc appreciation over 12 months as interest rate gaps narrow. We can foresee alternative scenarios that include further Swiss franc weakness with stronger global growth and sharp CHF appreciation amid economic or inflation shocks.

Japanese yen: expectations matter

The Japanese yen's rally stems primarily from markets anticipating tighter Bank of Japan policy, with nearly two additional increases priced in by year-end. However, we believe those expectations may be excessive given Bank of Japan Governor Ueda's cautious approach. As such, we expect some moderation in yen strength rather than an uninterrupted rally.

While the outlook for borrowing costs has become more complex, we still believe in the right circumstances 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, private market 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.

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- **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. This may be especially important for investors with concentrated portfolios, or in periods where the returns from stocks and bonds move more in lockstep (and so limiting bonds' diversification power).
- **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. In the current environment, borrowers should be mindful that low Swiss and Japanese interest rates relative to other major central banks do not eliminate exchange rate risk. A stronger franc or yen increases the home-currency amount needed to repay an initial loan. Borrowers should distinguish market pricing from a policy commitment. Neither a forecast of currency weakness nor an apparently attractive interest rate gap provides protection against a sudden appreciation. The practical response is to prepare for different outcomes, including considering the use of currency and interest rate derivatives to limit potential losses or try to cheapen loan costs, rather than rely on one exchange rate target.
- **Boosting return potential:** For those with a high risk tolerance, borrowing could lead to higher long-term gains if returns exceed borrowing costs, particularly in environments where interest rates decline. However, this strategy is risky in the current environment where many major central banks are raising interest rates. Investors should also be aware that the use of debt (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.

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
The asset class preferences provide high-level guidance to make investment decisions. The preferences reflect the collective judgement of the members of the House View meeting, primarily based on assessments of expected total returns on liquid and commonly known indices, House View scenarios, and analyst convictions over the next 12 months.
Absolute view
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. 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."
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.
Relative preferences
For the multi asset view, we also include relative preferences to help investors compare between items.
Preferred: We view this item more favorably than others within its asset class.*
Neutral: We see this item similarly to others within its asset class.*
Least preferred: We view this item less favorably than others within its asset class.*
*In the case of cross-asset, compared to other asset classes.
Note: The tactical asset allocation (TAA) positioning of our different investment strategies may differ from these views due to factors including portfolio construction, concentration, and borrowing constraints.

Appendix

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