FINANCIAL POST

FP Explains: The Smith Manoeuvre strategy and how to use it — the right way — to your advantage

It's a notoriously complicated investment strategy that uses debt to finance investments. Here's what to know

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The readvanceable mortgage lets you borrow against your home equity as you pay down your mortgage. PHOTO BY GETTY IMAGES/ISTOCKPHOTO FILES

If you've heard about the Smith Manoeuvre, then you know it's a smart, but controversial and often misunderstood financial strategy.

Let’s take a look at an example. The Smith Manoeuvre (SM) calculator shows that a homeowner with a $750,000 home, a $500,000 mortgage at 2.5 per cent amortized over 25 years with a readvanceable portion at three per cent should expect to see a gain in their net worth by the amounts listed in the accompanying table.

THE SMITH MANOEUVRE GAIN

Assuming a $500,000 mortgage at 2.5% over 25 years and a 3% readvancable line of credit.

	Net wealth gain			
Investment return	Tax refund ($) not applied	Tax refund ($) applied at following marginal tax rates		
		30%	40%	50%
3%	5	59,947	81,590	103,986
5%	172,493	243,918	269,621	296,197
7%	420,983	507,257	538,191	570,143

SOURCE: ALLAN NORMAN FINANCIAL POST

Remember, a readvanceable mortgage includes two parts: a mortgage and a line of credit that you can pay down or borrow against. Each mortgage payment increases the amount you can borrow on your line of credit while paying down your mortgage.

The table shows that a person implementing the SM with a 40-per-cent marginal tax rate may be able to increase their overall net worth by $538,191 over 25 years.

Here’s how the strategy works. You will need a home where you make a minimum 20-per-cent down payment, a readvanceable mortgage and two bank accounts. The readvanceable mortgage lets you borrow against your home equity as you pay down your mortgage. The two bank accounts provide a clear separation of transactions for accounting/tax purposes.

With each mortgage payment, you’ll borrow against the freed-up equity in your home and invest that borrowed money into a non-registered account (not in a registered retirement savings plan (RRSP) or tax-free savings account (TFSA)). In most cases, the interest on the amount borrowed to invest is tax deductible, which is why you are able to convert non-tax-deductible debt to tax-deductible debt.

For example, if you make a $2,200 mortgage payment and $1,200 goes to interest and $1,000 to principal, then you can borrow $1,000 to invest.

Picture in your mind two elevators: One is a traditional mortgage elevator that is coming down as the readvanceable elevator is going up. Once the traditional mortgage elevator hits the ground floor, the traditional mortgage is paid off. At the same time, the readvanceable mortgage elevator hits the top floor and you'll still have the same amount of debt you started with, but now the interest is tax deductible, and you'll have a large investment portfolio, according to the Smith Manoeuvre calculator. Plus, your monthly expenses remained the same.

If you borrow $1,000 at three per cent, you would have to pay about $2.50 in interest each month, which would increase your monthly expenses. The trick is not to borrow the full $1,000. Instead, borrow $1,000 minus $2.50, or $997.50.

Leaving the interest payment in the readvanceable mortgage means it is there when the interest comes due. You're effectively borrowing to make the interest payment.

This is a smart tax strategy that the SM takes advantage of: interest on interest that is tax deductible is also tax deductible. In other words, when you borrow money to invest, the interest on the loan is tax deductible. If you borrow money to make the interest payment on the loan, then that interest is also tax deductible.

Once you're creating tax deductions, you can use them to enhance the Smith Manoeuvre. Look back at the table and you'll notice there is a column where the tax refund isn't applied and columns where the refund is applied at different marginal tax rates. Ideally, each spring when you get your tax refund, you will use it to pay down your mortgage and then re-borrow that amount.

Are you still with me? That is the basic SM strategy.

To recap using the example, which is a $500,000 mortgage at 2.5 per cent and a readvanceable portion at three per cent. If you make mortgage payments of $2,200, $1,200 goes to interest and $1,000 to principal, allowing you to borrow $997.50 and use the remaining $2.50 to make the interest payment. Apply your tax refund in the spring to your mortgage and then re-borrow and invest as above.

At the end of 25 years, the SM calculator shows a person with a 40-per-cent marginal tax rate and earning a seven-per-cent investment return will have a $500,000 tax-deductible debt, and an investment portfolio of $1,039,191, for a net worth improvement of $538,191. Again, all done without an increase in cash flow.

Once the traditional mortgage is paid off in 25 years, or any time prior, you can sell the investments (subject to capital gains tax) and pay off/down the readvanceable mortgage. Alternatively, after 25 years of experience, you may decide it is a good idea to keep the debt, tax deductions and investments. It will depend on your circumstances at the time.

If you Google the Smith Manoeuvre, you will find other, more aggressive strategies that are based on the SM, but not the SM itself.

Before the financial crisis of 2008, there were some very aggressive variations of the SM. Afterwards, a number of investment dealers restricted their financial planners from recommending or even discussing the SM.

I suspect this is what has led to some of the criticism and misunderstanding of the SM and the reason Robinson Smith, the son of Fraser Smith, who originated the SM, created a designation program for financial advisers wanting to learn the proper tactics and implementation.

The bottom line? The SM is a strategy that uses debt to finance investments and, as a result, will likely remain controversial. However, unlike most investment strategies using debt, the SM starts small, dollar cost averages into the market, and instils financial discipline. Like most strategies, it is not for everyone.

If you would like to learn more about the SM, visit the SM website, where there are links to podcasts and other sites explaining the SM, as well as a calculator you can use at a small cost to see how it might apply to your situation.

Finally, whenever you are leveraging/borrowing to buy a home, vehicle or investments, you are taking a certain level of risk. If you are not sure what the specific risks are to you, then it's in your best interest to speak to a financial professional.

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