THE GLOBE AND MAIL

October 22, 2010

Deducting mortgage interest takes a fortitude many lack

By PREET BANERJEE
From Tuesday's Globe and Mail

The pros and cons of using the Smith Manoeuvre as a tax strategy

There is a controversial tax strategy known as the Smith Manoeuvre that some people mistake for an investment strategy. While some financial institutions bar their advisers from advertising it, other advisers base all their marketing on it. So what's the deal?

The Smith Manoeuvre essentially involves slowly converting your non-deductible mortgage payments into deductible interest payments on a loan used to fund an investment portfolio. Every month as the principal is paid down on the mortgage, an equal amount is added to the principal of the investment loan. If the proceeds of the new loan are placed in investments with a reasonable expectation of earning an income, the interest on this loan can be tax deductible. The resultant tax refunds are used to accelerate the mortgage. Wash, rinse and repeat until you've converted your entire mortgage into an interest-only investment loan.

So what is so controversial about that? On the surface, the math works just fine. There are many people who have had successful experiences with the Smith Manoeuvre. But then again, there have been many people who have not. It's that pesky psychological aspect of investing that gets in the way.

One of the criticisms of the Smith Manoeuvre, or any leveraged investment for that matter, is that many people find out that they don't have the conviction for leveraged investing until after the point in time in which they needed that conviction most: systematic market corrections during which almost everything goes down and asset class correlations all approach 1.

A mortgage is also a form of leverage. You're borrowing money to purchase your house and many people view their house as not just a home but an investment. But if real estate markets were to crash, you would be much less likely to call up your realtor demanding that you "need to get out now." Not so with a leveraged stock market investment. The reason? Psychology.

As a former colleague used to say, "You can't drive by your stock portfolio like you can your house." Many people simply don't understand their investments the way they understand their homes. If the newspapers published your home's estimated value on a daily basis and it fluctuated like the stock market did, you might be more inclined to chuckle. But flip the page and look at the stock market indexes and that can seem very worrisome.

So while the tax strategy makes sense from a numbers perspective, remember that it involves two different types of leverage: one that is tied to an investment you are a bit more involved with (the mortgage on your house), and one that may be new to you and linked to an investment portfolio that you are less confident about (the stock portfolio).

If you are looking at implementing the Smith Manoeuvre, it might be a good idea to have had some skin in the investing game during a full market cycle beforehand. If you're the type of person who views market corrections as opportunities, you might be right for the Smith Manoeuvre because the math works if you have the conviction to stick with the plan. Next step is to find an adviser who specializes in its implementation because it is a bit technical.

If market corrections make you nervous, you probably don't have the fortitude required for most types of leveraged investing. In that case, skip the Smith Manoeuvre and stick with the KISS principle.