



\$mith's ideas make sense

Some new twists on using home equity for investments

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It's been two years since retired financial planner Fraser Smith self-published an eponymous little book called *The \$mith Manoeuvre*. It described a way for ordinary mortgaged Canadians to emulate the rich by converting "bad" non-tax-deductible mortgage debt into "good" tax-deductible investment loan debt.

Now in its third printing, the manoeuvre has been a shrewd one for the 64-year-old Smith, based in Victoria. He's sold 10,000 copies and parlayed the idea into a lucrative seminar career catering to investment advisors who sell equity mutual funds.

Some of Canada's credit unions pioneered the concept of the readvanceable second mortgage, which is the key technical component of Smith's manoeuvre. If you have a traditional first mortgage locked in for five years, for example, the credit union would wrap around a competitor's first mortgage, letting the homeowners borrow up to 75% of the value of the house, minus what's left on the first mortgage. That additional borrowing power could be used to invest, at which point it becomes tax-deductible.

This started in British Columbia with Van City, Richmond Savings and Coast Capital and has moved east -- albeit in a slightly watered down fashion -- with Manulife One, BMO's ReadLine and RBC's Homeline plan.

While the banks tend to promote their versions of readvanceable mortgages for consumption purposes -- buying cars or other luxury items -- Smith believes Canadians would be better off using them to build non-registered investment portfolios.

His "manoeuvre" is perfectly legal and as Smith emphasizes, a tactic Canada's wealthy have always used in one form or another. He's trying to take it to ordinary families struggling to pay mortgages and save and invest in Canada's high-tax environment.

Smith says the reason the average family finds it hard to make ends meet is there is an albatross perched on each shoulder. One is the Canada Revenue Agency; the other the big banks holding most of the nation's mortgages.

In his seminar, the most compelling graphic is one showing how much the average Canadian must earn to pay for a house with a \$200,000 mortgage.

If the banks had their druthers, your amortization schedule would drag out 25 years and you'd end up paying \$220,241 in interest charges on the mortgage.

Therefore, the house ends up costing you \$420,241, once you pay back the principal and all the interest.

But it gets worse. The above is in after-tax dollars. In order to come up with that \$420,241 a salaried

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employee would have to earn considerably more than that: in the 40% tax bracket, they would have to earn \$700,401 in gross pay, from which \$280,161 income tax would be deducted at source.

In other words, the price of the typical home in pre-tax dollars has more than tripled after the government and the banks get their piece of the action.

This is why most financial planners recommend paying down mortgages as quickly as possible.

Through his Web site at www.smithman.net, Smith sells a calculator which compares his manoeuvre to those of two other author/seminar speakers: Garth Turner and David Chilton, the latter the author of the megabestselling *The Wealthy Barber*.

Chilton, like myself, advocates paying down a home mortgage as quickly as possible, then building a stock portfolio by saving at least 10% of your income.

In his book *The Strategy*, Turner advocates "sucking the equity" out of your home by paying a mortgage off, then reborrowing to invest in stocks or equity funds.

Smith blends these two approaches by advocating simultaneously paying down a mortgage and borrowing to invest, then pumping the resulting tax refunds into further mortgage paydowns and investments.

Because it takes so long for average people to pay off a mortgage, Smith doesn't believe they should wait that long before benefiting from investing in the stock market. The actual strategy can't be described in detail here, since the book takes 146 pages to outline the mechanics and some variants of it.

I can't question the overall logic, although it's debatable whether average Canadians have the discipline and long-term foresight needed to make the manoeuvre successful.

My main quibbles are two-fold. Smith advocates maintaining the typical \$200,000 mortgage debt in perpetuity, albeit gradually converting it from non-tax-deductible to tax-deductible status while building a non-registered investment portfolio. Personally, I prefer the security of having zero debt as quickly as possible, then building financial assets on an "invest-as-you-earn" basis.

The other problem I have with Smith's seminar is his overly optimistic assumption that financial markets will deliver 10% annual returns going forward.

Smith says that's the historic average going back 50 years but most financial planners I know use much more conservative projections like 6%.

True, Smith's software lets you plug in 6% or any other figure, but the seminars that get mutual fund prospects all hot and bothered are based on the optimistic 10% return.

Those are the kinds of projections that got the Universal Life sales people into trouble when the market turned south. Smith now says he will use 8% henceforth.

Of course, the book begins with a long one-page disclaimer that readers "seek the services of a competent professional with the required qualifications."

I'll second that.

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