

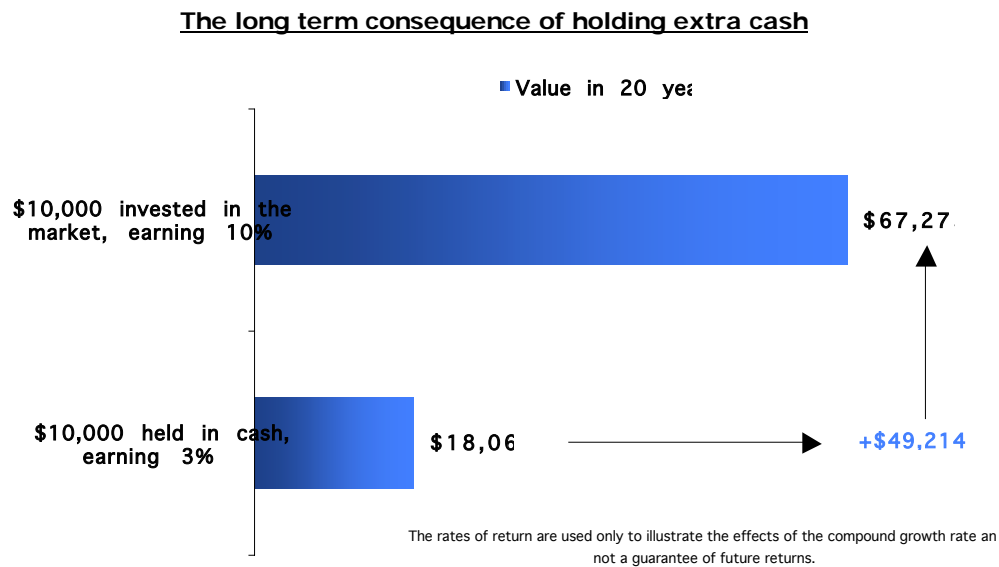
Income smoothing strategies for mortgage brokers

Your single greatest asset is not your home or your investment portfolio; it's you, and your ability to generate income. It would be nice if all your efforts led to a nice, smooth stream of income. Unfortunately, as a commissioned salesperson, your income is highly variable.

After interviewing almost 1,000 mortgage professionals from across the country in the past few years, it is clear that besides the endless drive to find new clients, one of the biggest challenges mortgage brokers face is the stress of managing an income that fluctuates significantly from month-to-month and year-to-year.

Many brokers admit that they take a simplistic approach to cash management: they either use their line of credit or keep lots of extra cash on hand. From a financial planning perspective, there may be a better way.

Drawing on a line of credit in tough months can be costly in terms of the interest you pay, particularly because the interest will likely not be considered tax deductible. It can also be a difficult cycle to break, leading to elevated debt levels if a few tough months occur in a row. Of course, it's equally costly to keep lots of extra cash on hand – costly from the perspective of lost investment returns that you might have otherwise earned on that money. In a business where cash is King, holding cash reserves is a missed opportunity that can have long-term consequences for your financial health (*see chart*).



There are a number of income-smoothing techniques that can help stabilize your family's financial situation. For example, many mortgage brokers are not aware that their investment portfolio can be mobilized to provide a dependable stream of income. High-yield investment categories include:

Preferred shares. In theory, preferred shares represent ownership interest in a corporation, similar to a common stock. In practice, preferred shares act similarly to bonds, producing a reliable stream of income in the form of pre-set dividends. Typically, these dividends yield one to three percentage points more than common stock dividends issued by the same company. One major advantage of investing in preferred shares versus bonds is the dividend tax credit, which leaves more money in your pocket after taxes are paid. While investors have often overlooked preferred shares, they can be an excellent way for mortgage brokers to enhance the income on their portfolio while managing the risk-return trade-off.

Income Trusts. Income trusts are designed to distribute significantly higher-yield returns to unit holders than dividends from common stock. The ability for a trust to pay out high distributions on a sustainable basis is a function of the cash flow quality of the underlying business. In other words, there are good income trusts and bad income trusts, just as there are good businesses and bad businesses to invest in. Income trusts operate within a tax-efficient structure that provides for minimal corporate income tax payments. Bear in mind that the greatest risk to investing in income trusts is that the distributions are not guaranteed, and the unit price can fluctuate based on normal market supply and demand. However, with a high-yield distribution stream and the potential for growth through capital appreciation, income trusts can be a very attractive investment category for long-term investors who also require regular income.

Looking for smoother income? Consider:

- Preferred shares
- Income trusts
- Income-oriented investment programs

Income-Oriented Investment Programs. Investment management firms are beginning to recognize the widespread need for higher-yield, income-oriented investments. Many firms have created investment programs specifically designed to meet the need for monthly income. Typically, investors receive a regular monthly payment, consisting of a combination of capital gains, interest income, dividends, and, in some circumstances, a return of capital (which is not taxable). Since the returns are generated from a mix of these investments, income is distributed in a much more tax-efficient manner than receiving interest income alone. The result is that you can expect a stable, regular monthly payment, while retaining the potential for additional returns in appreciating markets.

When thinking about how to construct your investment portfolio, part of your challenge as a mortgage broker may simply be accepting the idea that income generation can be a reasonable goal for your investments at this stage of your career. It is certainly a misconception that only retirees require income from their portfolios.

Many mortgage brokers are risk-takers by nature and have a difficult time implementing a conservative investment strategy, rather than pursuing maximum growth. By virtue of the fact that you have no steady paycheck, you already assume considerably more risk than the average investor. A high-yield investment approach may be one way to insulate your family from some of the risk associated with having a volatile income.

In fact, having a consistent stream of investment income might be the comforting foundation that allows you to focus on growing your business instead of worrying about your cash flow situation.

Some mortgage brokers have opted to pursue monthly income through private mortgage lending. Over the past few years, it's been hard to argue with this strategy, as private mortgages have yielded 10-20% returns with minimal defaults. However, anecdotally, high-quality second mortgage deals are becoming harder to find. Some investors are now assuming more risk than ever before in order to attain the lofty returns they've come to expect. Evolving real estate market conditions and increasing competition from institutional lenders could erode the private mortgage investment opportunity. This should be especially concerning to mortgage brokers whose income *and* investments are tied to the variability of the mortgage market. For these brokers, now may be an appropriate time to seek alternate investment strategies.

Although real estate income properties are an investment category that tends to be overlooked by most investment advisors, they can become a key component of your portfolio – if viewed as a long-term asset. However, for mortgage brokers focused on growing their business and smoothing their income, real estate can be a time-consuming and frustrating investment. Real estate rarely produces positive cash flow for the investor in the short-to-medium term, as properties are often heavily leveraged and most of the rental income goes to service the mortgage payments. Other practical challenges include ensuring 100% occupancy, collecting rent cheques and having to inject additional cash into upgrades or repairs.

As a mortgage broker, your financial situation is already more complicated than that of the average Canadian family. You have to worry about growing your revenue, controlling your expenses, protecting your assets and optimizing your investments. Preferred shares, income trusts, and income-oriented investment programs may help to smooth your income but they also must be considered as part of your complete financial situation.

If you want to maximize the amount of time you spend building your mortgage business and minimize the time spent worrying about your cash flow, consider speaking to your investment advisor to refine your approach. Ultimately, more effective income smoothing will enable you to focus on your greatest asset: you.

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