



Getting the edge with managed funds

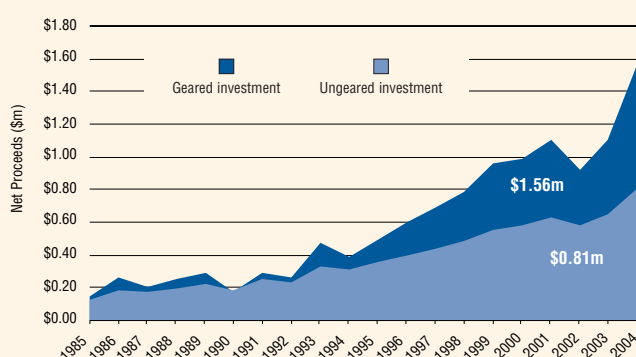
The nuts and bolts of gearing

Margin lending is particular type of loan used for investing in shares or managed investments. It uses your existing investment assets as security, whether they be cash, shares, or managed investments. Margin loans allow you to borrow up to 3 times (75%) the value of your security. And like any loan, investors are charged interest on the amount borrowed.

Margin lending is also known as gearing and borrowing to invest.

Investment in Australian sharemarket using gearing

Net proceeds from investment after Capital Gains Tax and Repayment of Loan



Net proceeds after capital gains tax and repayment of loan with an average interest rate of 12%. Annualised income of 4.5% reinvested and annualised capital growth of 9.0%. Estimated using a tax rate of 48.5%. \$100,000 cash, \$100,000 borrowed. Based on historical returns combining the All Ordinaries Accumulation Index from December 1985 to March 2000 and the S&P/ASX 300 Accumulation Index from 1 April 2000 to December 2004. Does not include any fees or expenses and assumes full reinvestment of income.

Source: Macquarie Bank Limited

Why borrow to invest?

Margin lending can increase returns if the return from the additional investments acquired with the loan is greater than the cost of the interest.

Over the medium to long term, shares often produce returns higher than loan interest rates. The graph shows the effect of borrowing the same amount as your investment capital and investing the total into the sharemarket index over 20 years to January 2004.

Borrowing to invest makes sense when you believe that investment returns will exceed the cost of borrowing. It also has the effect of converting income into capital growth, and can therefore be attractive for investors who do not have current income needs.

It's a strategy which is best suited to investors who can cope with higher risks, and who have plenty of income from other sources to service the loan.

In the chart opposite, the dark blue line tracks the investment growth of an investor who borrowed \$50,000 to invest on top of their own \$50,000 (geared investment), while the light blue line shows an investor who did not borrow any money, and simply invested their own funds of \$50,000.

Margin loans can typically be taken to invest in many major stocks and managed funds. Each lender will have its own list of approved securities. Stocks that tend to be excluded include initial public offers, smaller companies, and high-risk companies. Remember that many companies have borrowings of their own and are therefore already leveraged. Borrowing to invest in such companies can heap loans on top of loans and create a risky situation.

Why is it called margin lending?

The term "margin loan" refers to the way in which lenders protect themselves from market volatility and its impact on the security you have provided. Lenders permit you to have a maximum lending ratio.

For example, a managed fund might have a lending ratio of 60%. This would mean that if you had capital of \$40,000, you could borrow another \$60,000. Of the total \$100,000 60% would consist of borrowings.

Lenders then allow a margin of safety - say another 10% - which means that the value of the portfolio could fall without any action being required so long as the borrowings don't consist of more than 70%.

On the flipside, if the value of the portfolio did drop below \$85,700, your lending ratio would be higher than 70%. When this occurs, the margin has been breached and investors will be faced with a margin call.

What is a margin call?

A margin call requires you to restore the margin between the value of your investment and the balance of your loan. This can be done by topping up your account with cash or additional investment securities, or by selling off some of your managed investment units or shares. There is usually a strict time limit of a few days in which this must be done.

If you fail to meet a margin call, the lender has the right to sell enough of your investments to restore your margin. They are not usually obligated to consult further with you before taking action, and an investor has no control over which stock will be sold to cover the margin call.

Therefore, investors considering a margin loan need to ensure they have the necessary reserves available to meet margin calls. It's also critical that you review the brokerage's *margin agreement* prior to investing. This document will outline the terms and conditions of the loan, how interest will be calculated and what your obligations as an investor are.

The pros and cons

Borrowing to invest can accelerate wealth creation by multiplying the investment exposure of your capital. When markets are rising, the value of your capital will increase even faster.

But this multiplication effect works in both directions. When markets are falling, because the loan is a fixed amount, the impact on your capital can be greatly magnified. It is possible for severe capital losses to be incurred, or for your capital to be wiped out completely.

The dreaded margin call

The Reserve Bank of Australia (RBA) states that since September 2000, the average number of margin calls hovers between one and two per day per thousand clients.

However, their frequency will increase during market volatility.

- During September 2001, margin calls reached 7.8 per day, per 1,000 clients.
- During the 2003 war in Iraq, there were approx 6 per day per 1,000 clients.

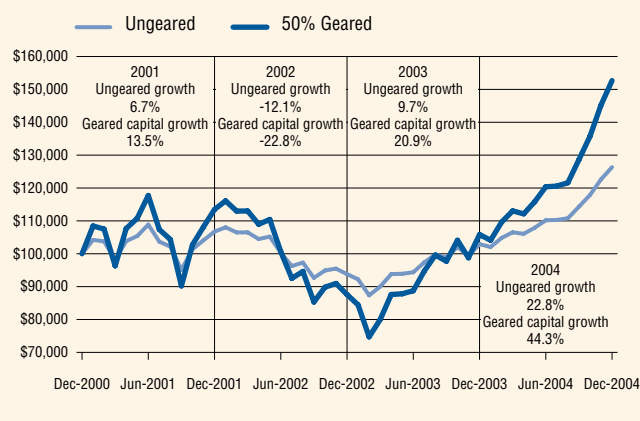
Source: RBA

What about interest rate rises?

Interest rate rises are not all bad news for margin lending borrowers. The interest that you pay on a margin loan can generally be claimed as a tax deduction.

So while a rate rise will trigger a rise in the rate on your margin loan, the after-tax impact could be less, depending on your marginal income tax rate.

Higher return potential - but higher volatility too



This capital volatility can be seen in the above chart (dividends are ignored for now). It compares the capital growth achieved by an ungeared investor, with \$100,000, with the capital growth achieved by a geared investor who also has \$100,000, but borrows another \$100,000 in order to be 50% geared. They both receive the market index return.

- > In 2001 for example, the ungeared investor achieves capital growth of 6.7%. The geared investor achieves capital growth of 13.5%.
- > But in 2002 the market fell sharply. The ungeared investor saw their capital fall by 12.1% - but the impact of the geared investor is magnified. Their capital fell nearly 23% in just one year.

The market in fact continued to fall into 2003 before recovering strongly. Geared investors have done very well over the period as a whole, but needed strong nerves to get through 2002 and early 2003. Some would also have needed to meet margin calls in this period. One of the risks is that geared investors are forced to sell, or lose their nerve, thus locking in their losses and being much worse off than the ungeared investor.

Because gearing magnifies gains and losses, it often makes sense to have a well diversified portfolio. Individual shares can experience substantial rises and falls, so an appropriate portfolio might feature a significant number of stocks or a managed investment such as a diversified share fund.

Are there any tax benefits?

Borrowing to invest through a margin loan offers various tax advantages. The interest on margin loans can generally be claimed as a tax deduction. Also, if you decide to invest the money you've borrowed in Australian shares (either directly or via a managed investment), any income in the form of dividends that you receive may be accompanied with franking credits, which can be used to offset income tax.

You may also be able to pre-pay the interest on your margin loan, effectively bringing forward an expense that would be tax deductible in the following year.

Example

	Ung geared investment	Geared investment
Investor capital	\$100,000	\$100,000
Borrowings		\$100,000
Total investment	\$100,000	\$200,000
Dividends <i>(assume 4% yield)</i>	\$4,000	\$8,000
<i>Less interest (assume 8.4% interest rate)</i>		<i>(\$8,400)</i>
<i>Less tax (assume 48.5% marginal tax rate)</i>	<i>(\$2,771)</i>	<i>(\$1,469)</i>
Franking credits <i>(assume 30%)</i>	\$1,714	\$3,428
Net cash income	\$2,943	\$1,559

As the above example demonstrates, a moderately geared strategy can still be cashflow positive once franking credits are taken into account. However, like any investment, a margin loan shouldn't be chosen because of the tax benefits alone.

Getting expert advice

A professional financial planner can determine whether margin lending is right for you. They can also help you to choose quality investments, identify the main risks, and recommend other relevant strategies to complement this type of investment.

For tips on choosing a financial planner refer to IFSA's *Six Easy Steps*.

Geared share funds - an alternative to margin loans

If you are not keen on taking on a loan yourself, there is a way for you to gear into shares without having to borrow. Geared share funds take the money from investors, supplement it with a loan made in the name of the fund - and then invest the total amount into shares. Interest on the loan is generally paid out of the fund's earnings.

The advantages are that you are not hit with any margin calls and the fund uses its considerable financial resources to borrow at very competitive rates.

The result for investors is less income, because of the interest cost, and potentially more growth than regular share funds. Of course, like margin loans, the structure of geared share funds increases not only the potential return, but also the risks.