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The Fundamentals of Margin Lending

Understanding the fundamentals of margin lending is very important for potential investors wanting to enhance their financial position using this strategy. When used correctly, margin lending can represent an attractive and worthwhile long-term option for investors.

Why Borrow?

Borrowing to invest, or gearing, is a tax-effective way of building your wealth, particularly over the long term. Effectively, you are "leveraging" the value of your investments through borrowing.

Interest on borrowed funds is generally tax deductible¹ provided the funds are used for investment purposes. However, there must be a direct link between funds borrowed and the amount invested to ensure a full tax deduction. Thus the investments should be made directly with the borrowed funds, although funds can be held in cash in an interest-bearing account on a temporary basis. (It is preferable not to mix the borrowed funds with private funds before the investments are made.)

There are three basic strategies to consider when gearing.

- Negative gearing – where cost of borrowing is greater than income received. This style is popular when investing directly into property.
- Neutral gearing – where cost of borrowing is equally offset by income received.
- Positive gearing - where total income is greater than cost of borrowing, and is typical when investing in shares that pay fully franked dividends.

Another advantage of borrowing to invest derives from the opportunity to access a broader investment portfolio than normally would be available. Funds can be invested in a diversified portfolio of direct shares, property trusts, international markets and/or managed funds in accordance with your investment risk profile. Diversifying this way reduces your level of risk in the market.

What is Margin Lending?

Margin lending is simply borrowing to invest using existing cash or listed securities as a deposit. This is the fundamental difference to a normal investment loan. That is, you must have cash or other listed securities to put towards the total value of the loan. You cannot use your home or other property assets as security, as you can with an investment loan.

In addition, with an investment loan you can generally borrow up to 100% of the total value of the asset you want to purchase. Margin loan providers generally only allow you to borrow up to a certain value, or percentage, of the shares you wish to buy. Commonly, limits are set at a maximum of 70% (known as the Loan-to-Value Ratio or LVR) of the value of the shares (less if the share is more speculative, or risky). This means you have to make up the difference (ie 30%) with your own cash or existing shares.

This difference is referred to as the "margin"; hence the term "margin lending".

Increase your capital returns

In the right environment, and with the right gearing level, margin lending can certainly increase returns. The following graph illustrates how a client with just \$30,000 equity can significantly increase their portfolio value with varying levels of gearing (assuming 100% investment into a fully franked Australian share portfolio).

Analyst

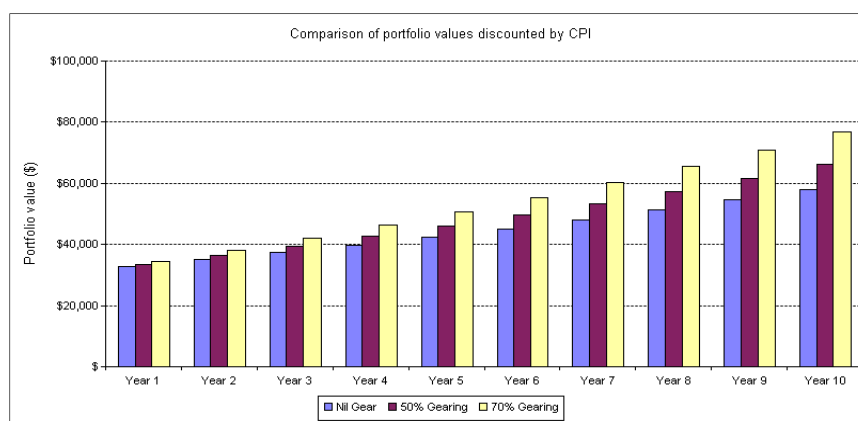
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¹ We are not tax advisers so it is important you seek professional tax advice regarding your own personal circumstances.

Important disclosures can be found in the Disclosures Appendix.



(source: ABN AMRO Morgans)

Nil Gearing = \$30,000 equity
 50% Gearing = \$30,000 equity + \$30,000 borrowings
 70% Gearing = \$30,000 equity + \$70,000 borrowings

Understand the risks

A margin lending strategy can also prove to be very damaging when conditions change and when employed incorrectly. Leveraging can significantly *decrease* potential returns in the event of a market downturn so you must take care.

Table 1 : The Benefits of Leveraging - Gains vs Losses

Details	Capital Gain of 5%		Capital Loss of 5%	
	Ungeared	Geared	Ungeared	Geared
Personal Funds	50,000	50,000	50,000	50,000
Amount of Loan	-	100,000	-	100,000
Total Investment	50,000	150,000	50,000	150,000
Annual Income @ 5% pa	2,500	7,500	2,500	7,500
Loan Interest @ 8% pa	-	(8,000)	-	(8,000)
Net Income	2,500	(500)	2,500	(500)
Capital Growth	2,500	7,500	(2,500)	(7,500)
Total Return	5,000	7,000	-	(8,000)
Client Funds Invested	50,000	50,000	50,000	50,000
Return on Investment	10%	14%	0%	-16%

Source: ABN AMRO Morgans

Whenever you borrow money to invest you take on a risk that if the investments fall in value you may not be able to repay the loan. To reduce this risk, margin lenders take security (ie a mortgage) over the investments you buy with the loan. If required, these investments can be sold to repay the loan (if you do not wish to inject additional cash into the loan).

Unfortunately, as most investors have experienced over the past year, share prices can move down quite quickly thus exposing you to greater risk. If this happens, the shares could be worth less than the loan creating problems for you and a shortfall of security for the lender. Hence why margin lenders limit the amount (LVR) you can borrow for the shares – that is, to protect themselves against this possible shortfall. If the value of your investments falls to a point where the value of the loan exceeds the maximum LVR, you might be required to top up your margin to keep the loan secure. This is known as a “margin call”.

Example:

John has a portfolio worth \$100,000 with a \$70,000 margin loan attached. The acceptable LVR on his portfolio is 70%. If the value of the portfolio drops to \$90,000 a margin call will be triggered and the loan balance would need to be reduced to \$63,000 (70% of \$90,000) before the loan returns to an acceptable LVR level. In this case, John would need to contribute \$7,000 in cash or be forced to sell some shares to reduce the debt. If the latter option, John may be selling his shares when prices are low, potentially realising a capital loss and also reducing the long term value of his portfolio.

You can minimise the risk of margin calls by borrowing conservatively – that is, by borrowing less than the maximum LVR allowed by the margin lender. While there is no guarantee that even conservative borrowers won't experience a margin call, in general your exposure to risk is reduced.

If you are not comfortable with this particular strategy for borrowing there are alternatives – for example, an investment loan or line of credit using other assets as security for the amount borrowed; or an instalment warrant, which is an internally geared product.

However, you must understand that any type of strategy that involves the use of additional debt will also involve additional risk. You should speak with your adviser before embarking on any borrowing strategy to decide which option is right for you and to ensure you understand all the risks involved.

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