

Leverage and Investing

The challenge for many investors whether professional or first time, is determining how to optimise returns from their investments with limited resources. One solution is a leveraged investment strategy. As the tax year-end looms many investors will be considering tax minimisation strategies such as negative gearing and prepaying interest.

Leveraging your investment portfolio through “gearing” means borrowing against your existing assets to invest in more assets. By borrowing against your existing assets, you can take advantage of other investment opportunities as they arise. Leverage is a simple principle commonly used by companies to raise capital for growth. Leverage provides you, the individual, with the ability to put into practice this very effective principle. By combining your own money with borrowed money, you can create a larger portfolio and increase your exposure to market growth.

Effectively, leverage provides you with greater spending power by extending the amount you have to invest with additional borrowings. This means that you can obtain larger investments for the amount of equity you currently have (your own cash and assets). Through extending the size of your investment, you can capture more upside in the market and gain more on dividends because you are holding more shares. If an investment is good enough to make with your own money then surely it makes sense to increase your exposure with someone else's money. Conversely, you can also feel the effects of a downward market more acutely and hence a leveraged strategy comes with an element of risk.

Types of leverage:

External Leverage

External leverage is simply increasing your exposure by adding borrowed money (debt based) to your own money or equity, for example margin loans or share financing. This type of leverage creates amplification in the returns you earn on your equity, both positively and negatively. Just as property investor's gear to buy more property to capture growth and income, this type of leverage applies across all types of securities. Investors borrowing money in this strategy often do so to take advantage of negative gearing whilst attempting to achieve growth and capital gains, which are taxed at lower rate.

Internal Leverage

Internal leverage is achieved through derivative instruments such as options, warrants or futures. (Derivative products are simply products that are derived from an underlying security. For example a share option on BHP is a derivative of the underlying BHP share.) Through the derivative market this type of leverage works through the purchase of rights to acquire an underlying asset in the future at a prescribed exercise price. Leverage is achieved through a view on future value, and as such, is not debt based like external leverage. This type of leverage is more speculative in nature. In the case of options an investor has to get both the timing and the direction of the market correct. This is not easy to do as exemplified by the fact that the majority of options expire unexercised.

Advantages and risks associated with leverage

The key advantage of leverage is that it can markedly increase the value of your investment over the long term provided you maintain a strategy that suits your appetite for risk. Advantages extend to include the ability to diversify your portfolio, and possibly reduce your tax liabilities.

However, gearing magnifies the volatility of your investment, so you must consider it as a long-term strategy, rather than for short-term exposure to potentially high upside. The long-term commitment of gearing for investment means that it is a strategy that can be used at any time.

With a long-term view, you can start leveraging with smaller amounts, and increase your leverage, as you become more comfortable with investing this way. The long-term nature of gearing makes it appealing to younger investors who are looking for growth in their investments rather than income.

Certainly gearing is not appropriate for all investors. For example, investors close to retirement are more likely to be seeking secure, income yielding investments and may not desire the potential downside risks that come with leverage. It is important that you seek the assistance of a professional fee based adviser who can explain how leverage works, and help you decide if it is a suitable strategy for your investment.

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