

The Pros and Cons of Margin Lending - By Michael Lannon

Traditionally, Australian investors have borrowed to invest in residential property. However, more and more are discovering the benefits of borrowing to invest in shares and managed funds, utilising Margin Lending to do so.

A Margin Loan is a revolving line of credit secured by shares or managed funds. Lending institutions typically lend between 40 and 70 per cent against the value of these investments. For example, if you wanted to invest \$100,000 in an investment that the institution lends 70 per cent against, you would need to provide \$30,000 and borrow \$70,000.

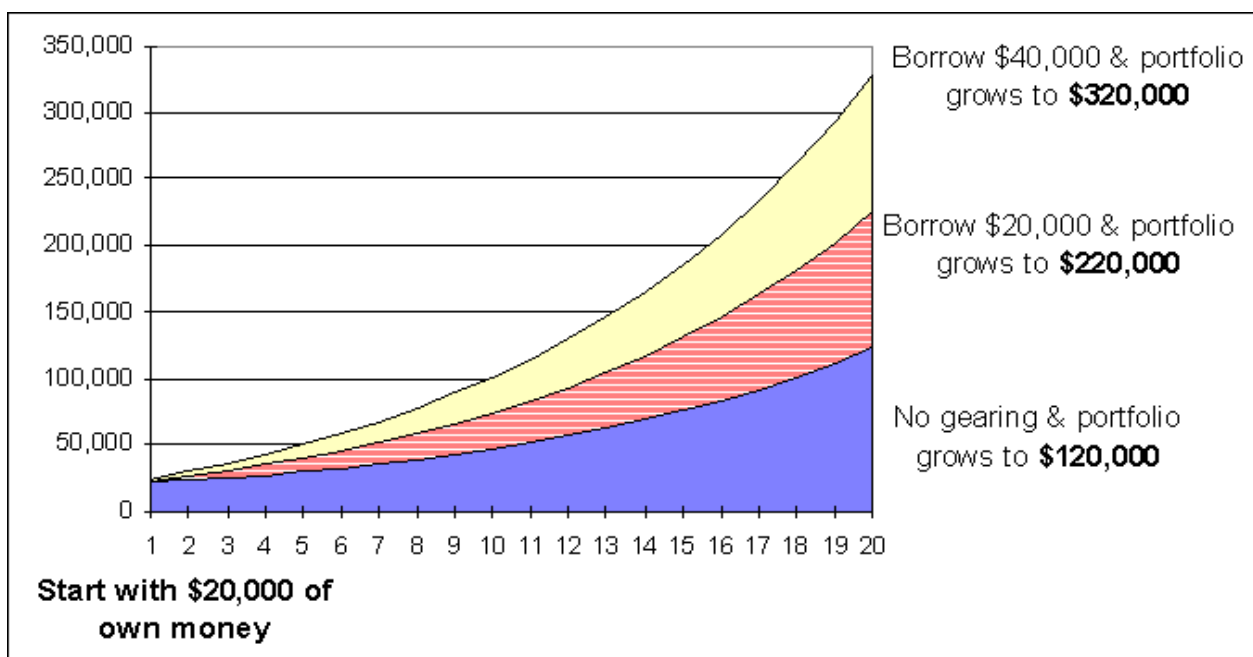
The advantages of Margin Lending - and getting the most from them

A Margin Loan can help you to:

- generate an investment portfolio that is much greater than you would have without borrowing; and
- expand and diversify your existing investment portfolio without needing any additional cash of your own.

By having more to invest you can gain access to a broader spread of investments, such as shares, property trusts and managed funds. By diversifying your portfolio across various sectors you can also minimise volatility, which reduces the overall risk of capital loss against your portfolio.

Expanding your investment portfolio can increase your potential for capital growth and investment income, as the following example illustrates. By using a Margin Loan and investing \$20,000 of your money (from your cash reserves or shares or managed funds), you could generate over \$320,000 in 20 years, compared with \$120,000 by not gearing.



Assumptions: capital growth 7% pa.; income 4% pa (reinvested); taxpayer is on the highest marginal tax rate of 48.5%; interest rate on loan 7% pa.; investment value is net of capital gains tax and after repayment of loan

Tip: To maximise your growth potential, your portfolio should include assets that will grow over the long term, like shares and property.

There is also possible tax benefits associated with gearing an investment portfolio. When you borrow for investment into income-producing assets, you should be able to claim a tax deduction for the interest you pay on your loan. If your interest costs exceed your investment income, the excess can be deducted from your other assessable income, reducing the tax you pay on your salary or other income.

Tip: To ensure full deductibility of your loan interest, your portfolio should be income producing as well as providing capital growth.

The risks of Margin Lending - and managing them effectively

Although there are many advantages with gearing an investment portfolio, there are also risks, including:

- Gearing magnifies the impact of falls in the value of your investments. For example, if you had \$15,000 to invest and the value of your investments fell 10% you would lose \$1,500. However if you had used the \$15,000 as equity for a Margin Loan and borrowed \$30,000 to invest \$45,000 in total, a 10% fall would lead to a loss of \$4,500 or 30% of your equity.
- You may experience a 'margin call'. This occurs when your gearing level exceeds the maximum the lending institution is prepared to lend and you are required to either pay off part of your loan, lodge more security or sell some of your investments. This generally means that you are forced to sell at a time when the value of your investments has fallen.

You can take the following steps to minimise the possibility of a margin call:

- Diversify your portfolio and minimise the risk of a capital loss in your whole portfolio just because one investment performs poorly.
- Borrow less than the maximum allowed. This increases the fall needed in the value of your portfolio before you have to meet a margin call. The table below illustrates the percentage fall required in the market value of your portfolio for a margin call at different gearing levels.

		Maximum permitted gearing level		
		50%	60%	66.67%
Actual gearing level	50%	9.09%	23.08%	30.24%
	60%	-	7.69%	16.28%
	66.67%	-	-	6.98%

Assumptions: This table compares actual gearing limits to allowable gearing limits. The percentages refer to the percentage change the market value of your portfolio would have to fall by before you would be in a margin call (including a 5% buffer).

- Re-invest your dividends & income distributions. This will reduce your gearing level by increasing your security.
- Pay off part of your loan, reducing your debt and therefore your gearing level.
- Pay your interest monthly and do not let it capitalise. The capitalisation of interest has the effect of increasing your gearing level.

Margin lending can help accelerate your wealth creation by expanding your investment portfolio using someone else's money. It can also provide valuable tax advantages. Margin lending is best suited to people with enough disposable income to cover interest payments and who are prepared to hold their investment for a long period.

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