Gearing – Costs and risks of margin lending

Margin lending is a form of gearing. Gearing involves borrowing money for investment purposes. The aim of gearing is to increase your investment return and wealth accumulation by investing borrowed funds in addition to your own capital.

Although gearing can deliver benefits, the risks associated with gearing may mean it is unsuitable for you. It is essential to carefully consider these risks before proceeding with a gearing strategy.

How it works

Borrowing money to invest is called gearing. Margin lending is a type of gearing facility where you use assets such as shares, managed funds or cash as security to borrow funds.

The amount you borrow is limited to a percentage of the investments that have been used as security, which may be a combination of investments you already own, and investments bought with the borrowed funds. This percentage is known as the Loan to Value Ratio (LVR). Most margin lending providers allow an LVR of up to around 70%. This means that if you already had investments valued at $30,000 (to use as security) you could borrow up to $70,000 to buy additional investments using a margin loan. The loan is then secured over the whole portfolio. The loan amount represents 70% of the total investment.

Gearing is generally only appropriate for investors who have a growth oriented risk profile. For gearing to be effective, the overall return from investments should exceed the costs of the investment, including the cost of the loan. This will typically only be achieved through investing in growth oriented assets such as shares and property. So you need to be comfortable not only with the risk of borrowing but also with the risk of investing in these asset types, including an increased level of fluctuation in the value of these types of investments.

You should also meet all of the following criteria before considering gearing:

- have a long-term investment timeframe of at least seven years
- have sufficient disposable income to comfortably meet interest costs as well as any margin calls (repayments) if the investment value falls (see below), and
- have a strategy in place to repay the outstanding loan at some point in the future.

As with any debt, it is important for you to have appropriate insurance cover to repay the debt or cover the ongoing investment expenses in the event of death, serious illness or total and permanent disablement.

Features of a margin loan

Each margin lender has a list of approved investments where the borrowed money and the assets offered as security can be invested. These generally include managed funds and shares listed on the ASX.

The margin lender will set a ‘lending ratio’. For example, if the lending ratio is 70% and you have $30,000 of your own money to invest you will be able to borrow up to $70,000 to invest.

The lending ratio may vary according to the type of investment. For example, blue-chip shares and many managed funds often have higher lending ratios of 65-75%, whilst higher risk assets such as small Australian companies may have lending ratios of only 40-50%.

Instalment gearing

A margin loan can be drawn as a lump sum or in instalments. A lump sum margin loan provides you with a lump sum to invest. An instalment margin loan lends you a smaller amount on a regular basis, which you use to add to your own contributions to gradually buy investments. An instalment margin loan may reduce your risk and provide benefits from dollar cost averaging. Dollar cost averaging involves investing a set amount of money at regular intervals. By investing this way you are not attempting to pick the lows or highs of the market but rather investing a fixed dollar amount regardless of investment market trends.

Double gearing

Double gearing involves borrowing funds, and using those funds to purchase investments. The investments are then used as security for further borrowing via a margin loan.

A double gearing strategy increases both the total amount of your debt and the amount you invest. As a result, a double gearing strategy involves more risk, as any investment gains and investment losses will be magnified significantly more than a standard gearing strategy. With this strategy, it is important to know that you will be responsible for the ongoing obligations for both loans. Any losses within your investment portfolio may affect your ability repay these loans. This may impact the viability of your investment strategy.

Margin calls

A margin call can occur if your loan balance exceeds your maximum loan limit (i.e. when the lender's maximum Loan to Value Ratio (LVR) is exceeded). This may happen as a result of market downturn which causes your portfolio value to fall or if interest has accumulated on your loan to the point that the LVR is exceeded.

A margin call is a demand from the lender that you take action to restore your position to an acceptable LVR.

To meet a margin call, you will be required to:

- repay part of the loan so that the lending ratio is restored, or
- lodge additional investments as security to increase the total portfolio value, or
- sell part of the portfolio and use the proceeds to repay part of the loan.

For example:

> Hugh commences an investment portfolio, comprised of $35,000 of his own funds, and $65,000 from a margin loan. The total investment amount is $100,000. Hugh's actual LVR is 65%. The lender's maximum LVR is 70%.
>
> The market falls in value and Hugh's investment portfolio reduces in value to $80,000. The lender's maximum LVR continues to be 70%, so now that the total portfolio value has fallen, Hugh's loan cannot exceed $56,000. Hugh will receive a margin call requiring him to reduce the actual LVR back below the lender's maximum limit of 70%.

Hugh must take action. He could do one of the following:

- repay $9,000 of the margin loan (from cash held outside the margin loan facility)
- lodge additional investments of $13,000 to the margin loan facility
- sell $30,000 of the margin loan's portfolio to repay part of the margin loan

If you do not meet the margin call, the lender can sell some of the investments to meet it.

Selling assets to meet a margin call may result in a capital loss. Therefore, to reduce the risk of a margin call occurring, consider borrowing so that there is a generous buffer between the lender's LVR and your actual LVR. For example, if your LVR was 50%, and the maximum LVR allowed is 70%, your assets would need to fall by over 30% to trigger a margin call.

Benefits

The benefits of margin lending may include:

- The loan enables you to increase the size of your investment portfolio.
- A larger portfolio enables you to increase the diversity of investments.
- You may be eligible to claim a tax deduction for some or all of the cost of the loan to help offset the cost of the borrowing or to reduce tax on other income.

Risks, consequences and other important things to consider

These include:

- Tax advantages from negative gearing should never be the sole reason for establishing a gearing strategy.
- You should ensure your employment and cash flow are secure so that you aren't forced to sell some or your entire investment portfolio at a time when the markets are down.
- An unforeseen event, such as injury or illness that prevents you from working, or a change in employment circumstances, may make it difficult to meet interest repayments. The risk of losing income because of injury or illness can be reduced by incorporating wealth protection measures, including Income Protection, Critical Illness Cover and Total & Permanent Disability Cover.
- Although margin lending provides the potential for increased capital gains when markets are rising, it also has potential for increased losses when markets are falling.
- A margin call could force you or allow your lender to sell some or all of your investment portfolio at a time when the markets are down, thereby creating a loss. It is important that you ensure your employment and cash flow are secure to avoid this situation and consider borrowing so that there is a generous buffer between the lender's LVR and your actual LVR.
- You should consider the impact of a rise in interest rates or a reduction in dividends, distributions, or other income from the investment. You should ensure you have sufficient cash flow to absorb interest rate increases and investment income decreases.
- The value of your investment portfolio may fall in value to a point where the sale proceeds are not sufficient to repay the debt. So even though you have been entitled to tax deductions over time, it is possible that you could end up carrying a debt once the investment portfolio has been sold.
- Double gearing involves more risk, as any investment losses will be magnified significantly more than a standard gearing strategy. Losses within your investment portfolio may affect your ability repay the loans used to double gear. You will continue to be responsible for the ongoing obligations for both loans, regardless of any investment losses.
- Legislation may change in the future in relation to tax deductibility of interest payments.

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