



Story Peter Freeman

# Gearing loses some spark

Investors gearing into the sharemarket and seeking some risk protection have been hit by Rudd government rule changes

**S**HARE INVESTORS WHO want to gear into the market are being confronted by two strongly countervailing pressures. On the one hand, the market's extreme volatility during most of 2008 has made gearing into the sharemarket riskier, in the process boosting the appeal of using a protected equity loan to insure against the full impact of falling share prices.

Against this, however, is the fact that rule changes announced in the federal budget on May 17 mean the tax breaks available on these loans are less generous than they were, in the process making these already expensive loans even more costly.

"At a time when there is a lot of concern about investors taking too much risk, it seems perverse to have made protected loans less attractive," says Duncan Fairweather, executive director of the Australian Financial Markets Association.

Protected equity (or capital protected) loans, the first versions of which were launched just on 15 years ago, enable investors to borrow 100% of the amount they want to invest while also protecting themselves against losses due to falling share prices.

Mark Johnston, managing director of research group Investment Trends, says one way of lowering the cost would be to offer loans with less than 100% protection.

"Several lenders are already investigating this possibility," he says. "It is likely it won't be too long before investors get the option of paying a lower rate in return for less protection."

The total value of protected loans reached

\$2.8 billion last year, more than 7% of Australia's \$37.8 billion margin lending market.

The main providers of protected equity loans are Commsec, Leveraged Equities, Macquarie Bank, Smith Barney Citigroup, St George Bank and Westpac Margin Lending.

"The sharemarket uncertainty means it is likely more investors are interested in taking out protection but are being put off by the tax change," says Pia Cooke, associate director with Macquarie Bank and an expert on protected equity loans.

Prior to the budget announcement any interest paid on protected loans up to 14.55% – the Reserve Bank's personal unsecured lending rate – was tax deductible.

Any interest over this was treated by the tax office as being the cost of taking out protection against loss and so wasn't deductible.

As a result of the rule change, borrowers who have taken out protected loans since 7.30pm on May 17 – budget night – now can claim a tax deduction for interest of just 9.35%, the Reserve Bank's indicator variable rate for standard housing loans. None of the rest of the interest is tax deductible.

Given that rates on even relatively conservative protected lending strategies are currently around 16% or so – and can be as high as 40% if the loan is used to buy more speculative shares – the rule limiting the deductibility of interest can be very costly.

This is highlighted by the federal government's estimate that its decision to cut the deductible rate from 14.55% to 9.35% will generate an additional \$70 million in tax revenue over the next four years.

This is on top of the existing tax savings already being made by preventing investors claiming a deduction for the cost of their borrowings in excess of 14.55%.

The only compensation for investors is that, as in the past, the non-deductible interest is added to the cost base of your investment when the time comes to calculate capital gains tax, reducing the tax you have to pay on any profit.

Of course, this benefit depends on investors actually making a capital gain. What's more, even if they do it delivers a much less valuable tax saving than being able to deduct the full interest cost each year.

"It was only about a year ago that the 14.55% rate was finally agreed on and now it has changed again," says Fairweather, who says his association is having ongoing discussions with the tax office about why the latest decision should be reversed.

He acknowledges, however, that the cut in the tax effectiveness of protected loans doesn't mean they no longer have a role.

Cooke of Macquarie agrees and says the best way to look at the situation is to assess the impact on the so-called break-even return an investor has to get on protected loans. This is the return that has to be achieved each year to cover the total after-tax cost of the interest paid on the loan.

Provided you achieve this break-even return, you will not lose anything on your investment even if the sharemarket collapses. Remember, the loan provides a 100% protection against falling share prices, so all you need to do is to earn enough to cover your interest costs.



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Cooke cites the case of a client whose portfolio was financed with a protected loan just before the change was announced as part of the federal budget.

In this particular case, it is necessary for the investor to earn an after-tax return of 5.6% a year to cover all his costs.

The same portfolio put together after the budget change now has a break-even point of 6.6% a year – an extra one percentage point that goes to paying for protection rather than being available as profit.

Cooke stresses that the break-even point obviously is higher the higher the interest rate you pay, which means it can be very costly at the moment to take out a protected loan for just one year.

If you do, the interest rate, including the cost of protection, is likely to be at least 16% but often closer to 20% and sometimes it is a lot higher.

In contrast, three-year protected loans can cost as little as 13% while a five-year loan to finance blue-chip shares may cost less than 12%, although in both cases loans used to finance riskier shares cost around 18% to 22%.

Perhaps the main issue for investors to focus on is whether fixing the rate for three to five years makes sense at a time when rates are relatively high.

If the Australian economy slows and inflation dips there is a good chance all rates will fall, in the process making the current cost of protected loans even more painful. ❧