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Living with the stress of investing borrowed money

James Dunn | *May 21, 2008*

GEARING a share portfolio is exactly the same as taking out a home mortgage.

You borrow money to buy a larger share portfolio than you could otherwise buy. And because your investment is geared, both profits and losses are magnified.

Borrowing 70 per cent of the portfolio value will produce percentage gains or losses that are 3.3 times the level of an ungeared portfolio. A portfolio geared to 50 per cent will generate double the gains in the equity -- and twice the losses. Say you have \$30,000 in cash and you borrow \$70,000 from a margin lender to buy a share portfolio worth \$100,000: the loan-to-value ratio (LVR) is 70 per cent, and the margin is \$30,000.

If the shares fall in value, you may be asked to sell some shares or deposit more cash to bring the margin back to an acceptable level. This is known as a "margin call" and protects the lender if your investment drops in value.

If the value of the portfolio increases by 20 per cent to \$120,000, your equity in the portfolio rises from \$30,000 to \$50,000, an increase of two-thirds, without any effort on your part. That's the good side of leveraged investment.

On the other hand, a decrease in the value of the portfolio ratchets up the fall in your equity. If the share market goes down and the value of the portfolio falls to \$90,000, your equity falls to \$20,000 (the difference between what you borrowed, \$70,000, and what the portfolio is now worth).

With \$70,000 borrowed and the portfolio worth \$90,000, the LVR has climbed to 78 per cent.

The lender will ask for the LVR to be restored to 70 per cent (in other words, the margin to be restored to 30 per cent), which means that the equity must rise to \$27,000. You receive a margin call to pay this \$7000.

With a conservatively geared portfolio, however, the likelihood of a margin call lessens considerably.

A portfolio geared to 70 per cent enters margin call territory if the sharemarket falls by just 6.7 per cent.

But if the portfolio is geared to 60 per cent, it needs to fall by a fifth in value to incur a margin call.

Gearing to 50 per cent increases this buffer to 30 per cent; if the portfolio is geared to 40 per cent, the value would need to fall by 45 per cent before a margin call would be made.

You can also use an existing portfolio as collateral to buy more shares. If you use this strategy and incur a margin call, the lender will request additional shares to the value required to top up the LVR.

You have to deposit the shares with the lender.

The advantage of taking out a margin loan secured by your shares is that you can raise capital for further investment without having to sell the shares or incur capital gains tax. But if the LVR drops below the allowed level, you will get a margin call.

Investors like gearing because the borrower owns the shares and is fully entitled to all dividends and bonuses. Because a margin loan is for the purpose of earning assessable (taxable) income, the interest payments on the loan are fully tax-deductible.

You can claim the whole of the annual pre-paid interest bill, for up to 12 months ahead, as a tax deduction in the current year. Interest can also be paid in arrears.

Say you've borrowed \$100,000 at an interest rate of 10 per cent, and bought a share portfolio. You can choose to pay -- assuming interest rates don't move -- \$833 a month for the next 12 months, or you can pay \$10,000 upfront. If you pre-pay, that \$10,000 is able to be offset against tax payable in the current tax year, and may be used elsewhere. But if you have a negatively geared portfolio and don't have any other income, you can't use the deduction. Paul Moran, principal of Paul Moran Financial Planning, says the taxation angle of a margin loan "should never be a consideration".

"It should always be a gearing play -- you're doing it because your expected returns are above your borrowing cost, and you want to enhance those returns. I'm always cautious when people come in at the end of the financial year and say they want a margin loan to use the tax deduction.

"To me that is giving money away -- especially when you have super that you can contribute to, as far as a tax deduction goes."

Moran says the share market crash and the surge in margin calls hasn't dented investor confidence in gearing -- far from it. "There's no question about gearing itself -- it's a genuine means of creating wealth. The real issue is the investor's level of gearing and the ability to deal with a falling market.

"The gearing level should be relative to where the market is. It's pretty simple: if somebody geared to 70 per cent in November last year, they have probably had a significant margin call -- and I would suggest their adviser was more interested in the sales commission than in quality of advice."

Moran says anyone gearing into the market "should know that it has a well-deserved reputation for volatility. A 20 per cent fall in the market should really be expected any day of the week, because that happens on the share market.

"That's in the realm of one standard deviation away from the average return, so you should always be prepared for a 20 per cent fall, and stress-test your situation on that possibility. Granted, a 35 per cent fall doesn't happen every week, but the people who'd decided to gear to a lesser extent weren't as exposed as those who geared to the hilt.

"We didn't have anyone who was geared at more than 40 per cent, so we didn't have a single client with a margin call. We're still not even close."

Brian Phelps, executive director of margin lending at CommSec, says being comfortable in margin lending is "all about being prudent" in your level of gearing.

"A lot of the press coverage seems to assume everyone is geared to the eyeballs, but in fact, the average gearing in the market is only just over 40 per cent. Right now, across CommSec and Colonial, our combined book is geared at 34 per cent.

"That's very low. That's more than 30 per cent away from the real capacity."

Phelps says now is a good time to be gearing. "We haven't closed down any facilities during this period. We had some clients who reduced their gearing levels back below 50 per cent, but on the whole, most of our clients were tipping cash in to their margin loans rather than selling stock, and they've ridden the slump out.

"Our clients are now looking to the opportunities -- they're looking to pick the right stocks."

Mark Johnston, managing director of research group Investment Trends, says the margin lending market has "had its growth arrested" for a time.

"The total lending book has come back a bit, which is the first time that's happened since the bear market of 2002-03," he says.

"Everyone is making a lot of noise about the elevated level of margin calls, but that's a side issue. It's still a very, very small number of clients.

"The biggest effect has been to arrest the growth of the market for a while, but for just how long, we don't

know.

"The other thing constraining growth in the market is higher interest rates. "Once you cross into double-digit interest rates, that becomes a barrier to further growth. It's even higher in the protected lending area."

Protected lending facilities allow investors to borrow up to 100 per cent of the value of a share portfolio -- with the benefit of capital protection.

If the value of the shares falls during the term of the loan, at the end of the loan the lender takes back the unprofitable shares as full repayment of the loan.

For this protection, borrowers can expect to pay accordingly: up to 40 per cent for a one-year loan, depending on the lender.

This cost is "a function of volatility", says Pia Cooke, division director at Macquarie Equity Markets. "The protected lender is taking out put-option protection on the stock, because it may have to take the stock back.

"Near-term volatility is very high at the moment, and on the rate curve, interest rates are cheaper if you go out further. The one-year cost on a protected loan looks pretty hefty, but really, most people would look at protected lending as having a three or five-year term. There, you're paying 16-17 per cent, but on an after-tax basis, on plenty of the stocks that we're looking at now, you will break even on about 6 per cent a year. That becomes a lot more profitable to clients in this environment: they know that the bank shares are still down 30-odd per cent from 12 months ago. They see 6 per cent a year from those stocks as more than achievable, especially over three to five years," she says. The protection afforded by a protected equity loan alters the tax deductibility situation.

"The investor not only has the normal cost of borrowing the money, there is also the cost of the 'put' protection," Cooke says. "That put protection means that you can only claim a portion of the interest cost as a tax deduction." Before last week's Budget, protected lending investors could claim up to the unsecured personal lending rate, at about 14.5 per cent, as their actual interest cost, with the rest of the cost treated as the notional cost of the put option.

But in the budget, Treasurer Swan announced that protected lending clients could claim interest up to the indicator variable rate, which is the rate used for a standard variable home loan -- at 9.35 per cent.

Anything above 9.35 per cent is viewed by the ATO as the cost of protection and added to the investor's cost base.

"Say you take out a three-year protected loan at 15 per cent. If it is a \$10 stock, you will pay \$1.50.

"Of that, 93.5c will be deductible, and 56.5c is broken out as the portion of interest that is the notional cost of the put option. That becomes a capital item, and is added to the individual's cost base. It is claimable, but only when you exit your position: your cost base on that stock becomes \$10.56, and your capital gain decreases," Cooke says.

While protected equity loans are "still relatively tax-effective," she says, the Budget decision means that post-tax break-even is slightly higher than it was before. "I put together a protected portfolio for a client two days before the budget that had a post-tax break-even point of 5.6 per cent a year -- but after the budget changes, that break-even point has become 6.6 per cent a year," Cooke says.

"But even that is still very palatable for clients who are looking to invest in the market -- particularly if they're considering the bank stocks, given how they have fallen since November," she says.