Margin lending

Margin lending is a form of gearing, which 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.

Benefits

- 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.

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 equity to borrow additional funds.

The amount you borrow is limited to a percentage of your own investments that have been used as equity. This 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 using a margin loan. 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 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.

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

- have a long-term investment timeframe of at least five to seven years
- have sufficient disposable income to comfortably meet interest costs as well as any margin calls (repayments) if the investment value falls, 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 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.

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The margin lender will set a 'lending ratio'. For example, if the lending ratio is 70% if 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 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.

Margin calls

A margin call can occur if your loan balance exceeds your maximum loan limit (i.e. when the 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.

Hugh commences a margin loan with a total investment amount of $100,000 and an LVR of 70%. This means Hugh could borrow up to $70,000, but he only borrows $65,000, which is below his maximum limit.

The market falls in value and Hugh's portfolio reduces to $80,000. The LVR continues to be 70% but given that the total portfolio value has fallen, his loan cannot exceed $56,000. Hugh will be asked to make a margin call to reduce the value of the debt back below the 70% limit.

A margin call is not a penalty, but you may be required to:

- repay part of the loan so that the lending ratio is restored
- 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.

If the margin call is not met, the lender can sell some of the investments to meet the margin call.

Selling assets to make a margin call may result in a capital loss. Therefore to reduce the risk of a margin call occurring, it is generally recommended that you do not borrow more than half of the total investment portfolio (ie. do not exceed a lending ratio of 50%). At this level, if the maximum LVR is 70% your assets would need to fall by over 36% to trigger a margin call.

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Consequences

- Tax advantages from negative gearing should never be the sole reason for establishing a gearing strategy.
- 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 to sell some or all of your investment portfolio at a time when the markets are down, thereby creating a loss. If is important that you ensure your employment and cashflow are secure to avoid this situation and consider only borrowing below the allowed LVR.
- A rise in interest rates will increase the cost of borrowing and a decline in dividends or distributions will reduce your income. You should ensure you have sufficient cashflow 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.
- Legislation may change in the future in relation to tax deductibility of interest payments.
- An unforeseen event, such as injury or illness that prevents you from working, may make it difficult to meet interest repayments. This risk can be minimised by incorporating wealth protection recommendations, including Income Protection, Critical Illness Cover and Total & Permanent Disability Cover.
- Fees may be charged on investments. You should check the details in the fee section of your Statement of Advice and the Product Disclosure Statement (PDS) for your selected investment

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