Wealth Creation

Margin lending

Aon Hewitt Financial Education Series

Margin Lending is where you borrow money against your existing cash, shares or managed funds to invest into shares or managed funds. Margin lending is usually used by those investors who do not have equity in an existing property. The interest rate on a margin loan is generally higher than a home mortgage.

Margin lending is considered to be riskier than home equity gearing because of the possibility of margin calls.

Please refer to the 'Overview of Gearing' fact sheet under the Wealth Creation Financial Education Series for more details on borrowing to invest.

What is an LVR or an LSR?

Your LVR or Loan to Value ratio is the value of your loan as compared to the value of your security. For example, if you have managed funds valued at $100,000 and a loan of $50,000 your LVR is $50,000/$100,000 or 50%.

Some margin lenders refer to an LSR which stands for Loan to Security Ratio, and is simply a different term for an LVR.

It is very important that you understand how your LVR is calculated and that you monitor your LVR on an ongoing basis if you have a margin loan.

How much can I borrow?

The amount that you can borrow will depend upon the assets that you use as security and the margin lending provider.

Not all shares and managed funds are alike. Because of this, margin loan providers specify a lending ratio for each investment that they are prepared to lend against. This may vary from 30% to 75%.

Your lending ratio changes according to fluctuations in the market. The lending ratios apply to the value of your investment. As that value goes up or down, your loan limit rises and falls as the lending ratio is applied to the new portfolio value. For example, if your investment increases in value, this lifts your loan limit and makes additional funds available to use. If your investment decreases in value, your loan limit will decrease and may result in a margin call.

If you wanted to invest $10,000 in a managed fund that was assigned a lending ratio of 70%, the amount you could borrow would be $7,000. You would then be required to fund the remaining $3,000.

The maximum amount that you can borrow on your entire portfolio within the margin loan facility is called your loan limit.

What is a buffer or loan buffer?

With a margin loan, you are given a limit on the amount that you can borrow. This is known as your loan limit, and is based on the LVRs of the investments in your portfolio. The margin lender then allows you a buffer usually between 5-10% between the loan limit and a margin call. This buffer gives you extra time to bring your loan back into line before a margin call is triggered.

It is very important that you understand that if you do trigger a margin call, you aren't able to simply return to your buffer zone. You must bring your loan back to below the loan limit amount. This means that if you do experience a margin call you will need to find a minimum of 5-10% of your loan amount to cover the call.

What is a Margin Call?

A margin call occurs when your loan to value ratio (LVR) goes above your buffer. To get out of the margin call you need to get your LVR back into the acceptable level. To do this you will need to repay part of the loan, sell some of your security (in this case the managed funds), or lodge additional security say cash or managed funds. If you are unable to do so, the margin lender may start to sell down your investments until your LVR falls back within the required range.

One reason investors get into trouble with margin calls is that if the market falls and they enter a margin call, the market may continue to fall. This means that the investor needs to put more security into the loan or pay down more of the loan. In some cases investors have had to sell their entire portfolio to repay the outstanding loan. This means that they will also lose their initial investment.

Minimising the Chance of a Margin Call

To minimise the chance of margin calls we suggest the following:

- Maintain a low LVR. An LVR of 40% means your portfolio has to fall 50% before you are subject to a margin call. We suggest keeping your LVR under 60% at all times.
- Monitor your margin loan. A margin loan is not a "set and forget" investment. If the market starts to fall in value you need to be monitoring your margin loan, possibly on a daily basis.
- Diversify your investment by spreading it across different industries and/or markets.
- Ensure you have sufficient cash, or other assets, available to top up your loan. You will need to respond very quickly in the event of margin call, usually within 24 hours.

If you are not comfortable with the possibility of a margin call then margin lending is not an appropriate investment strategy for you.

Risks of Gearing

While the rewards from gearing can be high, there are also a number of risks:

- **Gearing can magnify losses:** As gearing magnifies the potential return you may receive on your investment, it can also magnify the losses if your investment declines in value.
- **Risk of interest rate changes:** You need to ensure that you could manage the interest repayments if interest rates were to increase.
- **Importance of gearing into growth assets:** Gearing costs money. Each year you need to pay the annual interest on the loan. If the investment you have geared into isn't growing in value then you should reconsider the strategy.
- **Risk of loss of cash flow:** You should only borrow to invest if you have the financial ability to absorb the effect of potential falls in investment value, the ability to fund margin calls if using margin lending, and/or the increased cost of interest payments. Otherwise you might be forced to sell part of your investment at a low price to meet a margin call. Another risk is that the income from the investment (rent or dividends) may decrease or temporarily cease, which may place a burden on your cash flow.

Please refer to the 'Overview of Gearing' fact sheet under the Wealth Creation Financial Education Series for more details on each of the above risks.

Example 1

Let's have a look at how the LVR, loan limit and buffer zone work.

Donny has an existing margin lending account with a loan of $20,000 and a managed fund valued at $36,000. The margin lender has assigned the managed fund an LVR of 60% which means in this case the loan limit is $21,600. Donny is currently within his loan limit, as shown by the column titled "current situation".

What would happen if the value of his managed fund fell by 11% (Scenario 1) and 26% (Scenario 2)?

If Donny's managed fund fell in value by 11% it would be worth $32,040, and his loan limit would reduce to $19,224. However his loan stays at $20,000. Due to this, Donny's loan amount exceeds his loan limit. Donny is within his buffer zone, but is not yet in margin call.

In this situation, Donny should be monitoring his margin loan and ensuring he has either cash or additional funds he can transfer into his margin loan if required.

If Donny's managed fund had fallen in value by 26% it would be worth $26,640, and his loan limit would reduce to $15,984, again his loan stays at $20,000. Because of this, Donny's loan amount exceeds his limit and his buffer of $2,664. As such, Donny is in margin call and will need to contribute a minimum of $4,016 into his margin loan to return his loan amount to under the loan limit.

This is illustrated in the table below:

	Current Situation	**Scenario 1: portfolio drops by 11%**	**Scenario 2: portfolio drops by 26%**
Donny's Portfolio market value	$36,000	$36,000	$36,000
New Portfolio market value of Donny's portfolio following market fall	N/A	$32,040	$26,640
Loan to Value Ratio (LVR) **(Maximum percentage lent to you based on an individual security - assuming 60% in this example)**	60%	60%	60%
Loan Limit **(Portfolio market value x LVR%)**	$21,600	$19,224	$15,984
Loan balance **(What Donny has borrowed)**	$20,000	$20,000	$20,000
Total buffer allowable if the buffer is 10% of the market value of the portfolio	$3,600	$3,204	$2,664
Loan balance exceeds the Loan limit by	Loan is within Limit	-$776	-$4,016
Buffer/Margin Call		Remaining buffer $2,428	Buffer has been fully utilised and exceeded. Loan account in margin call and a payment of $4,016 is required to restore the account back to the Loan limit.

Example 2 – Margin Lending

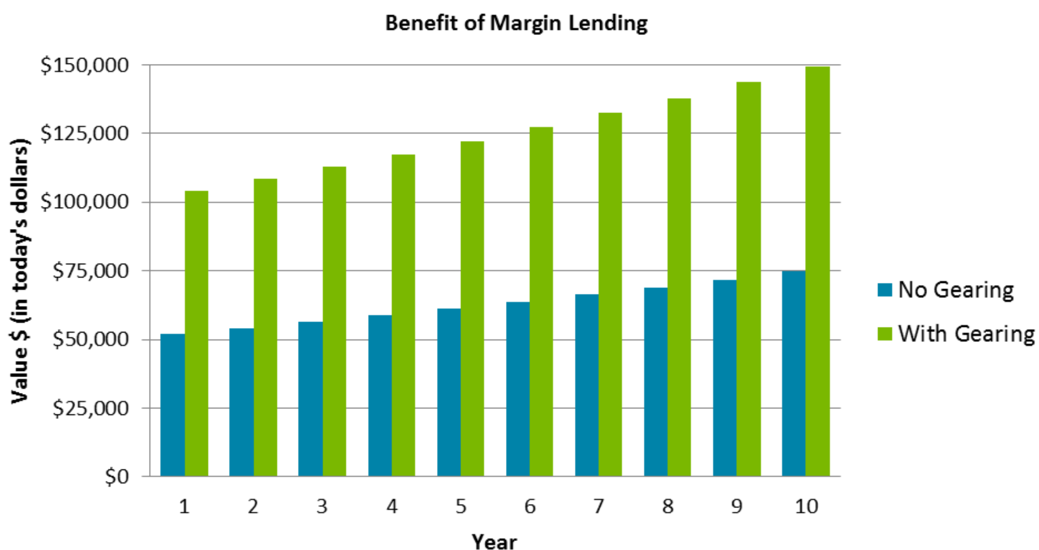
Brett is aged 28, earns a salary of $65,000 and has surplus income of $1,500 per month. Brett has recently received an inheritance of a $50,000 share portfolio. Brett is renting, but is interested in maximizing his wealth. He has heard of margin lending and thought he would ask his financial adviser for some more information.

His financial adviser recommended that Brett use the $50,000 share portfolio as security for a margin loan. They agree that an LVR of 50% would be appropriate due to his age and risk profile. This meant that Brett would borrow an additional $50,000 to invest, giving him a share portfolio of $100,000 and a loan of $50,000. The interest on the loan is 8% costing Brett $4,000 before tax each year.

Let's look at the advantage of undertaking the margin loan, against simply maintaining the $50,000 investment:

	No Gearing	With Gearing
Initial Investment	$50,000	$50,000
Plus Borrowed Funds	$0	$50,000
Total Invested Funds	$50,000	$100,000
Income and Growth at 7%	$3,500	$7,000

Over 10 years the difference between the two strategies would be $74,769 ignoring tax. After repaying the initial loan of $50,000, Brett has an additional $24,769 investment. In the 10 year projection below (based on today's dollars), what has not been considered is the possibility of a negative return which may ultimately impact the end result.



Before considering a gearing strategy, we strongly recommend that you read the 'Overview of Gearing' fact sheet under the Wealth Creation Financial Education Series and discuss this with your financial adviser.

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This document, including all tax and super calculations, has been prepared using legislation in place as at 1 July 2018.

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