

# The benefits of margin lending



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Peter van der Westhuyzen, Division Director, Macquarie Investment Lending

Margin lending has become a hot topic during recent months as financial markets have fallen to levels that qualified as a technical correction (-10%) then a bear market (-20%). As a result of these falls, the number of margin calls has increased.

At the same time, I have seen margin lending subjected to substantial negative opinion, portrayed as a monster of debt and downfall that leaves companies and investors alike struggling to meet their payments. This has not helped calm investors at a time of uncertainty, and I believe it paints an inaccurate picture of how the investment lending industry operates. It's therefore, an opportune time to reinforce margin lending as a long term wealth creation strategy which still works during times of market volatility. Now is also the time to revisit the basic rules which should be followed to manage and mitigate one of the key risks, margin calls.

Let's focus on margin calls first. The reality is that a large market fall does not automatically mean a margin call will occur. In fact, despite the Australian share market falling by almost 11 per cent in January 2008, less than one per cent of our margin lending client base received a margin call. This means that over 99 per cent of our clients were able to successfully manage their risk levels and avoid receiving a margin call altogether.

So how did they do it? In general, these clients followed the basic rules of gearing, which are to borrow conservatively and diversify your investment portfolio. To illustrate this, an investor who is geared conservatively at 50 per cent into a range of blue chip securities would need to experience a 35 per cent drop in their portfolio to receive a margin call. While the Australian share market fell by 24 per cent between 1 November 2007 and 22 January 2008, this fall would not have been large enough to cause a conservatively geared client to receive a margin call. Another interesting finding is that of those investors who did receive a margin call last month, many did not have a financial adviser which I think is a good example of the role professional advice plays in managing risk.

If we look even more closely at investors who had received margin calls since November 2007, a few trends begin to emerge. These can act as a checklist to give your clients if they are using a margin loan.

Generally, clients who experience a margin call can have the following characteristics:

- Their portfolios are highly geared, close to the maximum level which is often around 70 or 75 per cent;
- They are holding a concentrated portfolio, sometimes in only one of two shares;
- They are not actively monitoring their portfolio or loan account using online tools; and
- They do not take any pre-emptive action when there is increased market volatility and therefore have to react quickly when the margin call is issued.

Therefore, focussing on managing items like the above can be an effective way of reducing the chance of receiving a margin call.

It is, however, important to put this all into context. This is because in times of turbulent equity markets, margin lending is still a valid and safe way of helping clients to create wealth, when it's used in the right way.

Clients need to be sure of two things though:

Firstly, they need to have a strong, positive opinion about the equities or funds they are investing into and should be asking the question "do I want to invest in this company or fund and does it suit my growth profile?" If the answer is no, they should not be investing using their own money or anyone else's. However if the answer is yes, the next decision should be how to fund the investment, with typical options being cash, margin lending, protected loans or drawdown on home equity.

To help make the right funding decision, it is important to keep in mind that margin lending best supports a medium to long term investment strategy of five years or more. It is not a get rich quick approach and the best results are seen where margin lending is set up in a way that invests through market cycles. This can either be done via an upfront, lump sum investment or the "little and often" approach offered by instalment gearing to give the benefit of dollar cost averaging.

Secondly, investors need to understand the risks of using gearing. Rule number one says that the use of leverage increases risk, but increased risk is not a bad outcome if you understand what it is and how it can be managed. Risk management is a fundamental part of the decision making process when deciding whether a margin loan is appropriate or not and there are a variety of ways to mitigate risk such as:

#### 1. Diversify the investment portfolio

The investor's disciplined approach to risk management should start before they have even applied for a loan. They need to take a step back and ask themselves whether their portfolio is truly diversified.

#### 2. Use leverage wisely. Don't over borrow

The next step is deciding the appropriate gearing level. The margin lending industry average tends to be around 50% where good investment quality and diversification is found. Working with clients to ensure they are realistic about the amount of risk they can tolerate is key.

#### 3. Use professional risk management tools

It is paramount that an investor understands what will happen to their portfolio in different conditions, the good and the bad. An adviser can assist their clients by using various online tools, like our secure GearUp website which has live prices (20 minutes delayed) and provides up to date margin loan positions on request. This has proven to be a very valuable tool in times of high levels of volatility.

#### 4. Plan for a margin call

Once all of this is clear, talking to clients about what they would need to do if they are approaching a margin call is important, along with how to monitor their portfolio to safeguard against it ever getting that far.

## 5. Capital protection

It is also worth remembering that, for investors who do feel nervous, you can also introduce an element of capital protection into their portfolio to offer additional peace of mind if they need it.

The clear message is that combining margin lending with professional financial advice, the right approach to risk management and a good investment portfolio, is a tried, true, and well tested method of creating wealth. It enables clients to take advantage of the two fundamental building blocks of wealth creation – leverage and compounding. Done in the right way, your clients can have a very positive experience using debt.