

The myths of Icarus and margin lending

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Greek mythology is not everyone’s favourite read but most people remember the story of how Icarus and his father escaped their imprisonment in Crete.

Daedalus, the master craftsman, fashioned a pair of wings of wax and feathers for himself and his son. Before taking off from the island, Daedalus warned his son saying “take the middle way, in case the moisture weighs down your wings, if you fly too low, or if you go too high, the sun scorches them. Travel between the extremes”. After he fitted the newly created wings on the boy’s shoulders and giving a never to be repeated kiss to his son, Daedalus flew ahead, anxious for his companion, like a bird, leading fledglings out of a nest, into the empty air. He urged the boy to follow his example but the boy began to delight in his daring flight and abandoning his guide, drawn by desire for the heavens, soared higher. His nearness to the devouring sun softened the fragrant wax that held the wings and the wax melted. He flailed with bare arms, but losing his oar-like wings, could not ride the air. Even as his mouth was crying his father’s name, he vanished into the dark blue sea, the Icarian Sea, called after him.

Classic poets provided philosophical underpinnings to this myth, often linking Icarus analogically to artists or with Icarus acting as a vehicle for heroic audacity and high aspirations. Many modern writers have added more realistic variants, in which the escape was actually by boat, for which Daedalus invented the first sails, and that Icarus fell overboard and drowned.

Of course only an accounting philistine such as me would seek to draw an analogy between a glorious Greek myth and margin lending in the share market. Yet how apt that analogy now seems. There have been many unfortunate cases of Icarus-type borrowers in the share market, who ignored Daedalus-type advisors and borrowed too much and flew too high for too long, had margin calls, made forced share sales at losses, depleted cash buffers and liquidated real property investments - all at the least opportune time.

Having said that there are also plenty of Daedalus-type borrowers who are still flying between the extremes, albeit a little closer to the water than the sun. In fact some are starting to test their wings again or for their first time.

As Warren Buffet has recently been reported as saying in the New York Times: “be fearful when others are greedy, and be greedy when others are fearful”. Given his rationale and the widespread fear in the international share markets, his investment portfolio could soon comprise 100% in US equities!

To be sure though, investors should now be much more wary of highly geared equity investments. However the recurring question is whether one should still try and fly between the extremes or should one keep their feet firmly on the ground?

The rise and rise in popularity of margin lending

According to Australian Tax Office records, over 1.5 million taxpayers own investment properties with over 1.2 million having borrowed money to buy them. Real property and negative gearing of real property is

something of an obsession in Australia. The gearing comes when the income derived from an investment property is less than the expenses incurred, including the interest costs on borrowings associated with buying the property. The consequent tax breaks have merit in their own right but the overall property investment and future capital growth must make sense too.

But are Australians equally obsessed with negative gearing in the share market? Another form of borrowing has in fact emerged over the past decade in respect of non-property investments, including direct shares and managed funds. This mainstream borrowing is commonly referred to as margin lending. Over 200,000 Australians used margin lending products which had a total of over \$40 billion invested. Of this total amount invested in margin lending products approximately 45% is borrowings.

Not surprisingly, the growth over time in geared property investment was relatively constant but growth in the margin lending market has grown at accelerated rates trailing the once buoyant equity market returns.

Why try and fly with margin lending?

There are typically three main reasons why investors are attracted to margin lending:

1. To build an investment portfolio faster;
2. To multiply investment returns; and
3. To take advantage of the tax concessions.

The theory is wealth builds more quickly as more is invested in the market.

The much used adage is that you cannot simply save your way to wealth but should use other people's money.

Margin lending facilities generally allow investors to borrow up to three times (75%) of an investor's original investment portfolio to purchase additional shares. This gives the investors the power to capitalise on their existing assets and make the most of their existing wealth.

Margin lending also provides some Australian share investments with yield imputation credits that can reduce the amount of tax paid on investment income. The tax concessions also flow from the tax deductibility of interest expenses and other costs as well as the capital gains tax concessions flowing from holding the underlying shares for more than 12 months.

However, whilst margin lending accelerates wealth creation, compared with non-geared portfolios, it can also magnify losses. This is especially so when the market you have invested in is retreating rapidly, as is currently the case. Gains can be wiped out in an instant and not being prepared to manage a margin call could actually see the demise of an entire portfolio.

Margin lending - the detail is in the wax and feathers

The reason that margin lending can be so risky is because the investment is the security for the margin loan and its value varies with market movements.

The amount of a margin loan available is calculated in accordance with a loan to value ratio (LVR) expressed as a percentage of the value of a particular share, and is the maximum amount a margin lender will lend

will however have to provide 25% of the total purchase price of any additional shares he chooses to acquire.

Ignoring his Daedalus-type advisor, he chooses to use the entirety of the initial available funds of \$37,500 (to provide 25% of the purchase price). This then means he can borrow an additional \$112,500 (representing the additional 75% of the loan funds) enabling him to acquire further investments up to a value of \$150,000. The total combined value of his portfolio is now \$200,000 (column 2). Dr Icarus is flying high - so far so good!

Margin lending (and borrowing) becomes most vulnerable as the value of the investment changes in accordance with market changes, thereby also altering the loan limit. Margin calls are often regarded as the main risk of a margin loan facility and occur when the ratio of a loan compared to the value of the investment (LVR) rises above the pre-

Table 1.

Dr Icarus' Portfolio	Column 1 Original	Column 2 Newly Geared	Column 3 Revised Gearing
Value	\$50,000	\$200,000	\$130,000
Loan limit (at 75%)	\$37,500	\$150,000	\$97,500
Loan balance	Nil	\$150,000	\$150,000
Funds available	\$37,500	Nil	-\$52,500

to purchase additional shares. Typically up to 80% of the investment can be borrowed, although a more conservative 45% represents the average amount of debt in all investment portfolios using margin lending.

In the example in Table 1, an LVR of 75% is assigned to the investments within the existing loan portfolio of Dr Icarus. He purchases his original portfolio worth \$50,000 from his own funds. He wishes to avail himself of additional funds under a margin loan facility in order to purchase more shares. In order to do so he pledges the entire portfolio to ensure repayment of the (margin) loan. Dr Icarus establishes a facility (column 1) under which he can borrow up to 75% of the value of his existing portfolio, or \$37,500 as available funds for additional investing.

The value of any additional shares will be added to the loan portfolio. This then in turn increases the loan limit. Dr Icarus

determined level. In this example, 75% is the pre-determined level and Dr Icarus has borrowed to the flight ceiling limit.

So if the market suddenly falls and the portfolio value also drops, so will the security value of the margin loan. Margin lenders usually allow for a 5-10% "buffer" (the percentage amount by which the security value can be exceeded) before a margin call is initiated. However, the more highly geared a portfolio, the quicker a falling market will trigger a margin call.

In column 3, we assume Dr Icarus' share portfolio has fallen by 35%. Not so outrageous an assumption nowadays compared with when we started to run such worst case scenarios with many of our clients back in early 2007. Back then it was seen as conservatism but so too were recommendations to revise share portfolios and take defensive share positions associated with longer term investment strategies.

The total value of the portfolio falls to \$130,000 and the revised loan limit now also falls to \$97,500 (down from \$150,000). A margin call of \$52,500 is made requiring immediate action (usually by close of business next day) to either:

1. repay part of the loan (so that the loan balance no longer exceeds the \$97,500 loan limit) from external funds;
2. deposit additional securities or cash to increase the loan limit;
3. sell the portfolio and use the proceeds to repay the loan; or
4. a mix of the above.

The worst case scenario is item 3 as it results in a \$70,000 capital loss and still requires an additional \$20,000 funds in addition to the \$130,000 sale proceeds to extinguish the \$150,000 margin loan facility.

So flyer beware - there are always risks to consider whenever using borrowed funds to achieve financial objectives. Gearing magnifies both the gains and the losses on an investment portfolio. In addition to the above overall loss there are other considerations such as the costs of establishing the loan facility and interest paid on \$150,000 (of borrowed funds). In addition the losses in the above example portfolio will be higher still after factoring in the costs associated with establishing the initial underlying share investments.

How to keep your flight trajectory between the extremes

Some market commentators have long argued that margin lending requires investors to take unacceptable risks. Some also argue that financial planners embrace margin lending because they make more in investment and finance commissions because the client's funds under management are bigger. No doubt they are saying "I told you so" right now.

Well the real issue is whether you are an Icarus-type investor or a Daedalus-type investor. You should balance your flight path between the extremes.

You should work closely with your accounting, broking and financial advisors to ensure that your focus remains on:

1. commerciality of your equity investments;
2. understanding how margin lending operates;
3. understanding the potential risks;

4. the use of debt strategies within your overall investment strategy;
5. cash flow forecasting;
6. best and worst case scenarios in both the short and medium terms;
7. revising the appropriate levels of gearing;
8. assessing the probability of margin calls; and
9. optimising alternate loan facilities such as home equity, goodwill, etc.

The uncertainty traditionally associated with margin calls can often prevent investors maximizing their investment potential by avoiding gearing strategies altogether. Instead you should be working to try and eliminate some of the uncertainty by having advisors that use historical data from (many) market situations, allowing real and hypothetical market situations to develop more informed gearing strategies.

Insofar as margin lending is appropriate then your advisors should help you gauge the probability of a margin call by balancing the interplay between:

1. LVR;
2. margin loan buffers;
3. expected growth of portfolio; and
4. expected diversification mix of portfolio.

Also we ensure that clients realise that margin loans are not a "set and forget" strategy. There is no "auto pilot" to be availed of. Clients need to be well grounded and:

1. exercise basic common sense;
2. adopt conservative borrowing approaches to ensure potent safety nets are kept in place by borrowing less than the maximum afforded;
3. keep a watchful eye on a portfolio under a margin loan facility;
4. maintain a well-diversified portfolio (under any market conditions);
5. service loans and stay on top of loan interest repayments; and
6. hedge risks against losses.

Notwithstanding all of the above, margin lending is not for all clients and suits other clients in varying degrees. The gearing spectrum can be seen to stretch between the following two opposites:

1. wholly inappropriate as you approach retirement or are in retirement; and
2. appropriate for younger clients who have high income but little or no equity in residential property.

Notwithstanding the appropriateness of

gearing for younger clients, and no matter how keen they are to maximize their borrowing potential (up to 80% in some cases), we still strongly recommend, based on a range of issues, that margin loans initially commence well below and never increase to more than 50% over time.

Managing the risk also includes other matters that help clients sleep at night. We are also pro-active in recommending clients have appropriate income protection insurance to ensure that sickness or an accident does not cut off personal income streams required to service their investment debt levels.

So who continues to fly and who is strapping on their wings?

Our client experience has largely been that brokers use margin lending for direct investment into equities. On the other hand, financial planners tend to use margin lending to put their clients into more widely diversified wholesale managed funds. As such we have worked more closely with brokers during the rising markets when brokers wrote most of the business. However financial planners are currently writing bigger percentages of overall business during the falling market period.

Overall we have also found that financial planners are more focused on having a long-term strategy for our mutual clients and are less influenced by day-to-day market moves. Now that should not be construed as a criticism of brokers, particularly as a number of brokers are insisting that only medium term views should be taken on most current acquisitions given the bumpy market uncertainty (subject to happily closing out short term profitable upward bounces of anywhere between 10-20% in targeted share trades).

Most people understand wealth creation is not necessarily about *timing your entry* into the market but about *the amount of time you are in* the market. What about the length of time involved in gearing strategies? Is it worth hanging on to the same degree or servicing more modest debt levels through this investment cycle?

A subsidiary of the NAB group of companies has compiled share market data over the past 95 years to model gearing

strategies over various rolling time periods. The results have ostensibly shown that:

- Gearing added value to a portfolio on *most occasions*;
- The *longer the time period gearing was used*, the greater the likelihood of success;
- The *longer the time period gearing was used*, the greater the potential upside;
- Over a 10-year rolling period, *gearing added value 81% of the time*; and
- Over a 20-year rolling period, *gearing added value 90% of the time*.

So all in all, a geared investment portfolio requires a client to take additional risk but if one works proactively with their broker, financial planner and accounting advisors to mitigate those risks, then gearing into share markets is beneficial enough to warrant these risks. Of course we have worked to rationalise debt as most of our clients appreciate that it is important to work more closely on cash flows through negative investment cycles. Man-

aging short to medium term cash flows optimally means the long term thinking behind their selected products and equities is not prejudiced and ensures they remain a relevant part of their broader strategy.

It may ultimately reflect our conservative approach but our experience has been that only a minority of our clients have experienced margin calls and those were managed effectively. As a consequence, many of our clients continue to pursue the attractive benefits of margin lending which have included facilitating short term capital gains and portfolio performance in a rough market.

It must be understood that margin lending can be highly technical and tricky, not to mention costly, if not properly understood but there is no need to stop flying altogether and instead just stand with both feet firmly rooted to the spot. Just keep your flight path further from the sun than in the past and be absolutely sure your advisor has taken you through the

A-Z of margin lending, the risks involved, both the downsides as well as the upsides.

Disclaimer

This article is designed to provide generic information only and should not be viewed as a recommendation to act. Individuals should seek advice from a qualified advisor to ensure their actions are commensurate with their financial needs and requirements.

About the author

Garry Pammer is a Partner of Clark & Jacobs Accounting and Business Advisers, specialising in providing advice to dentists. Advice includes planning for your financial wellbeing, superannuation, insurance, practice management, computer software and the buying and selling of dental practices. For a free assessment of your financial position and to see how you can achieve your goals, please do not hesitate to call Garry on (02) 9264-1111.