

q&a

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Q 1: 3 years ago my 24 year old son took out a personal loan for \$10,000 to purchase shares in 2 companies. He has recently repaid the loan in full and the shares are now worth \$12,000. He would now like to purchase more shares in other companies by borrowing another \$12,000 via a personal loan at an interest rate of 14.75%. Is this a good idea?

R.W., Canberra

A 1: While your sons strategy to date has been OK, there are better ways build his portfolio. Here are some comments:

- 1) Purchasing more shares as an investment is a good idea so long as you have a long term timeframe in mind, ie 7 years at least and preferably 10 years. This is to give yourself a long enough timeframe to have a successful investment experience from quality companies.
- 2) If your preference is to buy direct share holdings then know you need 20 different companies across different sectors to have statistically "effective" diversification.
- 3) Managed funds provide a far greater diversification effect as you can invest \$1,000 in a managed fund that gives you exposure to thousands of companies instead of 1 company.
- 4) Consider the benefits of using a "Margin Loan" instead of a personal loan. This is a loan secured against existing assets (shares, managed funds, cash) held as security for the loan. The benefit is the interest rate is lower than a personal loan, ie 8% pa instead of 14.75% pa. You are also only required to pay interest only on the loan instead of paying down the principal. You can also prepay interest in advance for 12 months to bring forward a tax deduction into the current financial year.
- 5) An example: You contribute your \$12 k in direct share holdings as security for a loan of \$12 k (1 to 1 ratio). This loan is used to buy more shares leaving you with a share portfolio \$24 k and margin loan \$12 k. The Loan to Value Ratio (LVR) of this loan is 50%. If the investment value were to fall to hit the maximum LVR of say 80% (percentage determined by the underlying investments) then you may hit what is called a "margin call". This means either you contribute more assets to bring LVR back above 70% (allowing for a 10% buffer) or you need to sell down some investments to bring back a 70% LVR. This margin call situation is the risk of a margin loan. However, in this example you would need the investment values to fall from \$24 k to \$15 k (37.5%) to hit the margin call.
- 6) You can also borrow even more funds for investment, ie contribute your \$12 k in direct share holdings, to borrow \$24 k for investment. This would leave you with a portfolio value of \$36 k with a loan of \$24 k being a LVR of 66.7%. If investment values rise then you will not hit a margin call, but if they fall enough then you may.
- 7) While there are benefits to using a margin loan you should always be aware of the risks of using a margin loan aswell. Know what you are getting into and know that borrowing to invest can accelerate gains aswell as losses!
- 8) If your son is not sure about his employment stability then do think carefully before committing to a loan for investment. Worst case scenario is a loan is taken to buy investments, he finds himself out of employment and so unable to keep paying the interest on the investment loan and the investments need to be sold at a time markets are down (and therefore crystallising a loss) to pay back the loan.

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