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Q 1: I am looking to start a long term investment in a high growth share type portfolio. I would like to use borrowed money for the leverage and tax benefits and I have been told that I should use a "Margin Loan". Is this correct, and if so, how does this work?

Withheld, Jerrabomberra

A 1: A "Margin Loan" is a good way of allowing you to use borrowed money for investment purposes, particularly where you do not have residential property against which you can borrow. It allows you to get greater exposure to investments and you can find yourself in a negatively geared tax position, where any taxable "loss" can be offset against other assessable income to receive some tax benefit back. Features of a margin loan include:

a) Asking a margin lending financial institution to loan you money for investment, usually into shares or managed funds, upon which you pay interest.

b) The institution will ask you to contribute some funds or existing investments as security for the loan.

c) To hold existing and new investments as security, the financial institution will need to have the security investments held in custody in their name (no capital gains tax event is triggered though).

d) The loan interest rate will be 1% to 2% higher than normal home loan rates.

When lending you money, the institution will assess the risk of the investments held and the investments you intend to purchase, and determine a "loan to value ratio" (LVR). It is this LVR plus a "margin" which the institution does not want your loan to exceed. Eg. you have $10,000 in shares which you wish to contribute to a margin lending program. The investment you plan to purchase has a lending ratio of 60%. This means that you could borrow a maximum of $15,000, which when added to your $10,000 gives you a total investment of $25,000. Should your LVR exceed say 80% (due to a drop in investment value), then you are in a "margin call".

It is the margin call situation where the risk of this program exists, which is that should a margin call arise, then you are required to either:

1. Sell down some of your investment and pay back some of your loan until an appropriate LVR is established again, or
2. Sell out your entire investment, pay back the entire loan and keep any remainder, or
3. Contribute more funds or existing investments to the program to restore the appropriate LVR.

As a margin call situation is created due to the security investments having fallen in value, then the first 2 options will generally result in creating a capital loss, and effectively you have lost some of your wealth. Option 3, however, will encourage the investor to make a further contribution to the investment, which may be the best thing to do over the long term as you

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are purchasing more investments while the value has dropped and is effectively a good buying opportunity.

Margin lending can be an appropriate long term investment strategy, but you need to be aware of the potential for a margin call should the investment value drop. To reduce this risk, you should allow a buffer from the LVR and have funds available to contribute should a margin call occur.

As this strategy involves the use of borrowed funds, you can accelerate growth but also increase losses if not handled correctly. If you are not entirely clear on how a margin loan would operate, or of the risks involved, then you should seek advice from a Certified Financial Planner.

Phil Thompson is a certified financial planner and authorized representative of Rise Financial Pty Ltd (ABN 86350987645), AFSL 311718, an Approved Financial Planning Association Professional Practice. Answers should be used as a general guide only and professional advice should be sought before making investment decisions.

Send your financial questions to phil@risefinancial.com.au

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