

Margin Leading Explained

What is Margin Lending?

Margin lending means borrowing to invest in the share market.

By combining your own investments (cash or shares) with money borrowed allows you to invest more in the share market.

In the same way home buyers put down a deposit and borrow the rest of the money to purchase a home a margin loan allows the investor to be exposed to a much larger share portfolio than would have otherwise been the case.

The combination of your own investments and borrowing money is known as gearing your investment portfolio.

Like most home loans your lender (e.g. a Bank) will not provide you with all the money you want to make share investments. Rather, your lender will require you to have something at risk as well. Hence, you will be required to put in cash (to be invested in shares) and or shares into the portfolio. Lenders have different requirements but you can expect them to lend you between 60% and 80% of the value of the portfolio leaving you to contribute 20% to 40%. Your contribution is in effect a "buffer" from the lender's point of view.

Why is it called a Margin Loan?

Its called a margin loan because if the value of your portfolio falls to will come closer to the value of the loan, the lender may require you to contribute additional investments (cash or shares) to build the buffer back up. This is known as a margin call.

How to meet a Margin Call

If you are required to meet a margin call you can do so by:

- Repaying part of loan;
- Deposit additional securities (e.g. shares)
- Sell part of the portfolio thereby raising cash to lower the loan amount

How likely is a Margin Call?

Being asked to make a margin call is more likely when:

- The share portfolio has been recently established - because its value is less likely to have appreciated;
- You have borrowed after a long period of big increases in share values - as the market will suffer a correction at some stage;
- If you have borrowed the maximum amount allowed - because the buffer is relatively small;
- If you hold a portfolio concentrated in a small number of shares and or is not well diversified (e.g. exposed to one or two industries) – because there is more chance that the values of each company will decline together.

Why take a margin loan?

While you should consult a professional adviser such as a financial planner, private banker or accountant before making a decision on borrowing money for share investment there are a number of advantages to using a margin loan.

INTRINSIC INVESTMENT MANAGEMENT

It may suit people who:

- Believe they understand the margin loan concept and feel comfortable with it;
- Want an investment exposure to the share market greater than they could with their own resources;
- Have a relatively high, secure disposable income;
- Are willing to bear greater risk for the chance of greater earnings;
- Have adequate cash reserves or other security to meet margin calls;
- Have a reasonable understanding of the share market;
- Can benefit from the tax deduction that borrowing money brings.

Over the longer term, using borrowed money to invest in the share market should, other things being equal, allow you to retire on a bigger share portfolio than others would have been the case.

What are the risks?

Given that the money is used to invest in the share market, you are subject to share market risk.

If you loan has a variable interest rate, you are also subject to the risk that interest rates will increase.

While borrowing to invest can accelerate your investment returns, it also increases your exposure to investments that can also decrease in value. Margin lending therefore magnifies the potential for both gains and losses. It is recommended that you seek independent advice and make sure that you fully understand the tax implications as well as the legal and financial ramifications of margin lending.

How can the risks be minimised?

There are a number of ways to minimise the likelihood of a margin call:

- Don't use borrow to the maximum amount say 80% Creating a bigger buffer reduces the likelihood of a margin call;
- Diversify across different market sectors. A diversified portfolio enhances the ability to balance exposure over various sectors;
- Use options and futures to hedge your portfolio;
- Stick to your original strategy and evaluate your portfolio regularly.

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