

A healthy margin

There is still a role for gearing as part of a wealth creation strategy. Five industry figures share their views with Zoë Fielding.

Asset

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From left to right:
David Simon, Westpac
Financial Planning
Eric Blewitt,
Leveraged Equities,
David Price, Strategy
First Financial
Planning, Jennifer
Porter, Bloom
Advisory Group and
Colin Lewis, ipac.

Margin lending has lost a lot of the shine it had three years ago when the burgeoning industry was attracting hundreds of new borrowers every week. The downturn clearly demonstrated the way in which gearing magnifies losses as well as gains and scared off many people – both clients and advisers – from investment lending.

Now with \$17.8 billion in loans outstanding, the market is less than half the size it was at its peak of almost \$37.8 billion in loans in December 2007.

But as a wealth creation strategy, margin lending is just as relevant as it was in the past, as long as it suits the client. That's the view shared by participants in Asset's round table discussion on gearing for investment, sponsored by Leveraged Equities.

Jennifer Porter, financial planner at Bloom Advisory Group, which is licensed by Patron Financial Advice, says that she recommended and implemented a margin lending strategy at the start of February.

It was the first one in a while but not because of the sharemarket environment so much as the lack of clients for whom the strategy was appropriate.

Porter doesn't believe her views on margin lending have changed as a result of the market turmoil caused by the global financial crisis. Her decisions about whether to suggest that people consider gearing into investments involve the following:

- Do they have sufficient cash flow and liquid assets?
- Is she prepared to put the time and effort into the strategy?
- Is she also willing to dedicate the effort required to monitor the portfolio?
- Will the client be prepared to pay her enough to do that?

Each person's needs and circumstances must be assessed to determine whether a margin lending strategy will suit them. David Simon, an executive financial adviser with Westpac Financial Planning says: "The assessment [is] relevant to the individual's circumstances: factors such as their current situation; their investment time horizon; cash flow; risk profile; previous experience of margin lending; understanding of gearing. It's no different from their point of view."



If gearing suits the client's objectives and the return on capital stacks up against the interest cost, David Price, a director and representative of self-licensed advice business Strategy First Financial Planning, says he would recommend margin lending to investors now just as he would have been happy to recommend it two years ago, or at any other time in the past. "It all comes down to getting a capital return that's greater than the cost of that interest," he says.

Ipac Securities head of technical services Colin Lewis encourages advisers in the Ipac network to concentrate on costs of gearing if it is a strategy that would suit their customers. "Why not look for the cheapest form of finance?" he says. "What we often recommend is take a home equity loan to do that."

Margin loans are more expensive than they were a few years ago and that changes the balance of costs to benefits.

Price says forecast returns on the underlying investments must be balanced against higher interest costs.

Leveraged Equities general manager Eric Blewitt says that as with other forms of debt that are financed via securitisation, the cost of funding for margin loans has risen as a

Above: Bloom's Jennifer Porter, Right: Westpac's David Simon
Opposite pages: Strategy First's David Price: The crisis reminded financial planners of getting the basics right.



result of the crisis. But despite the costs, margin lending offers advantages over borrowing against the equity in the home. "It's easier to access, it's easier to set up and you don't have to go through valuations and as with many things in life, there comes a premium with that."

There are also emotional reasons why a client might want to segregate housing debt from investment debt. Lewis says some people have a "barrier or road block in the psyche" when it comes to borrowing against their home to invest. "Some still like to segregate where their risk is and the house is sacrosanct," he says.

Westpac's Simon agrees there is a belief that it's prudent to minimise housing debt and borrow to invest separately. "In my opinion, I don't think it is overwhelming," he says. "It's the duty of a planner to educate their clients in the benefits and disadvantages associated with either forms of borrowing but also, when you're providing quality financial advice, you are providing the optimal solution."

Protection from barbecue talk

A big part of finding the best option for the client is to match their needs with investment strategies that will be suitable to them.



[Recommending margin lending] all comes down to getting a capital return that's greater than the cost of that interest.

Bloom's Porter says she tries to keep things simple. "I've always subscribed to dollar-cost averaging and salary sacrifice and all the good old workable easy to understand, very boring strategies that are what I think are tried and true," she says. "but I still am quite amazed that clients come in and say, 'I've got a personal loan. I think I'm going to buy some shares with it. It's not every day, of course, but once a month or so people will come and say something very scary like that."

"Putting all of these strategies into the client's portfolio or plan is our job, and it's our job to protect them from the things they hear and other people they talk to who have completely different circumstances to their own."

Price says in his experience, investors are more likely to be conservative in their outlook at this point in the investment cycle and less likely to push for aggressive strategies.

Some planners also got burned by gearing when equity markets turned down and are now ignoring margin lending which may put people for whom the strategy is appropriate at a disadvantage, he adds. "A lot of advisers I've seen have really copped a battering in regards to the advice they've given, not just in margin lending but in a lot of different areas. [Their advice] looks bad, potentially inappropriate,

their businesses have suffered, their business models have been held up as being inefficient potentially and that's hard because they've got lives, they've got families, and I think that's going to impact on their ability to provide impartial advice to clients because their risk appetite has been battered."

Blewitt fears that some advisers are turning their backs on margin lending because they are afraid to disagree with their clients. "There's still a fair amount of fear which emanates from clients and permeates to the advisers and then they go on the line of least resistance. 'I'm meeting my clients' needs because that's what they think their needs are,'" he says.

As yet there are no real signs that the market for margin lending is picking up again although the total number of accounts has not fallen substantially from its peak.

"While you've got your natural net flows of account closures and accounts opening, total debt outstanding is just halved which is pretty consistent with the overall leverage in corporate and personal balance sheets," Blewitt says. "What you really have is people left in the market who had it as part of a genuine accumulation strategy and have planned accordingly to meet those turbulent times."

People who had margin loans but did not adequately prepare for a market downturn suffered most during the GFC crisis. Without a contingency plan in place, many received margin calls that required them to top up their account with extra cash or securities to return the balance to a gearing ratio that the lender considered appropriate. Worse still, some were forced to sell parcels of their investments at the worst possible time.

Others were prepared for a downturn (although perhaps not of the magnitude experienced). Even in the depths of the market crisis, in the September and December quarters of 2008, Blewitt says the total number of margin calls was still less than 20 per cent of the market and most of those were consecutive margin calls on the same borrowers.

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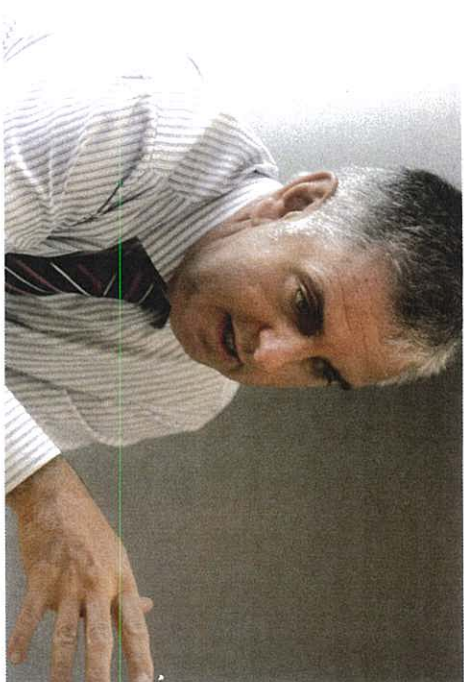
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Of all those on Leveraged Equities' books fewer than 7 per cent received a margin call.

Blewitt says.

"They might have received multiple calls because the asset value continued to deteriorate and in particular they went diversified," he says.

Adequate diversification is one of the keys to managing risk. Westpack's Simon says, "What [the GFC] has done is remind us just how important it is to ensure we are getting the basics right: to maintain responsible loan to value ratios; to ensure you are doing stress testing and simulations to portfolios before you change anything," he says. "These are just basic concepts which a financial planner providing quality financial advice already did - demonstrate the benefits of quality advice, ensure the clients have adequate surplus cash flow and factor in interest rate rises. Some of my colleagues factor in rate rises of up to 4 percentage points."

Lessons learned

Other lessons that the financial crisis taught advisers about gearing restated that an investor should not rely on income generated by the

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Colin Lewis

portfolio to fund the loan and interest repayments. It also reinforced the importance of having an adequate contingency plan in which liquid assets are available to meet a margin call rather than being forced to sell off investments.

Only one of Simon's clients received a margin call during the recent market turmoil. "It was a very confronting communication to have with your client," he says.

None of Price's customers received margin calls, as far as Lewis is aware. The strategies that advisers in the dealer group recommended involved only conservative levels of gearing which shielded them from the scale of losses that people with more aggressive strategies suffered.

"Our view is that if you can achieve the client's goals and objectives without the risk in the first place, you don't gear for gearing's sake," Lewis says.

"I know it's boring and I totally agree with you that some clients want to come in and get that solution they can talk about around the barbecue but if we can, we take the least possible risk to achieve their goal."

Two of Price's clients received margin calls. "[It's] still never pleasant for anybody, but in terms of the impact that had on the quantum of the margin loan and the impact it had on them and the money they had to find to make the call was insignificant," he says.

In contrast, Price says, he did pro bono financial advice work for about 25 or 30 former clients of failed Queensland-based planning group Storm Financial whose accounts had been managed out of the North Sydney offices.

He says he saw examples of where clients had been recommended to borrow against their homes and through margin loans, which in his opinion were completely inappropriate to their situations.

Storm Financial collapsed in January 2009 after having encouraged investors to leverage their homes and take margin loans to invest in Storm-hedged index funds. Hundreds of people lost their life savings

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