

Using your shares to build wealth

Introducing Anthony

Anthony is a 25-year-old electrician working for an Australian mining and exploration company.

Despite earning a good income Anthony hasn't spent much time thinking about his financial future. After speaking with his brother and remembering his New Year's resolution to take his finances a little more seriously, Anthony decides he'd like to start investing and sets a budget. After allowing for living expenses including rent, he realises that he has \$1,000 a month available. While happy that he will be able to add some of this to his existing savings of \$3,000 and company shares received through an annual employee share scheme (worth \$10,000), he wonders what is the best way to get started?



Most successful investors would agree that the hardest part was getting started. Having a goal in mind, setting a budget and picking what to invest in are all parts of the typical plan ... but is it possible to start investing sooner rather than later and achieve your goals even earlier?

Getting started – investing and borrowing

Australians start investing at different points in their lives and for a range of different reasons. For many people the first asset/investment they buy is a property ... but what if you don't want to buy a house or unit, already have one, or instead want to start investing in shares or managed funds?

Even with a good income and some goals, building wealth can sometimes be a slow process – especially when it comes to saving enough to get started. For decades many Australians have overcome this by using other people's money (or borrowing to invest) to create wealth. There are a range of reasons why people use this approach, which includes being able to:

- > Invest more than they could have by just using their own money.
- > Gain more income from the larger investment.
- > Receive a tax deduction for interest on the loan.

While borrowing to invest has been used for decades when investing in property, in recent years the same approach has been adapted to allow people to invest in shares and managed funds. A margin loan is a commonly used product that allows you to buy shares or managed funds and then use them as security (rather than real estate). While the product has a range of features, one of the most popular is a regular gearing plan, which allows you to increase the size of your own monthly savings/investment plan by adding borrowed money.

Margin lending in Australia – statistics*

- > Number of margin loans – \$199,216
- > Average loan size – \$91,701
- > Average value of security – \$231,832
- > Average daily margin calls per 10,000 investors – 13.2

*RBA Margin lending statistics – June 2009

The strategy

After seeing a brochure in the lunchroom Anthony contacts his company's human resources team and is introduced to a financial adviser. After carefully considering his situation, the adviser recommends Anthony invest in managed funds and offers two strategies:

Option 1 – Invest with no borrowed monies

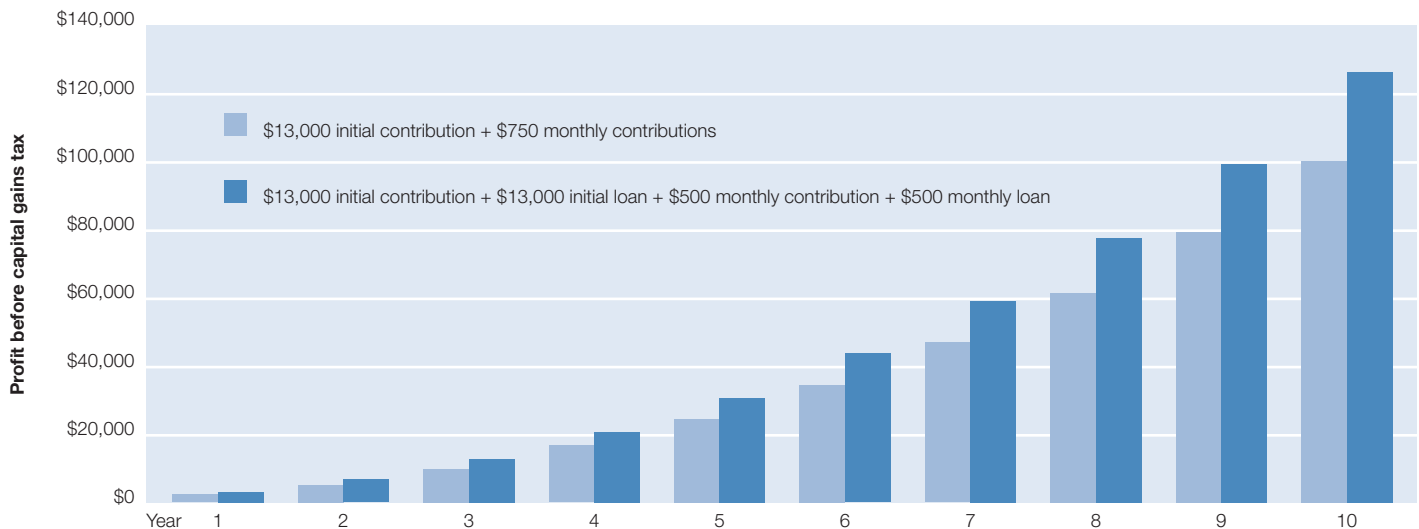
- > Retain \$10,000 of company shares.
- > Invest \$3,000 as a starting point.
- > Invest \$750 a month as an ongoing contribution.

Option 2 – Invest with borrowed monies

- > Retain \$10,000 of company shares and use them as security against a margin loan.
- > Invest \$16,000 as a starting point (\$3,000 own money & \$13,000 borrowed).
- > Invest \$1,000 a month as an ongoing contribution (\$500 own money & \$500 borrowed).
- > Save \$250 a month to help fund interest costs.

After discussing the potential risks and returns, Anthony agreed to go ahead with option 2 and used a margin loan to increase the size of his investment.

The result



Assumptions: The graph compares the potential return on Anthony's investment portfolio with and without a margin loan. The calculations show the profit before capital gains tax of each strategy after loan and interest costs have been paid. It assumes an average annual capital growth rate of 8.50%, an income yield of 3.50% with all income reinvested, distributions are 80% franked, a company tax rate of 30%, a marginal tax rate of 41.5% including Medicare levy of 1.5%, an average annual margin loan interest rate of 9.80%, an initial margin loan gearing level of 50%, brokerage and any other fees are excluded. While capital gains tax implications have been ignored, they should be considered before investing.

If Anthony had chosen to only invest his \$3,000 in savings and \$750 a month, his portfolio would have grown to \$209,996 after 10 years. After deducting his contributions (initial and ongoing) and allowing for tax on his investment income, the profit on his portfolio would have been \$100,045 before capital gains tax.

But having followed his financial adviser's recommended strategy of borrowing to invest to increase his exposure to growth assets, Anthony's portfolio grew to \$306,911 after 10 years. After allowing for his contributions (initial and ongoing), the margin loan, investment income, interest paid and income tax, the profit on his portfolio was \$125,994 before capital gains tax. The difference in the profit outcomes of both strategies is more than \$25,949 or 25.9% over the 10 year period.

Risks and management

As with any investment strategy, borrowing to invest with a regular gearing plan has some risks. Just as it can accelerate your profits when your investments are successful, it can also multiply your losses if they fall. There are several ways you can reduce these risks, including:

- > Borrowing less than the maximum allowable.
- > Diversifying your investments to help reduce volatility.
- > Using your distributions to reduce your loan balance.
- > Working with your financial adviser to review your loan on a regular basis.

Please speak to your financial adviser for more information about how using a regular gearing plan can help you build a larger investment portfolio and achieve your goals.