



MONEY DUE REWARDS:



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Margin Loans – Powerful but Perilous

Margin lending – the practice of borrowing money using listed shares as security – is something which comes and goes with the market cycle. A few years ago, when share markets were booming, the margin lending industry was also experiencing something of a dream run. As markets rose, and investors became more confident, there was a growing realisation that money could be made very quickly and easily using this strategy. It became a very widespread practice, and the loan books of the lending institutions just kept growing. The “power of gearing” had been discovered by many who hadn’t known about it previously.

Now, however, we are in the midst of a raging bear market, and the Australian stock market has fallen something like 44% in the last 12 months. It is definitely a different story. Some investors have been very badly burnt, and it is probably an appropriate time to explain how this happens.

The first point to make quite clear, is that a margin lending strategy is a bit like the girl who had “a little curl right in the middle of her forehead”. When it is good, it is “very, very good”, but when it is bad it is “horrid”.

To illustrate the “good” side, consider Jack, who in July 2003 – a time when the market was pretty much in the doldrums – decided to put in \$40,000, borrow a further \$60,000 using a margin lending facility, and to invest in the stocks which make up the ASX 200 index. To simplify matters, he decides to pay the loan interest from his salary. In October 2007, having been invested for a little over four years, his \$40,000 investment has grown to roughly \$160,000. In other words, he has quadrupled his money. Needless to say, Jack is delighted, and so he winds up the investment and buys himself a holiday cottage with the proceeds.

However, it doesn’t always work out that way. Let’s consider Jill, who is Jack’s new lady friend. At the time of selling his investments in October 2007, Jack tells Jill the story of how he made the money. Jill is pretty impressed at his success, and decides to do the same. The next day, she contributes \$40,000 of her own, borrows another \$60,000, and invests the resulting \$100,000 in the ASX 200 index. Same strategy, but very different result.

Unfortunately for Jill, the market begins to fall. On 22 January 2008, some three months later, the market plunges, and the next day Jill is notified of a margin call. Not having any spare cash or shares to add to the facility, she is forced to sell shares worth \$21,350, leaving her with a portfolio valued at \$55,250 and a loan of \$38,650. This situation continues for a few more months, but in July the market falls sharply again, triggering a series of further margin calls of ever diminishing amounts.

On 28 October 2008, a little over a year after her initial investment, Jill is faced with her sixth margin call, and after selling the necessary shares, is left with a portfolio worth \$18,150 and a margin loan of \$12,705. The net value of her investment has fallen from \$40,000 to \$5,450, a loss of 86%. Ouch! The gearing strategy which increased the profits during the good times, has now worked in reverse and has magnified the loss during the more difficult times.

The moral of the story, needless to say, is that margin lending is a perilous strategy when markets are falling. Speak with a professional financial advisor if you need further information about this sobering topic.

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