

Creating wealth

Gearing into shares & managed funds



Welcome

Much of the wealth in Australia has been built on borrowed money. Successful people and businesses have long recognised that, by borrowing money and investing it productively, they can grow their wealth faster than if they relied on cashflow alone.

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Borrowing to invest, or gearing, is increasingly popular with private investors. Used prudently, gearing can help you achieve your financial and personal goals more quickly than you could otherwise hope to, or indeed achieve higher goals than you could otherwise aspire to. Gearing is both simple and effective. It works on the principle that, if you can earn a better return on borrowed money than it costs you by way of interest, and you can manage the risk involved, then gearing becomes an attractive proposition.

Australians have a history of gearing property, such as investment units. Only now are they becoming more aware of the attractions of gearing into shares and managed funds, which in many ways are better suited to gearing than rental property. This booklet introduces you to the concept of gearing into sharemarket investments. It looks at the important issues to consider, and provides answers to some of the most commonly asked questions.

Please understand that the booklet is for general information only and is not a substitute for personal advice. If you are considering gearing, we recommend that you discuss the options with your financial adviser and taxation adviser. They can help you understand any potential risks involved, how they can be effectively managed, and the tax implications of embarking on a gearing strategy.

If you would like to find out more about gearing investments and the opportunities available at Macquarie, visit our website:
www.macquarie.com.au/lending

You can find out more about other investments available at Macquarie by visiting our general investment website: www.macquarie.com.au

Contents

03 Introduction to gearing

Gearing explained

Why should you consider gearing?

Degrees of gearing – negative, neutral and positive

10 Investment principles come first

Gearing as part of your financial plan

Sharemarket investments – ideal for gearing

Deciding your level of involvement

18 Understanding and managing the risks

Get time on your side

Put some eggs in different baskets

Build in some flexibility

21 Choosing the gearing method which suits you

Margin lending

Borrowing by instalments

Home equity loans

Protected loans

28 Practical issues

Lender requirements

Ownership of investments

Fixed or variable interest?

Claiming tax deductions

Taxation of capital gains

Planning for capital gains

33 Where to from here?

Is gearing for me?

35 See your financial adviser – or Ask Macquarie

Introduction to gearing

Gearing explained

Gearing means borrowing money for investment. By adding borrowed funds to your own funds you increase the total amount invested so that you control more investment assets. So the returns, as a proportion of your original capital, are “geared up”, or magnified. This can be illustrated with some examples.

Example 1

Personal funds	\$50,000
Borrowed funds	Nil
Total investment	\$50,000

A 10% increase in value gives a gain of \$5,000.

Compare this with:

Personal funds	\$50,000
Borrowed funds	\$100,000
Total investment	\$150,000

A 10% increase in value gives a gain of \$15,000, which represents a return of 30% on the personal funds invested.

Example 2

Personal funds	\$50,000
Borrowed funds	Nil
Total investment	\$50,000

A 10% decrease in value creates a capital loss of \$5,000.

Compare this with:

Personal funds	\$50,000
Borrowed funds	\$100,000
Total investment	\$150,000

A 10% decrease in value gives a loss of \$15,000 which represents a loss of 30% on the personal capital invested.

In this simple example, gearing has tripled the size of the investment and tripled the return on the investor's original capital. A detailed analysis would incorporate cash flows and the net costs of borrowing.

Note that gearing not only magnifies profits, it magnifies losses as well. (In examples 1 and 2, gains and losses are realised only if you sell the investment at that time.)



Jeremy, 25

graduate accountant

Jeremy is on an annual salary of \$42,000. He has current assets of \$17,000: \$5,000 invested in a cash management account, and \$12,000 invested in a managed share fund. He makes additional investments into the share fund at the rate of \$500 per month.

"The main reason I started investing in the sharemarket was that, although I was saving money, with interest rates so low I didn't seem to be getting anywhere."

In addition to his regular savings, Jeremy borrows \$1,000 per month and invests this together with his \$500, providing him with a \$1,500 monthly investment (or \$18,000 pa).

"I'm prepared to take on some debt at the moment because my job's secure and I don't have any major commitments. I thought about property, but I can't afford to buy anywhere I'd like to live, and anyway I'm quite happy renting for the next few years."

"With this gearing plan I know my money's really working for me. It allows me to 'put my toe in the water' and learn more about the sharemarket. Later on, when I know a bit more, I'd like to buy some shares based on my own research."

Why should you consider gearing?

Gearing not only gives you more funds to invest, it can also allow you to start investing sooner rather than later.

There are gearing plans available which allow you to get started without having to put in a large amount of your own funds. This is a big advantage for younger people who may only have limited savings, but have a reliable income which allows them to "kick start" their wealth building with the help of borrowed funds.

Gearing can help you own a better quality portfolio

Another advantage of gearing is that it helps you own a better quality investment portfolio. For a start, with more funds to invest, you can spread your investments more effectively.

Diversification – the investment equivalent of “not putting all your eggs in one basket” – is one of the best ways of reducing risk. In a share portfolio, a spread of investments across different types of companies in different industry sectors means that one poor performer won't have an undue influence on your overall return.

Jeremy's managed share fund invests in more than 100 companies, ranging from banks like National Australia Bank to resources giants such as BHP, and from telecommunications, including Telstra, to media and entertainment, such as News Corporation.

“To get the same sort of spread myself I'd need to invest hundreds of thousands of dollars. The gearing plan gives me all this every time I make my \$500 monthly contribution, and match it with the \$1,000 monthly loan drawdown.”

Gearing may also open up investment opportunities which you could not otherwise consider.

Some managed investments, for example, require a minimum contribution which may be out of your reach without the added financial muscle that borrowed funds can give you.



Helen, 38

dentist

"I am approached a lot about tax schemes, but most of the investments seem pretty obscure. The presentations seem more concerned with tax than with making money. Like any high income earner I do want to minimise tax, but I want to be able to see some profit at the end of the day!"

I had about \$60,000 in Coles, Rio Tinto and Telstra shares, and on the strength of that and my credit rating, the bank was happy to lend me up to \$140,000 to invest in blue chip shares. I've only borrowed \$90,000 so far, because I want to be prepared to take opportunities as they arise, but now I've got a portfolio of \$150,000 spread across about a dozen different companies. I'm finding it really interesting, building up my portfolio.

With negative gearing I get the best of both worlds – a tax deduction every year and an opportunity to make capital gains over the longer term."

Gearing can reduce the costs of investing

Having more funds to invest can reduce the impact of transaction costs, which are sometimes a barrier for small investors. These days, it can cost very little more to invest \$10,000 than to invest \$2,000. So with more funds at your command you can benefit from economies of scale and reduce your average cost of buying and selling.

Gearing can be a tax-efficient investment strategy

The other advantage of gearing is that it can be a tax efficient investment strategy. This is because the interest costs on money borrowed for investment purposes can generally be claimed as a tax deduction. One of the main qualifications is that the purpose of the borrowing must be to earn assessable income.

This potential tax efficiency is not in itself a reason for gearing, but it can certainly add to the attraction of a geared investment strategy.

Degrees of gearing – negative, neutral and positive

There is a common misconception that gearing automatically means negative gearing. In fact an investment can also be neutrally or positively geared. The difference is simply to do with cashflow. And that in turn depends on how much you borrow, how much interest you pay, and how much income you receive from the investment.

When your cashflow is negative – in other words your net investment income is less than your interest cost – the investment is said to be negatively geared. Although the interest cost exceeds the income from the investment, the excess is not wasted. It can generally be claimed as a tax deduction against your other assessable income, such as your salary or interest income, and so reduce your overall tax liability.

So... why gear?

A larger portfolio, a better spread, more opportunities, lower transaction costs and potential tax efficiencies – that all adds up to a more dynamic investment plan.

We recommend you seek independent advice from your financial adviser about the taxation consequences of gearing as the tax position of investors may vary according to individual circumstances.

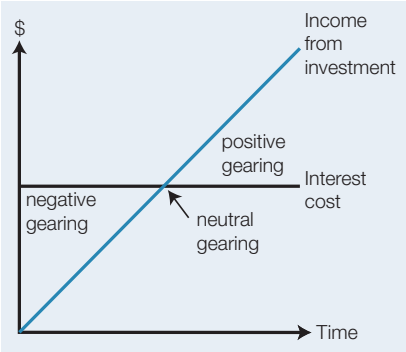
You are still left, of course, with a loss in terms of cashflow from the investment so to justify a negative gearing strategy you must expect that:

- The income flow from the investment will over time increase sufficiently so that your cashflow eventually becomes positive, and/or
- The capital value of the investment will increase sufficiently to compensate you for the negative cashflow.

Neutral gearing occurs when the income you receive from the investment matches the interest cost of the borrowed funds. At this break-even point your investment is effectively self-funding.

Once the investment income is more than your interest cost, your cashflow is positive and the investment is positively geared. This means additional investment income which you can use to supplement your regular income, reduce your borrowings or add to your investments.

Types of Gearing



Negative Gearing:

Annual net interest cost is greater than investment income

Neutral Gearing:

Annual net interest cost is equal to investment income

Positive Gearing:

Annual net interest cost is less than investment income

The degree of gearing you choose will depend on your objectives and your own financial circumstances. The more highly geared you are, the greater the potential rewards, particularly if you are on a high marginal tax rate and may be able to maximise the tax efficiencies of negative gearing.

Gearing is flexible

You can decide on your preferred level of gearing at the outset. You can also adjust that level over time, such as by repaying borrowings out of the profits from any investments you sell or from surplus income.

Remember, too, that the degree of gearing will often change naturally over time. Usually, a sound gearing strategy will take account of this. For example, the income from the investment may increase to the point where what was once a negatively geared investment becomes neutrally or positively geared.



Bob, 52 and Carol 48

newsagency owners

"We started negative gearing into shares about 5 years ago, when we were earning good money in the business and paying a lot of it away in tax. Over the years we've built up a good, solid portfolio, and we've done well out of floats like Commonwealth Bank.

Now we're easing off a little and looking towards retirement. The dividends from the shares have grown so much that we've paid off most of the loan. By the time we do retire, we plan to have paid it off completely, so the dividends will be one of our main sources of income."

Investment principles come first

Gearing as part of your financial plan

A decision to gear your investments should not be taken in isolation. Gearing is a strategy that may be part of your financial plan, but it is not a plan in itself.

A good starting point for any financial plan is to eliminate non-productive borrowing and replace it with productive borrowing.

Gearing can help you reach your long term goals sooner

Gearing comes into its own if you either need, or want, to accumulate wealth faster than you can by more conventional means. There is no point gearing just for the sake of it. You need to have a definite objective in mind in terms of your own wealth creation and long term income requirements (as a supplement to or a replacement for your income from work).

Gearing is one of a number of tax-efficient investment strategies available, and should not be seen as a substitute for other wealth building methods such as superannuation.

Ideally, gearing should fulfill a specific role in your overall plan and complement your other investment activities.

Remember to spread your investments

Another important investment principle is diversification. You should never rely exclusively on one investment, or one type of investment, but should aim for a balance across the main asset sectors. Not just shares and property but also more defensive assets such as cash and fixed interest.

Because gearing is best suited to growth assets – shares and property – a geared portfolio should not include much fixed interest or cash investments. And because there may be restrictions on the potential tax efficiencies available if you gear into international investments, a geared portfolio will usually be concentrated on Australian assets.



Ally, 31

business analyst

To achieve a diversified investment portfolio, you will need to hold your cash, fixed interest and international investments elsewhere in your financial plan. You should seek professional advice about the investments that are appropriate to your own circumstances.

As well as having their geared share portfolio, Bob and Carol make regular contributions to a superannuation fund, which they view as the cornerstone of their long-term retirement planning.

“The fund gives us a choice of investment options, so we have weighted our super investments towards fixed interest, property and international assets. That way, with liquid funds in a cash management account and our separate share portfolio, our overall investment picture is well diversified.”

Ally recently inherited \$30,000, which she invested in a managed share fund. She now wants to buy a small car worth \$20,000.

“I was all ready to go out and buy the car on a lease, but my financial planner suggested a far more efficient approach. That is to sell \$20,000 worth of my investments, use the net proceeds to buy the car, and then borrow \$20,000 to invest back into managed funds. This way, the interest payments on the borrowed \$20,000 will be tax deductible.*

I'd never realised there was any difference between borrowing to invest and any other sort of borrowing. I'm glad I do now, because the difference is saving me over \$700 a year in tax.”

*We recommend that you seek professional advice regarding the taxation consequences of selling your investments.

Above all, you should never gear an investment simply to claim a tax deduction. It makes no sense to plan to make a loss unless you have a very strong expectation of turning it into a profit in the future. Any investment should be attractive and appropriate in its own right, regardless of how you fund its purchase. In the next section we see why sharemarket investments (both direct share investments and managed share funds) are ideally suited for gearing.

Sharemarket investments – ideal for gearing

The ideal investment for gearing – and negative gearing in particular – is one which you expect to grow in value over time, and also to generate an increasing income return. For that reason, gearing should only be considered for growth investments.

Often the most suitable growth investments are shares and property. Both have a history of long-term capital growth, and both deliver a potential rising income stream (either as dividends or rent) over time.

While investing directly into property has its attractions, there are even better reasons for gearing into shares and property securities. Included in this category are:

- Australian company shares listed on the stock exchange,
- Shares from an overseas stock exchange,
- Listed property trusts, which hold property assets but perform somewhat like shares,
- Managed property securities funds, which are unlisted funds which themselves invest in listed property securities, and
- Index share funds.

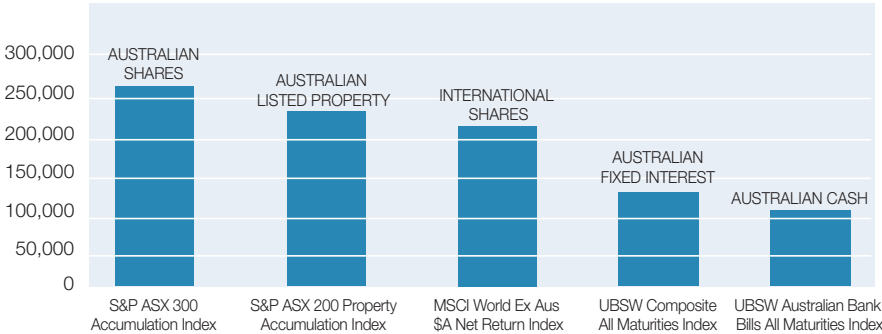
These investments offer advantages over direct property investment, the most important of which are:

- Performance
- Liquidity
- Ownership costs
- Accessibility
- Tax efficiencies

Performance

While the price of shares can be volatile over short periods, over the long term (based on historical performance) they are expected to outperform other major asset sectors.

Value at December 2003 of \$10,000 invested December 1978



Investment	Dec 1978 value	Dec 2003 value	Annual compound rate of return
S&P ASX 300 Accumulation Index	\$10,000	\$258,292	13.89%
S&P ASX 200 Property Accumulation Index	\$10,000	\$237,133	13.50%
MSCI World Ex Aus \$A Net Return Index	\$10,000	\$215,098	13.06%
UBSW Composite All Maturities Index	\$10,000	\$133,871	10.93%
UBSW Australian Bank Bills All Maturities Index	\$10,000	\$106,590	9.93%

To understand why, you need to consider the main factor which drives share prices. Share prices are driven, for the most part, by the prospect of future dividends. As quality companies grow and increase their profits, so shareholders enjoy an increasing stream of dividend income. Ownership of the shares becomes more attractive, and the share price rises to meet the growing demand. It is precisely these characteristics which make shares suitable for gearing. By gearing into shares, you can expect your investment to grow in value over the long term. Along the way, you can use the increasing flow of dividend income either to reduce your level of gearing (by repaying some of the borrowed funds) or to finance additional investments, or simply to spend.

Liquidity

Compared with direct property, shares also have the great advantage of liquidity. A typical investment in a physical property is an “all or nothing” proposition. If you need to sell the investment, you have to sell all of it and that sale usually takes months to complete.

A share portfolio allows much more flexibility. It can be adjusted quickly, with transactions effective almost immediately. It can also be adjusted in small amounts, because small parcels of shares can easily be sold if, for example, you require funds at short notice.

Ownership costs

The cost of buying and selling shares is considerably less than for a property investment of similar value.

When you buy shares, brokerage and stamp duty will generally account for less than 2% of the investment. Selling costs are similar. Managed share funds and property securities funds usually have an

The graph on page 13 was prepared by Macquarie Bank Limited. It is based on indices we commonly use to measure the performance and risk of the relevant investment markets. All indices are before fees and tax and assume reinvestment of dividends and/or income. Past performance is not necessarily an indication of future performance.



Helen, 38

dentist

entry cost but no exit cost, and again the total cost of buying and selling is generally no more than 5%. This compares with typical costs for buying and selling a property of 7% – 8%, including searches, surveys and inspections, agents' commission, legal fees and government stamp duty.

Similarly the ongoing ownership costs of share investments are minimal, while a property involves maintenance and letting costs, as well as outgoings such as rates and insurance.

Accessibility

The entry point for investing in shares is much lower than for property, making it much more affordable, particularly for young investors. You can start investing for just a few thousand dollars, and you can build on your initial investment in small increments. A geared share portfolio can also be used to set you on the road to an investment in property, which usually requires a much bigger initial commitment.

Helen receives a fully franked dividend of \$70 from her investment in Telstra. The dividend notice tells her she is also entitled to a franking credit of \$30. What this means is that Telstra has distributed to Helen \$100 worth of its profit, on which it has already paid tax at the company rate of 30%.

When Helen comes to lodge her tax return, she will declare the cash dividend (\$70) plus the franking credit (\$30) – a total of \$100. She will be assessed for tax on that \$100 at her marginal tax rate (48.5% including Medicare levy) – in other words \$48.50. But against this she can claim the franking credit of \$30, so she ends up paying only \$18.50 tax on the dividend.

So for Helen the \$70 fully franked dividend has the same value as \$100 of interest or rental income.

Deciding your level of involvement.

Depending on your level of interest, confidence and experience, you may decide to choose your own share investments, make your own investment decisions and look after your own paperwork.

Tax efficiencies

Shares and investment property both enjoy tax efficiencies*, but for most investors the tax efficiencies of shares are even more powerful.

An important feature of share investment is dividend imputation, where the dividend income you receive carries potential franking credits which may reduce or eliminate your personal income tax liability.

The combination of tax deductions on interest payments, potential franking credits on dividend income and (ultimately) potential tax discounting on the capital gains received makes gearing into shares a very tax-efficient strategy.

* The taxation consequences of a gearing strategy depend on the individual circumstances of the borrower.

Managed share funds

The alternative, if you don't want to be so actively involved in picking, managing and monitoring, is to gear into a managed share fund. In these funds, your money is pooled with that of other like-minded investors, enabling you to share in a large and diverse portfolio.

Many people find managed share funds more convenient than direct investment. The fund manager handles all the day-to-day administration while investment experts research, select and manage the portfolio. With the superior resources they have available, the buying power at their disposal, and their access to prime investment opportunities, they are well equipped to deliver attractive returns.

Managed share funds are particularly suitable for regular investing, because they allow you to make multiple small investments without incurring prohibitive transaction costs. There are funds specialising in particular sectors of the sharemarket, as well as more broadly-based funds covering all the major market sectors.

Index funds

Included among these are index funds, which aim to replicate the performance of a specified index (for example the S&P/ASX 200 Index). The main advantages of index funds are that their performance will not contain any surprises, compared with the market as a whole, and their management fees will generally be lower than for actively-managed funds. Because of this predictable performance, some lenders offer low-risk gearing arrangements into index funds.

Understanding and managing the risks

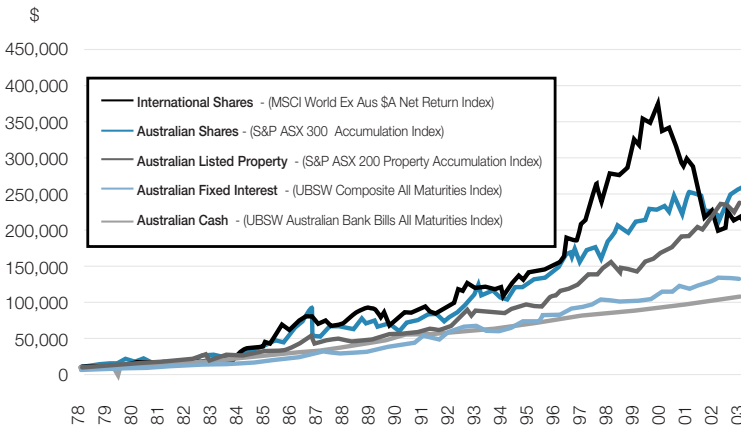
We have seen that gearing magnifies the returns from an investment, whether the returns are positive or negative. It has to be acknowledged, therefore, that borrowing to invest increases your risk of financial loss. That is not a reason not to borrow, but it is a good reason to make sure you understand the different types of risk involved and the steps to take to manage those risks to acceptable levels.

Get time on your side

One of the characteristics of shares, and managed share funds, is that they produce unpredictable results over short periods. Probably the biggest risk you can take is to enter into a geared share investment with too short a timeframe.

Your timeframe must be long term, and by that we mean a minimum of 7 years and preferably 10 years or more. Over that sort of period, it is more likely that any short-term volatility (fluctuations in returns) will be smoothed out and you can be reasonably confident of enjoying sound capital gains.

Putting volatility in perspective



Still on the subject of time, you may often need to be prepared to cope with the temptation of trying to time the market. Trying to “outsmart” the market is futile and can be costly. Even full-time investment professionals have difficulty predicting the way the market will head next, let alone calling the top or the bottom.

The key to success is to set your strategy, stick with it, and try to filter out the ‘noise’ which inevitably comes from media and commentators looking for a story. Only if there is some fundamental change to your own circumstances, or to the nature of the market or the tax laws, should you consider making substantial changes.

Put some eggs in different baskets

Diversification is a very effective way to control risk, so within your geared portfolio you should try to maintain a good spread of investments. The very fact that gearing gives you more money to invest makes it easier to diversify, and you can achieve it either through your own selection of shares, or by investing in managed share funds where you can achieve a very wide spread for a relatively small investment.

You should aim for a spread:

- Between industrial and resources companies;
- Between different industry sectors (such as banks, retail, engineering, transport, telecommunications and property trusts); and
- Between large and small companies.

The graph on page 18 was prepared by Macquarie Bank Limited. It is based on indices we commonly use to measure the performance and risk of the relevant investment markets. All indices are before fees and tax and assume reinvestment of dividends and/or income. Past performance is not necessarily an indication of future performance.

It makes sense to prepare for the unexpected

Some of the steps you can take are:

- Keep enough cash to cover any emergency spending
- Protect your income, by taking out insurance to cover a protracted illness or injury
- Make sure that termination payments will be adequate to cover a loss of salary in the event of retrenchment
- Borrow well within your theoretical limit
- Lock in at least some of your loan at a fixed interest rate
- Pre-pay interest when you can
- Ensure you have a stable, regular income from other sources to meet your interest expenses
- Use dividend income to repay borrowings or reinvest
- Don't just rely on dividend income to pay your interest costs.

In each case, the idea is that different sectors will react to economic and market influences in different ways. By “covering all bases”, you reduce the influence of any one sector and reduce the risk of one poor investment spoiling your overall performance.

Build in some flexibility

Any good financial plan will build in some flexibility to cope with changed circumstances, whether they be personal or job-related. With gearing, it is particularly important to avoid being forced into a position where you have to sell investments at a time which is not of your choosing. That can happen if you need cash at short notice or if you suffer a loss of income and cannot service your borrowings.

Choosing the gearing method which suits you

There are many different approaches to gearing, and a variety of products and facilities are available.

Most equity investment loans are set up on an 'interest only' basis, meaning that the only compulsory payments you make are to pay the interest due. You can repay the principal either at your own discretion along the way or at the end of the loan. This type of loan is suitable if you need funds to finance the initial purchase of the investment, and then plan to discharge the debt either out of cashflow or by realising profits/capital gains.

The long-term goal is to eliminate the debt that you initially used as leverage. At the same time, you can keep your geared share portfolio as a discreet and separate facility from other loans such as your home loan.

Security

Unless you are providing cash and/or putting up separate assets as security, you can use the investments you are buying as security for the loan. The lender will usually provide a specific list of shares and managed share funds that it will accept as security.

With margin lending, these approved securities will have a percentage allocated to them, which represents the maximum amount that the lender is prepared to advance against that security.

This is usually between 40% and 70% of the market price of the security, and is based on the lender's view of the security's quality and the volatility of the share price.



Bob, 52 and Carol 48

newsagency owners

Carol recalls:

"When Bob and I first thought about gearing we used some of the shares we already owned, which were worth about \$30,000 at the time, as security.

"We had about \$15,000 in cash, and we qualified for a loan of \$50,000, so putting it all together we had nearly \$100,000. Having the extra money at our control meant we could act on our broker's recommendations quickly, as well as getting our fair share of the major floats."

Margin lending

A margin loan allows you to borrow money against shares or managed share funds you already own, as well as enabling you to buy more shares, which form part of the security. A margin loan can be a powerful wealth creation tool, allowing you access to more shares than would be possible under normal circumstances. It effectively provides you with a flexible line of credit.

The shares or managed share funds are usually the only security required. If you are active in buying and selling investments, settlement for each trade can be made by debiting or crediting your margin lending account - provided that the loan balance remains within the limits agreed to at the start of the plan.

The main difference between a margin loan and a conventional property loan is that shares change in value each day. This means you can check the daily market value of your investments, and the lender will also monitor your portfolio value daily. If the value falls below an agreed minimum, the lender will require you to make a margin call.



Helen, 38

dentist

Margin calls

A margin call will be made if your equity – the value of the assets that you contributed to the investment – falls below the agreed lending ratio. If this happens, the lender will ask you to provide additional funds to restore at least the minimum equity position. To help protect against small market fluctuations, there is usually a “buffer” (typically 5% of the total portfolio value) within which a margin call may not be made.

A margin call requires prompt action (usually by 2pm on the third business day) so it is important to plan what you would do if you were faced with one. To satisfy a margin call one of the following actions is required:

- Provide cash to reduce your loan balance;
- Provide additional shares or managed funds as security;
- Sell securities from your portfolio and use the net proceeds to reduce the loan; and/or
- A market rally occurs causing a sufficient reduction in your current gearing level to satisfy the margin call.

Helen’s bank was prepared to lend her up to \$140,000 to invest in blue chip shares, on which their maximum lending ratio was 75%. The value of her existing Telstra, TAB and AMP shares (\$60,000) made up the remaining 30%.

So far, she has only borrowed \$90,000. Her portfolio is worth \$150,000, so her ‘loan to valuation’ ratio is $\$90,000 / \$150,000 = 60\%$.

This is well within the maximum lending ratio of 75%, and Helen’s portfolio could fall in value by as much as 25% without her having to deal with a margin call.

“I know a 25% fall is possible, but it’s pretty unlikely. In fact it’s only happened once in the past 60 years, my adviser tells me. In any event, I keep some cash available at short notice just in case it should ever be needed.”

If you do not initiate one of these actions, the lender will act on your behalf, usually selling shares to reduce the loan.

The best way to avoid margin calls is to be conservative in the amount you borrow. The table below shows how far a portfolio must fall in value before you would face a margin call.

You can also reduce the likelihood of a margin call by:

- Diversifying your investments;
- Making interest payments regularly rather than adding your interest onto your loan;
- Reinvesting dividends to reduce your loan as a proportion of your total portfolio;
- Monitoring your investments closely; and/or
- Taking a long term view of your investments.

How much the market needs to fall for a Margin Call to be made

Maximum Gearing Level	Current Gearing Level			
	75%	70%	60%	50%
75%	6%	13%	25%	38%
70%		7%	20%	33%
60%			8%	23%
50%				9%

* Assumes that the lender allows a buffer of 5%.



Diane, 36

retail manager

Borrowing by instalments

“Little and often” is a very sound way to build your investments. It can also be very convenient because once you have set up your investment plan, you don’t have to think about it all the time or make a lot of “big” decisions.

Instalment gearing is a margin lending facility which incorporates a regular savings option. Investment is restricted to managed share funds, which allow investments to be made in relatively small parcels. The initial investment can be as low as \$1,000 and regular investments as little as \$250 per month.

Every contribution you make is matched by borrowed funds, so instalment gearing can be a convenient way of accumulating geared investments. The idea is to have a regular, automated facility in which you save, borrow and invest each month so that you gradually increase your total investment.

Diane wants her son Ben, aged 9, to go to university when he finishes school. She already has about \$2,000 saved, but has found the low returns from her bank account disheartening -

“I need my money working harder for me”.

Diane’s financial planner suggests she uses gearing in her investment strategy to earn a better return. With the \$2,000 to invest initially, she is able to contribute another \$500 a month to invest in a managed share fund. Every dollar she invests will be matched by a further dollar from the lender so the capital she has working for her is doubled.

“I know my investment could fall in value, but I am confident in the long run it will grow and produce strong returns. I’m not borrowing as much as I could, but there should still be enough for Ben in 8 years’ time.”

Dollar cost averaging

One advantage of regular investing is that, if the price of what you are buying fluctuates, you can reduce the average cost of your investment. By investing the same amount each month, you buy more units in the share fund when the price is low. This is known as dollar cost averaging. It doesn't guarantee you a profit, but it does offer a relatively low-risk way of investing in a volatile market.

Example

Joan invests \$1,000 a month over the six months to June as follows.

	Monthly Investment	Unit Price	No. of units purchased
January	\$1,000	\$1.00	1,000
February	\$1,000	\$0.60	1,666
March	\$1,000	\$1.15	869
April	\$1,000	\$0.95	1,052
May	\$1,000	\$0.80	1,250
June	\$1,000	\$1.10	909
TOTAL	\$6,000		6,746

Average unit price is $\$6,000/6,746 = \0.89

In total she invests \$6,000, at an average unit price of \$0.89. At the end of June the investment is worth \$7,420 (6,746 units at \$1.10/unit).

Home equity loans

There are gearing products available that allow you to unlock the equity you have built up in your home and use it to help finance new investments. The aim of the facility is to pay off your home loan faster while allowing you to build wealth at the same time. This type of loan is, in effect, a line of credit secured against the asset value of your property. You may have paid off your mortgage completely, in which case the full amount of the loan facility is available for investment, or you may still owe money on your home, in which case the facility can be split into two components.

Home equity loans are highly flexible. Within one facility, for example, you might have a variable rate housing loan into which you direct your salary, coupled with an investment account from which you 'draw down' for investment purposes. With all the borrowings at home loan interest rates, this is a very cost-effective way of gearing.

It can also be a tax-efficient strategy, because usually you are directing your salary towards paying off a housing loan on which the interest is not deductible, while freeing funds for investment where the interest cost is deductible. Any extra income from your investment can be used to repay your home mortgage even faster.

Protected loans

Protected loans enable you to benefit from sharemarket growth without the risk of losing any capital - an ideal way to get started in the sharemarket. The lender provides 100% of the funds to invest in quality Australian shares and these shares are the only security required for the loan.

Protected loans usually attract a higher interest rate than other gearing facilities - similar to credit card rates, but the bonus is that you are protected from a fall in value of any shares held under the facility. This means that if at the end of your loan term some of your shares have fallen below their original value, you can return those shares to the lender in full repayment of that portion of the loan. On the other hand, you can take the profit from any shares that have risen in value. In addition, profits are not netted against losses, so you ignore any losses, while the profits are yours. Best of all, there are no margin calls.

Protected loans typically involve buying and holding your share portfolio for the full term of the loan, usually 3 or 5 years. Protected loans are now also available for investment into managed funds. They can be useful in insulating you against a correction in the sharemarket and for this reason protected loans often attract a more risk conscious investor than say margin lending.

Practical issues

Lender requirements

Lenders for geared share or managed share fund facilities may want to assess:

- Your ability to meet interest repayments; and
- The security that you can offer.

If you cannot satisfy the lender's requirements on your own, it may be possible to set up the facility with the help of a joint borrower.

Your income, either from employment or other investments, may need to be disclosed.

In the case of a margin lending or instalment gearing facility, the security for the loan is typically the investments themselves. This is why lenders will impose a percentage limit on how much they will advance against any given asset.

For a home equity loan, your home constitutes the security, so the lender will take a mortgage over the property. With your home as the loan security, it is clearly sensible to take a fairly conservative attitude with this type of facility.

Ownership of investments

Under most gearing arrangements, the ownership of the investments, including any existing investments used as security, remains with you as borrower. This not only ensures that you are entitled to the dividends and franking credits, but also means that you receive all the other entitlements of ownership, such as reports, voting rights, discount cards and other shareholder benefits.

It is usually possible to invest in an individual name, in joint names, or in the name of a trust or company. Otherwise, you should aim to own the investment in a way which delivers the best after-tax result. This will depend on your individual circumstances and on the current and prospective returns for the investment.

As a general rule, if the investment is expected to generate a negative cashflow for a lengthy period, it may be better to hold it in the name of a high rate taxpayer, who can gain the greatest advantage from the potential tax deductions. An investment which will quickly become cashflow positive may be best owned by a low rate taxpayer. Your financial adviser can help you assess the taxation implications of gearing.

Whilst the ownership issue is crucial to the success of a gearing strategy, and issues other than cashflow may also be important. You should always take independent legal and tax advice to determine the most appropriate arrangement for you.

Fixed or variable interest?

Most lenders offer a choice of variable or fixed interest rate loans. Sometimes a combination is available, with the flexibility to switch from one to the other.

Variable rates are subject to change at short notice. The main advantage they offer is flexibility. They usually allow you to vary your repayments, and to make “one-off” repayments without penalty.

The main advantage of fixed rates is certainty. The rate is generally set for a period of up to 5 years, which protects you from any unexpected increase in interest rates and makes it easier to plan ahead. However, fixed rate loans are generally less flexible, so you may not be able to vary repayments or make extra payments without penalty.

Claiming tax deductions

Interest is generally deductible in the year in which it is paid where the loan funds are used for investment or business purposes. Some investors choose to pay their interest monthly in arrears and, if they have funds available as they approach 30 June, pre-pay the following year's interest prior to 30 June. A deduction can generally be claimed for up to 12 months' interest paid in advance in the year the interest is prepaid.

Taxation of capital gains

As we have already seen, a gearing strategy should always have as its key objective the creation of a capital gain. For so long as the investment is held, that capital gain will only exist on paper. At some stage, however, the investment may need to be sold and the gain realised. This may be part of the original plan, for example if the investment was to pay for a specific future expense, or it may become necessary to allow for the balance of the loan to be repaid.

Because of this focus on capital gain, the operation of capital gains tax (CGT) is of particular importance to geared investors. CGT applies when you sell or otherwise dispose of an asset (except for certain excluded assets such as your home and motor vehicles) and realise a capital gain.

Discount method of calculating CGT

On 21 September 1999, the capital gains tax rules changed and a new method for calculation of a taxable capital gain was introduced. All capital gains on assets held for at least 12 months are now eligible to be reduced by the CGT discount, which is 50% for individuals. These are called discounted capital gains. The discount can be applied only where an asset is held for at least 12 months. The discount method must be used for all assets that were purchased after 11:45am on 21 September 1999.

(Old) indexation method

For assets purchased up to 11:45am on 21 September 1999 and held for at least 12 months, you can use either the discount method described above or the old indexation method.

Broadly, under the old indexation method, the capital gain is calculated by deducting the cost base from the sale price. The cost base is the original cost base indexed to account for inflation. Note, however, that indexation of the cost base is frozen at 30 September 1999.

Planning for capital gains

If you are likely to make substantial capital gains, it makes sense to do some planning. Some of the options to consider are:

- Avoid having to realise the gain, by making sure separate assets are available to pay off any remaining borrowings;
- Offsetting capital gains by realising capital losses in the same financial year;
- Arranging sales to occur in a year when your income is relatively low, so the capital gains are taxed at a lower marginal rate of tax.

Geared share investments can involve a variety of tax issues, including interest deductions, negative gearing, capital gains and franking credits. For these reasons we strongly recommend that you obtain professional tax advice that is specific to your individual circumstances.

Tax efficiency of Protected lending

In May 2003, the Assistant Treasurer and the Australian Taxation Office (ATO) announced an interim costing method for capital protected loans with a separately identifiable put option.

Investors who entered into such protected capital loans after 16 April 2003 need to use this methodology to calculate how much of their expense should be apportioned between the interest on the loan component and the cost of the capital protection component.

To keep up to date with this development, please visit www.macquarie.com.au/protectedlending

Where to from here?

Gearing sharemarket investments is a dynamic strategy which many people find attractive and stimulating. However geared investments are not for everyone. The prospect of higher returns inevitably means higher risks, so the question you need to ask yourself is ...

Is gearing for me?

You should think seriously about gearing if you have a long-term outlook towards investment, and the need or desire to accumulate wealth more quickly than you can by conventional means. The minimum time that you should contemplate for a geared investment into shares is 7 to 10 years. Property investment needs an even longer timeframe – preferably 15 years.

Gearing has great potential tax efficiencies, but they are of secondary importance compared with the ability gearing can give you to own a larger, more diversified and better quality portfolio than you could otherwise afford. Never gear purely for the tax efficiencies.

Many gearing arrangements rely on you continuing to earn income to pay interest on the borrowed funds. If your income is not completely secure, make sure you can protect yourself by taking out insurance. Your financial adviser can assist you here. Apply the same caution if you are thinking of using your home as security – borrow conservatively.

Whatever type of loan facility you are looking at, make sure you understand how it works and that you are aware of, and comfortable with, any risks involved. Recognise your own tolerance of risk, and take steps to manage your risks to a level which you find comfortable. If the idea of margin lending leaves you uncomfortable, consider a low-risk alternative such as an index fund package which has no possibility of margin calls.

Your next step.

If you decide that gearing may be for you, take the time to get some independent advice. Speak to your financial adviser about the investment and tax aspects, and find out whether the proposal sits sensibly in your overall financial plan.

Gearing into shares is not a 'set and forget' strategy. You will need to monitor your investments regularly, so it helps if you have a real interest in shares and/or a working knowledge of how the sharemarket works. You should be prepared to research what you are actually investing in, as well as take professional advice.

If sharemarket investing is new to you, consider starting with a low risk approach, such as gearing into a managed share fund. From there you can progress towards an individual share portfolio when you have built up your knowledge and experience.

See your financial adviser or Ask Macquarie

We hope this booklet has raised your awareness of gearing, and how borrowing for sharemarket investments can be a powerful and potentially tax-efficient method of wealth creation.

If you have any questions, or require more information, we recommend you talk to your financial adviser or Ask Macquarie.

Gearing facilities

Macquarie offers a range of gearing facilities including:

Macquarie Margin Lending - a potentially tax-efficient way to gear your share portfolio or managed share funds

Macquarie Instalment Gearing – regular savings combined with the power of gearing

Macquarie Quick Start Instalment Gearing - the quick way to get your Instalment Gearing strategy started without any existing savings

Macquarie Premium Choice - a highly flexible home equity loan

Macquarie Geared Equities Investment (*plus* shared upside) - the zero capital risk sharemarket investment

Macquarie Fusion Funds – gain exposure to wholesale managed funds with 100% gearing

Macquarie Margin Lending, Macquarie Instalment Gearing, Macquarie Premium Choice, Macquarie Geared Equities Investment (*plus* shared upside), and the loan to invest in Macquarie Fusion Funds are offered by Macquarie Bank Limited ABN 46 008 583 542 (Macquarie). Full terms and conditions are set out in the relevant loan contracts, and fees and charges apply. Units in Macquarie Fusion Funds are issued by Macquarie Financial Products Management Limited ABN 38 095 135 694 (MFPML), the Responsible Entity for Macquarie Fusion Funds. A Product Disclosure Statement (consisting of a Master Document and current Offer Document) ("PDS") will be made available by MFPML when there is a current offer of the Macquarie Fusion Funds. Please contact us on 1800 550 177 to see if there is a current offer of Macquarie Fusion Funds and for a copy of the PDS. In deciding whether to acquire or continue to hold an investment, you should obtain the relevant Product Disclosure Statement (PDS) and consider its contents. Any current PDSs for the above products are available at www.macquarie.com.au/protectedlending or www.macquarie.com.au/fusionfunds or by phoning 1800 656 819. To acquire the products, you must complete the application form attached to the relevant PDS. MFPML or Macquarie or their associates, officers or employees may have interests in the financial products referred to in this information by acting in various roles including as investment banker, dealer, broker, lender or adviser. MFPML or Macquarie or their associates may receive fees, brokerage or commissions for acting in these capacities. In addition, Macquarie or its associates, officers or employees may buy or sell the financial products as principal or agent and as such may effect transactions which are not consistent with any recommendations in the information. You may contact MFPML or Macquarie on 1800 550 177. MFPML is not an authorised deposit taking institution for the purposes of the Banking Act (Cth) 1959, and MFPML's obligations do not represent deposits or other liabilities of Macquarie. Macquarie does not guarantee or otherwise provide assurance in respect of the obligations of MFPML.

Why Macquarie?

Macquarie is one of Australia's most successful independent investment banks.

Our heritage, and future, rests in our ability to constantly challenge conventions. At Macquarie, generating, accelerating and protecting your wealth comes first. We aim to be innovative in everything we do. We search for new opportunities. Seek out wealth creation strategies. Then we pass that information on to our clients.

We are no ordinary investment company and we invite you to share the benefits of our expertise.

This booklet is dated 1 April 2004 and is provided for general information only and without assuming any duty of care. It does not take into account the investment objectives or financial needs of individual investors. These matters should be considered with a financial adviser when deciding whether the investment is appropriate. The information is not intended to constitute financial or taxation advice, and it should not be relied upon as such. The taxation statements in this booklet are based on our interpretation of the law current as at 1 April 2004.

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