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Shadforth Financial Group

understanding gearing risk

INTRODUCTION

Borrowing to invest is an effective way of increasing an investor's asset class exposure, achieving tax benefits and increasing returns in the process. However, as with every aspect of financial planning, it can only be successful if implemented as part of a sensible strategy. A good strategy is an outcome of thorough consideration of both potential rewards and risks.

While gearing is common and straightforward, some fundamental implications can easily be overlooked in the pursuit of improved returns. These fundamentals are equally important for both margin lending, geared funds and home equity, so it is worth revisiting these basics.

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IMPLICATIONS OF GEARING

1. There is a cost involved. In every case this includes an interest rate cost and, in some cases, additional management fees.

2. The Loan to Valuation Ratio (LVR) indicates the level of debt held by the portfolio. An LVR of 0.5 means that every dollar committed by the investor is matched with a dollar of debt. In this case, a portfolio is comprised of 50% debt and 50% equity. An LVR of 0.33 means that every dollar committed by the investor is supplemented by 50 cents of debt, i.e. the portfolio is comprised of 33% debt and 67% equity.

3. Returns are magnified, but the borrowing costs must be considered. An LVR of 0.5 will yield a return on initial investment double that of the underlying asset return, minus costs. Positive returns therefore will be slightly less than double the return of the underlying asset.

4. Risks are also magnified and again, borrowing costs must be considered. With an LVR of 0.5, negative returns will be slightly more negative than double the return on the underlying asset. This is an important consideration.

5. Because losses are magnified, the investment horizon should be extended as the time to recover from any potential losses is increased.

6. Because investment returns need to outpace borrowing costs, any asset return that is less than the prevailing interest rate represents a negative return to investor. Therefore, negative returns become much more frequent. Highly frequent negative returns are a serious risk-profiling consideration.

With geared funds, borrowing is undertaken by the fund itself. As such, costs, margin calls, cashflow management and all the associated accounting occurs at fund level. This means that a lot of the implications and risks associated with gearing are not visible to the adviser or investor. For this reason, this paper will focus primarily on geared funds.

IMPLICATIONS FOR ASSET ALLOCATION

It may seem obvious that gearing into an asset class increases an investor's exposure to it. However, what is not so obvious is the impact that gearing has on overall asset allocation. As an example, consider a "growth" portfolio. A typical growth portfolio might consist of 10% cash, 20% bonds, 10% property and 60% equities, for an overall exposure of 70% to growth assets. If 50% of the equities component is geared with an LVR of 0.5, the asset allocation changes to the extent the investor has no effective exposure to defensive assets whatso-

This article by Patrick Bennett (above), Head of Research.

ever. The impact on the risk profile of the portfolio versus the risk profile of the investor is enormous and the intended benefits of diversification can be completely eroded.

THE BORROWING COSTS REALLY MATTER

A common misconception is that the LVR and the returns of the underlying asset will dictate geared fund returns. The LVR and asset return will dictate the investor's return before borrowing costs are applied. If underlying asset returns are substantially positive, then the LVR will have a proportionately substantial positive impact. If underlying asset returns are substantially negative, then the LVR will have a proportionately substantial negative impact. Borrowing costs however, will always have a negative impact regardless of the direction pre-geared returns are taking.

During good years, returns won't be magnified to the same degree that losses are magnified during bad years. This is because borrowing costs detract from any positive returns. While the investor may be rewarded with an additional return on the upside, this is less than half what they risk losing if markets move by an equivalent negative amount The risk/reward equation is skewed against the investor. Of equal importance is the implication of a 0% return. In the geared fund, even a 0% asset class return results in a negative return to the investor.

THE RISKS ASSOCIATED WITH DOUBLE GEARING

Double gearing occurs when investors use borrowed money to invest in a geared fund. This further multiplies the impact on returns, risk and asset allocation. However, given that margin lending is considerably more expensive than using geared funds, the potential upside is more limited while the potential downside is considerably worse.

Double gearing is an extremely dangerous strategy. An investor with a conservative LVR of 0.25 investing into a geared fund that is itself geared with a LVR of 0.5 is very exposed. A -20% market return will result in an almost complete loss of capital, as shown in Table 1.

When combined, margin lending and geared fund strategies produce outcomes that no longer bear any resemblance to the behavior of the underlying investment assets. In fact, double gearing strategies produce results that more closely resemble gambling outcomes. The potential for high returns is matched with the potential for large losses and even the complete loss of capital. This is why double gearing should be avoided.

Table 1: Double gearing

	Ungeared investment	Geared fund, no margin lending	Margin lend @ 0.25 LVR into geared fund	Margin lend @ 0.5 LVR into geared fund
Return in a good year	20%	32.7%	41.5%	61.1%
Return in an average year	10%	12.7%	14.8%	21.1%
Return in a bad year	0%	-7.2%	-11.8%	-18.9%
Return in a disastrous year	-20%	-47.2%	-65.2%	-98.9%

Assumed cost of borrowing for the geared fund is 7.25%. The geared fund has a 0.5 LVR. Assumed cost of borrowing for retail margin lending is 8.75%.

CONCLUSIONS

Borrowing to invest is an aggressive strategy, whether in the form of margin lending or investing into a geared fund. As the level of gearing increases, so too should the investment horizon. A geared 'moderate' portfolio may need a similar time to recover from a period of underperformance as an ungeared 'aggressive' portfolio.

Investors should be aware of the real risk that is being embedded in their portfolio. This risk can be either in the form of greater losses when markets underperform, or an asset allocation that is no longer aligned with their targeted risk profile. It is better to gear to what is an acceptable level of risk, rather than seek a higher return irrespective of the additional risk.

Borrowing costs are a relentless drag on returns, diminishing the ultimate returns to investors irrespective of whether the investment itself rises or falls in value.

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