Margin Lending

Set your sights higher

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NAB Margin Lending is a Facility provided by National Australia Bank Limited (ABN 12 004 044 937 AFSL 230694) ('NAB'). A PDS is available for the NAB Margin Lending Cash Management Account (CMA) that may be used in conjunction with NAB Margin Lending. The NAB is the issuer of the CMA and recommends you consider the PDS before making any decisions regarding this product. The CMA PDS and the NAB Margin Lending Brochure kit is available via our website at nab.com.au/marginlending or by calling NAB Margin Lending on 1300 135 145.

This brochure is not a substitute for reading the NAB Margin Lending Facility Terms or the CMA PDS.

A NAB Margin Lending Facility is only available to Australian residents and in relation to property in Australia. Applications from people other than Australian residents will not be accepted.

Historic performance is not indicative of future performance. The future value of an investment may rise or fall with changes in the market.

The information in this brochure is based on our interpretation of relevant taxation laws as at 1 September 2007. It is current at the date of publication but may be subject to change.

Give your investments a lift

Borrowing to invest (gearing) has long been a popular wealth creation strategy. By enabling you to invest more money, gearing has the potential to multiply your profits. And along the way, it may also help you to reduce your annual tax bill.

Establishing a margin lending facility is a potentially powerful way to implement a gearing strategy. A margin loan is simply an investment loan that is secured by a range of assets, including managed funds, shares and cash.

Like other investment strategies, margin lending does have its risks. However, if you plan in advance and review your circumstances regularly, margin lending could help you achieve your long-term financial goals sooner.

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How does margin lending work?

A margin loan is a flexible line of credit that can be used to borrow money for investment purposes. You simply provide approved shares, managed funds or cash as security for the loan. You can then use the borrowed money to access a range of investment opportunities.

The maximum percentage amount you can borrow against an asset (the 'security ratio') is generally 100% for cash and between 40% and 75% for approved shares and managed funds.

Assuming the investments securing the loan have a security ratio of 60%, here are three different ways margin lending can be used to build an investment portfolio.

1. Set up a new investment portfolio

By using a combination of cash and borrowed funds, you can invest more money. For example, if you have $40,000 in cash, you may be able to borrow up to $60,000 through a margin loan and invest a total of $100,000 in approved assets.

Note: The loan ($60,000) divided by the total value of the approved investments used as security ($100,000) = 60%.

2. Increase an existing portfolio

If you already own approved assets, you can borrow money via a margin loan and make a larger investment. For example, if you have existing investments worth $40,000 you may be able to borrow up to $60,000 and increase your total investment to $100,000.

Note: The loan ($60,000) divided by the total value of the approved investments used as security ($100,000) = 60%.

3. Free-up existing investment capital

Margin lending can also be used to access capital currently invested in approved assets without having to sell them. For example, if you already have $100,000 invested in approved assets, you may be able to borrow up to $60,000 for business or other investment purposes. In this scenario, the assets purchased with the borrowed money are not used as loan security.

Note: The loan ($60,000) divided by the value of the approved investments used as security ($100,000) = 60%.

Key benefits of margin lending

- **You can start small**
  Unlike investing in residential property, you don't need to borrow large sums of money to start (or build on) your investment portfolio.

- **Broad investment choice**
  Most margin lenders allow you to borrow against an extensive list of approved managed funds and shares. This can enable you to diversify your portfolio and ensure you don't rely too heavily on the performance of any one investment.

- **Third party security**
  You may be able to arrange for another person (or company) to provide some of the security for your margin loan. Third party security may be a suitable option if you would like to use margin lending, but don't have sufficient investments of your own.

- **A choice of gearing levels**
  While you may be able to borrow up to 75% of the market value of certain approved assets, you can establish a margin loan with a lower gearing level.

- **Flexible loan arrangements**
  You can pay off part of your loan and redraw funds at a later date, provided there is enough security for your loan.

- **Interest rate options**
  You typically have a choice of fixed and variable rate loans (or a combination of the two). You may also pre-pay interest on fixed rate loans.

How can margin lending increase your wealth?

Margin lending can help you build your wealth faster than if you relied exclusively on your own investment capital. Not only can a larger investment potentially multiply your long-term profits, you may be able to benefit from a range of tax concessions (see page 12). While there are no guarantees, these two key benefits can collectively make margin lending a powerful wealth creation strategy.

Lump sum gearing

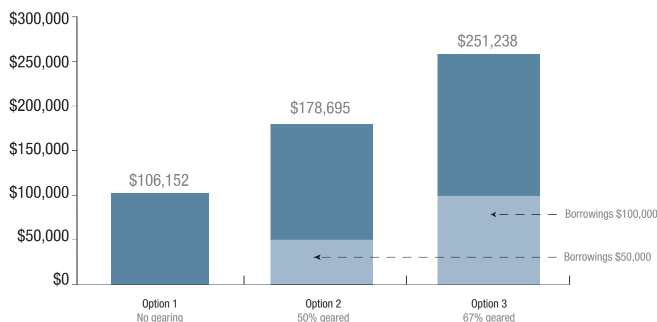
One way to accelerate your wealth is to make a larger lump sum investment using borrowed money.

Case study:

Jack has $50,000 invested in an approved Australian share fund. After speaking to his financial adviser, he is considering three options for the next ten years:

1. Maintaining his investment at $50,000.
2. Doubling his existing investment by borrowing $50,000 through a margin lending facility (ie 50% gearing).
3. Increasing his existing investment even more by borrowing $100,000 through a margin lending facility (ie 67% gearing).

The graph below illustrates the potential outcome of these three options after ten years.



Assumptions:

Ten-year investment period. The managed fund has a security ratio of 70%. Investment return is 8.5% pa (split 3% income and 5.5% growth). The franking level on income is 75%. Interest on the loan is 8% pa. Jack's marginal tax rate is 41.5%, including a Medicare levy of 1.5%. These rates are assumed to remain constant over the investment period. With the margin loan in options 2 and 3, where investment income and tax benefits are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax savings are reinvested.

As you can see from the graph, the higher the gearing level the greater the potential gains. It must be remembered, however, that Jack still has an outstanding loan in options 2 and 3 of $50,000 and $100,000 respectively.

If Jack withdrew a portion of his investment after ten years to repay the outstanding debt (and pay capital gains tax on the amount withdrawn), the value of his investment is shown in the table below.

Value of investment after repayment of loan

Option 1 No gearing	Option 2 50% geared	Option 3 67% geared
$106,152	$123,989*	$141,826*

** After CGT on the amount withdrawn.*

Clearly, margin lending has the potential to help Jack achieve his goals, so long as the value of his investment rises sufficiently.

Note: Before you use margin lending, you should understand the risks (see page 8-11). In particular, if your investments fall in value, your financial situation could be significantly worse than if you don't use margin lending.

Gearing by instalment

Establishing an instalment gearing facility is another way to make your money work harder. Instalment gearing enables you to invest in approved managed funds on a monthly basis, using a combination of your own capital and money borrowed through a margin lending facility.

This strategy may suit people with a regular income, but no sizeable lump sum to invest. It may also appeal to investors who prefer to drip-feed their money into the market rather than investing it all in one transaction.

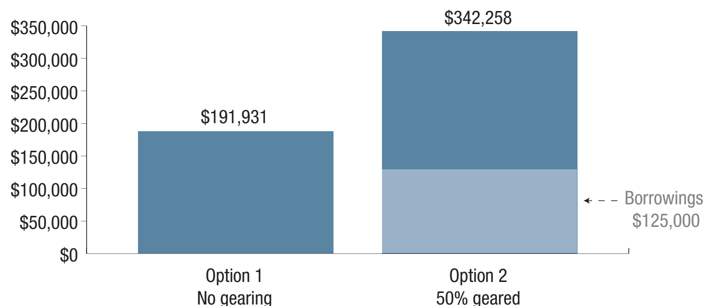
By investing regularly, you can 'average' the price you pay for your investments without trying to time your entry into the market.

Case study:

Jillian wants to invest in an approved Australian share fund on a regular basis over the next ten years. After consulting with a financial adviser, she is considering the following options:

1. Investing $1,000 per month from her regular income, in addition to an initial lump sum of $5,000 (a total investment of $125,000 over a ten year period).
2. Using an instalment gearing strategy, initially investing $10,000 (ie $5,000 of her money plus $5,000 in borrowed money), followed by monthly investments of $2,000 (ie $1,000 per month of her money, together with $1,000 per month of borrowed money). Over ten years, the total amount invested will be $250,000 (ie $125,000 of her money, plus $125,000 of borrowed money). Her investments will therefore be 50% geared.

The graph below illustrates the potential outcome of these two options after ten years.



Assumptions:

Ten-year investment period. The managed fund has a security ratio of 60%. Investment return is 8.5% pa (split 3% income and 5.5% growth). The franking level on income is 75%. Interest on the loan is 8% pa. Jillian's marginal tax rate is 41.5%, including a Medicare levy of 1.5%. These rates are assumed to remain constant over the investment period. With the margin loan in option 2, where investment income and tax benefits are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax savings are reinvested.

If Jillian decides to pay back the $125,000 loan in option 2 at the end of ten years by selling units in the Australian share fund (and paying capital gains tax on the amount withdrawn), the value of her investment is shown in the table below.

Value of investment after repayment of loan

Option 1 No gearing	Option 2 50% geared
$191,931	$206,805*

** After CGT on the amount withdrawn.*

When compared to the 'no gearing' scenario, instalment gearing has clearly made a significant difference to Jillian's financial position.

Note: Before you use margin lending, you should understand the risks (see page 8-11). In particular, if your investments fall in value, your financial situation could be significantly worse than if you don't use margin lending.

Tips & Traps

- Lump sum and instalment gearing (via a margin loan) may multiply your profits and help you achieve your goals sooner.
- Instalment gearing also takes the guesswork and emotion out of picking the right time to invest.
- You should seek financial advice to ensure that a margin lending strategy is appropriate for your circumstances. An outline of some of the key issues to consider can be found on page 16.

What are the risks?

While a margin loan can increase your gains in a rising market, it can also magnify your losses when the market declines. That's why you should consider investing in a diversified portfolio of quality assets and allow enough time (and discipline) to ride out the inevitable investment market ups and downs.

Another key issue to keep in mind is that fluctuations in the value of your investments can impact your borrowing capacity. In particular, you may need to make some adjustments to your loan amount (or your investments) if your outstanding loan balance exceeds your portfolio's 'security value'.

The security value and market movements

The security value is the maximum amount you are able to borrow (in dollar terms) and is calculated by multiplying the market value of the approved investments in your portfolio by the relevant security ratio(s).

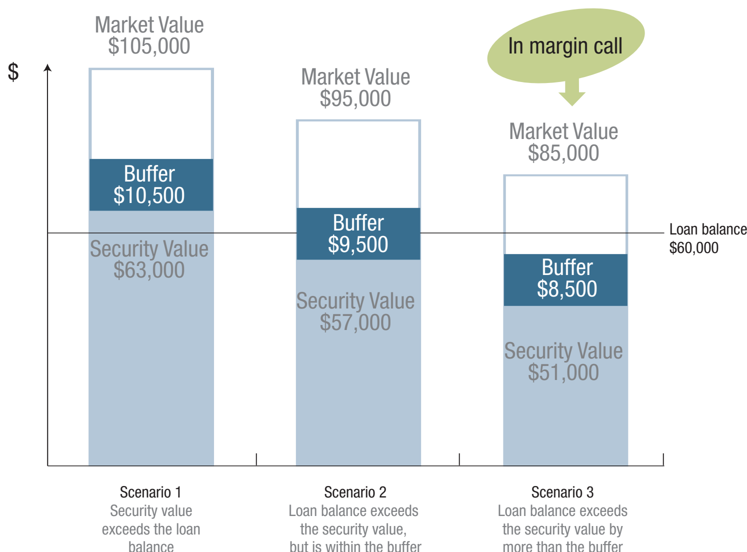
For example, if you invest $100,000 in an approved managed fund with the help of a margin loan and the investment has a security ratio of 60%, the security value will be $60,000. However, once your loan is established and your investments are made, the security value of your portfolio can change over time, according to market performance.

Implications for your margin lending facility

Generally, as long as the security value of your investments exceeds your outstanding loan balance (see Scenario 1 in the graph on the opposite page), your facility is operating within its limits and you may be able to draw additional funds for investment purposes – if that's what suits your goals and circumstances.

If the security value falls below your loan balance by a small amount, most margin lending institutions will allow for some fluctuations in the form of a **'buffer'** (see Scenario 2). The buffer usually amounts to between 5% and 10% of the market value of the approved investments in your portfolio. While in the buffer, you are not required to take any action, although you will not be able to withdraw funds or make further purchases.

However, if your loan balance exceeds the security value of your investments by more than the buffer (see Scenario 3), you will need to meet what is known as a **'margin call'**.



Note: This graph is included for illustrative purposes only. It assumes you invest in managed funds and the buffer is 10% of the market value of your investment.

What should you do if a margin call occurs?

If the lending institution makes a margin call, you will be required to undertake one (or more) of the following steps to restore the loan balance below the security value:

- Reduce your loan balance;
- Provide additional approved investments as security; or
- Sell some of your approved assets and use the proceeds to repay part of the loan.

In the event of a margin call, you should speak to your financial adviser to determine the best course of action.

What happens if you don't meet a margin call?

If you don't meet a margin call within the specified time period, the lending institution will usually sell sufficient securities on your behalf so the security value is again greater than the loan outstanding. You should therefore read the terms and conditions of any margin lending agreement very carefully and make sure you are aware of all the implications.

How to manage margin calls

There are a number of strategies you can use to minimise the risk of a margin call occurring.

1. Gear conservatively

The best way to avoid a margin call is to borrow less than the maximum available. For example, if you borrow 50% to purchase an investment with a security ratio of 70%, your investment would need to decline in value by 37.5% before you would have to meet a margin call (assuming a buffer of 10%).

The table below shows how much an investment would need to fall before a margin call would occur, based on a range of security ratios and actual gearing (borrowing) levels.

Security ratio of portfolio	Loan divided by portfolio value			
	70%	**60%**	**50%**	**40%**
70%	12.5%	25.0%	37.5%	50.0%
60%		14.3%	28.6%	42.9%
50%			16.7%	33.3%
40%				20.0%

Note: The figures in this table assume a buffer of 10%.

2. Diversify your investments

Investing in a range of companies, spread across different industries and geographical areas, can smooth out the ups and downs in your portfolio and minimise the impact poor performing companies could have on your portfolio's security value. An easy way to diversify is to invest in managed funds.

3. Make regular interest payments

Some margin lending institutions let you capitalise your interest (ie add it to your loan balance). However, paying your interest frequently (eg monthly) can help ensure your loan balance doesn't increase over time.

4. Reinvest the income from your investments

Reinvesting your dividends and distributions can increase the market value of your investments and the security value supporting your loan. Alternatively, you could consider using the investment income to reduce your loan balance.

5. Monitor your investments and loan balance frequently

By conducting regular reviews, you can see whether your investments are performing effectively and ensure your level of gearing remains appropriate. You can also take suitable action if your loan is in the buffer and therefore potentially avoid a margin call before it happens.

Managing other risks

Risk	How to manage
The security ratio assigned to an asset may change over time	• By gearing conservatively, you can potentially minimise the possibility that a reduction in the security ratio could result in a margin call.
Rising interest rates	• You should ensure you have enough surplus cash flow to absorb higher interest payments. • You could consider fixing the interest rate on some (or all) of your margin loan to offer protection.
Falling investment income	• You should ensure you have enough surplus cash flow to cover any income shortfall.
Loss of salary due to illness, injury or death	• You should make sure you have enough income protection and life insurance.

How can margin lending save you tax?

Borrowing to invest through a margin loan can potentially deliver some powerful tax benefits that have an important role to play in the success of a gearing strategy.

Tax-deductible interest

The interest you pay on a margin loan can generally be claimed as a tax deduction. Furthermore, if the interest (and other tax-deductible costs) exceed the income from your investments (including franking credits), you may be able to offset these additional costs against other sources of assessable income. This is known as 'negative gearing'.

Case study:

Lisa invested $100,000 of her own money plus $100,000 of borrowed money (at an interest rate of 8% pa) into an approved asset that produced an income of 3% pa. Because her interest bill exceeds her total investment income by $2,000, Lisa is able to offset this additional cost against her salary. Given she pays tax at a marginal rate of 41.5%[1], this will save Lisa $830 in tax when she submits her tax return.

	Tax position
Loan interest paid (8% of $100,000)	$8,000
Less investment income received (3% of $200,000)	($6,000)
Excess tax deduction	$2,000
Tax saving at marginal rate of 41.5%[1]	**$830**

Although her tax return is likely to be completed some time after paying her interest bill for the relevant financial year, this tax saving will reduce Lisa's net interest cost to $1,170.

	Cashflow position
Loan interest paid	$8,000
Less investment income received	($6,000)
Less tax saving made	($830)
Net interest cost	**$1,170**

[1] *Includes a Medicare levy of 1.5%.*

Interest pre-payments

Most margin lending institutions will also allow you to pre-pay interest on fixed rate margin loans for up to 12 months. This can allow you to bring forward an expense that may otherwise be tax-deductible in the following financial year. This additional tax deduction may be used to reduce your taxable income in the current financial year.

Capital gains tax

You don't need to sell your existing investments to use them as security for a margin loan. This means you can take advantage of additional investment options without triggering a capital gains tax (CGT) liability.

You may then be able to sell your existing (and your geared) investments at a time when your marginal tax rate is lower (eg in retirement). This can potentially help you reduce or eliminate the CGT payable.

You can also save on CGT by holding your investment for 12 months or more. For individuals, CGT is generally only payable on 50% of the capital gain if an asset is held for more than a year, reducing the maximum tax rate payable on capital gains from 46.5%[1] to 23.25%.

[1] *Includes a Medicare levy of 1.5%.*

Franking credits

If you invest the borrowed money in Australian shares directly or via a managed fund, the income you receive may come with valuable franking credits. These credits can be used to offset some (or all) of the tax payable on the dividends or distributions. Lower income earners may also be able to use the franking credits to reduce the amount of tax they have to pay on other income sources and in some circumstances may be entitled to a refund of excess franking credits.

Note: Your tax position will depend on your personal circumstances. You should therefore seek advice from your financial or tax adviser regarding the tax consequences of establishing a margin lending facility.

Third party security

Using assets owned by another person (or company) as security for a margin loan could also be quite tax-effective.

Case study:

Vanessa and Martin pay tax at marginal rates of 16.5%[1] and 41.5%[1] respectively. They have $40,000 in cash available and want to use a margin loan to make a larger investment. After evaluating their options, they decide to invest the cash in an approved managed fund in Vanessa's name. However, Vanessa also allows Martin to use her investment as third party security for a margin loan, so he can borrow $60,000 for investing in other approved assets[2].

When approached this way, earnings on the investment in Vanessa's name will be taxed at her lower marginal rate. Furthermore, by holding the geared investments in Martin's name, he is able to derive a greater benefit (than Vanessa) when claiming the interest payments as a tax deduction. As a result, they can potentially minimise the amount of tax they pay as a couple.

Note: When you provide assets as third party security for a margin loan, you may be required to act as a guarantor or a third party mortgage provider to the loan facility. You should therefore seek independent advice regarding your legal obligations and responsibilities.

[1] *Includes a Medicare levy of 1.5%.*

[2] *Assumes Vanessa and Martin's investments have a security ratio of 60%.*

Never invest for tax reasons only

If you invest borrowed money in assets that fail to produce enough income or capital growth over the longer term, your losses could outweigh any reduction in your tax bill.

For a margin lending strategy to be profitable in the long term, the investments you acquire with borrowed money must generate a total return (income and growth) that exceeds the cost of financing the investment (after all the tax considerations are taken into account).

On the next page we cover a range of other issues you need to consider before you set-up a margin lending facility.

Is margin lending right for you?

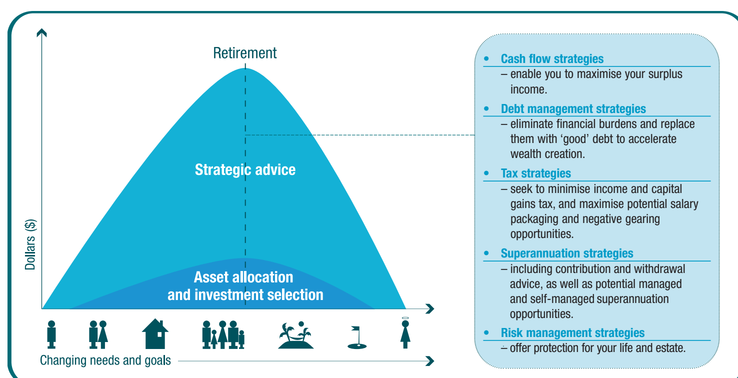
Before you take out a margin loan, here are some important issues that need to be considered:

- ☐ Do you intend to invest for at least five years?
- ☐ Can you tolerate short-term fluctuations in the value of your investments?
- ☐ Do you have a regular, secure income stream (eg a salary)?
- ☐ Do you have sufficient surplus cashflow (eg to service your debt if interest rates rise)?
- ☐ Do you have access to additional cash or investments, should a margin call arise?
- ☐ Do you have enough insurance to protect yourself against a loss of income due to illness, injury or death?

You should also seek financial advice. A financial adviser can determine whether margin lending is right for you. They can also help you select quality investments, identify and manage your risks, and implement a range of other strategies that can help you achieve your lifestyle and financial goals.

The value of advice

The diagram below illustrates the importance of various elements of financial advice. Moving from left to right, this diagram also shows how much these elements can contribute to achieving your goals during your life.



Why NAB Margin Lending?

If you and your adviser think margin lending is the right strategy for you, here are some compelling reasons to choose NAB Margin Lending:

1. Low minimum loan amount
   The minimum loan amount is $20,000.

2. You can tailor your facility
   With NAB Margin Lending, you can combine variable rate and fixed rate loans within the one Facility, so long as the fixed rate component of the loan has a minimum amount of $20,000.

3. Competitive interest rates
   NAB Margin Lending aims to keep interest rates competitive when compared to other margin lending institutions and the interest rate environment.

4. Individual and joint applicants pay no application* or ongoing service fees
   Note: This benefit is not available to companies and trusts.

5. You have a broad choice of investments
   A NAB Margin Lending Facility allows you to borrow against an extensive range of listed shares and managed funds.

6. You can gear by instalment
   Instalment gearing facilities are available with a minimum Facility limit of $20,000.

7. You can offer third party security
   This means you may be able to use investments owned by another person (or company) as security for your margin loan.

8. You can access your Facility easily
   The NAB's extensive network enables you to access your Facility via internet banking, telephone banking, over 1,000 conveniently located ATMs and 1,200 branches Australia-wide.

For more information on NAB Margin Lending, including the latest interest rates and list of approved investments, phone 1300 135 145 or visit the website nab.com.au/marginlending

* Applicants and guarantors residing in Tasmania are subject to a State Government charge for registration and stamping of the Power of Attorney.

For more information on
NAB Margin Lending call **1300 135 145**
or visit **nab.com.au/marginlending**

For details on MLC's range of products and
services, call MLC from anywhere in Australia
on **132 652** or visit **mlc.com.au**

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MLC also has guides on wealth creation, debt management, wealth protection, superannuation and retirement.
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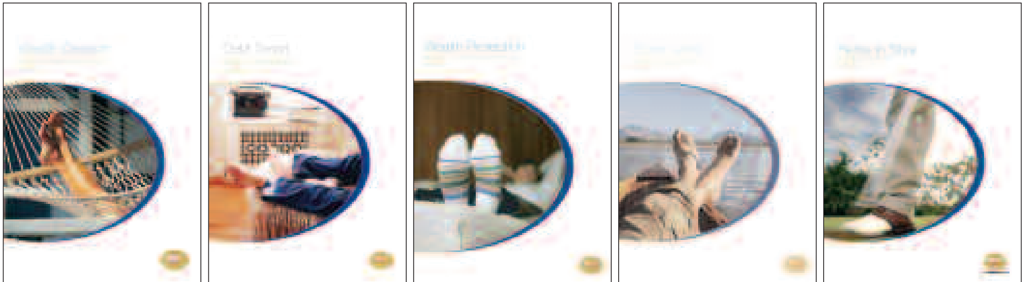

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