

# Mitigating the risk of margin calls in times of volatility



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The global financial crisis and recent decline of the Australian share market has resulted in an unprecedented increase in the number of margin calls facing investors with margin loans. While many investors have maintained their loan to valuation ratio (LVR) obligations with cash payments, many were forced to sell down holdings at significantly depressed levels, thereby losing out on any future dividends, franking credits and capital growth following a recovery.

Investors with existing margin loans may look to mitigate the risk of future margin calls, particularly in times of high market volatility. With the right financial advice, the stress of margin calls can be eliminated by using Commonwealth Bank's Protected Loan.

## Introducing Sarah

Sarah is an IT consultant in a medium-sized technology firm. Back in April 2006 Sarah opened a \$100,000 margin loan facility so that she could take a leveraged position over BHP; a stock which she believed had strong capital growth potential over the medium term. Sarah contributed \$30,000 of her own funds and borrowed the remaining \$70,000 through her margin lender.

A summary of Sarah's initial investment is outlined below:

Initial investment (1 April 2006)	BHP holding
Equity contribution	\$30,000
Margin loan contribution	\$70,000
Total investment amount	\$100,000
Margin loan interest rate	8.50% p.a.
Purchase price per share	\$18.00
Number of shares	5,555
Market value of BHP holding	\$99,990

Since investing back in April 2006, Sarah has been extremely pleased with the performance of her BHP investment. Over the last couple of years, however, she has seen an increase in volatility, with the BHP share price trading as high as \$50.00 on 16 May 2008 and as low as \$20.00 on 21 November 2008. Sarah is concerned that volatility will continue to prevail in the share market and is eager to find a strategy which will allow her to eliminate the potential for margin calls on her existing BHP holding and any new funds she invests.

Sarah's investment as at 15 August 2011 is outlined below:

Current holding (15 August 2011)	BHP holding
Margin loan interest rate	9.60% p.a.
Current price per share	\$39.85
Number of shares	5,555
Current market value	\$221,367
Capital growth on original investment	\$121,367

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## The strategy

Sarah decides, together with her financial adviser, to explore her options. After discussing her financial situation and investment objectives, Sarah's adviser recommends that she take out two Protected Loans:

**Protected Loan 1** - Sarah can refinance her existing margin loan by rolling her BHP shares into a one year reduced interest rate Protected Loan using the share roll In feature<sup>1</sup>. Commonwealth Bank will repay her existing margin loan of \$70,000 and take security over the 5,555 BHP shares under the facility.

The details of Protected Loan 1 are as follows:

Existing share	BHP
Current price per share	\$39.85
Portfolio value	\$221,367
Protected Loan amount	\$154,957
Protection / gearing level	70%
Capped rate	140%
Unlocked funds	\$154,957
Margin Loan repayments	(\$70,000)
Net cash payment after Margin Loan refinance	\$84,957
Marginal tax rate	41.5%
Term	1 year
Protected Loan interest rate <sup>2</sup>	8.60% p.a.
Interest rate type	Variable (paid monthly in arrears)

After refinancing her margin loan of \$70,000 and taking out a reduced interest rate Protected Loan for \$154,957 (i.e. 70% of the current portfolio value), Sarah is left with \$84,957 which will be set aside for diversification purposes.

Sarah has protected her holding at 70% of the current value and will also be able to receive all upside in BHP up to \$55.79 (i.e. 140% of the current share price of \$39.85) over the next 12 months.

By accepting to cap the upside at 140% of the current price, Sarah is also able to reduce the interest cost of her loan facility from 9.60% p.a. under the margin loan to 8.60% p.a. under the Protected Loan, a saving of 1.00% p.a.

**Protected Loan 2** - Sarah, together with her adviser, decide this is an opportune time to invest in the broader market for the long term. Having seen the S&P/ASX 200 slide from a high of 6,851 in late 2007 to current levels of around 4,200, Sarah applies for a \$200,000 reduced interest rate Protected Loan in which she will be required to contribute \$100,000 of her own funds.

The details of Protected Loan 2 are as follows:

Portfolio of shares	STW
Portfolio value	\$200,000
Protected Loan amount	\$100,000
Protection / gearing level	50%
Capped rate	180%
Marginal tax rate	41.5%
Term	5 years
Protected Loan interest rate <sup>2</sup>	9.86% p.a.
Interest rate type	Variable (paid monthly in arrears)

Under Protected Loan 2 Sarah will have a portfolio exposure of \$200,000 and potential for up to 180% capital growth over STW (an ETF that offers exposure to the S&P/ASX 200 Index).

While Sarah acknowledges the risks associated with gearing (i.e. the capital she contributed is at risk) and the current volatility present in the market, she takes comfort that over the course of 5 years she will not be subject to margin calls and the possibility of deleverage.

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## The result

Implementing this strategy has enabled Sarah to:

- refinance her BHP shares at a 1.00% discount to her margin lending rate in regards to Protected Loan 1
- receive all capital growth for both Protected Loan 1 and 2 up to the capped level of 140% and 180% respectively.
- unlock a cash amount of \$84,957 for Protected Loan 1, which can be used for interest payments
- claim a potential tax deduction in relation to the interest expense on both Protected Loans
- receive ordinary dividends and potential franking credits on both Protected Loans
- have the peace of mind knowing that she will not be subject to margin calls over the respective loan periods.

At maturity there are a number of options available to Sarah, including re-financing through a margin loan or a new Protected Loan. Alternatively, Sarah could also use her own funds to repay the loans and retain the shares.

In the event any shares in either portfolio have exceeded the capped rate at maturity, Sarah will be required to repay the amount above the capped price to Commonwealth Bank in order to retain all her shares. Alternatively, she can instruct Commonwealth Bank to sell a sufficient amount of shares to repay the amount exceeding the capped price.

Selling shares may result in tax implications which have not been taken into account in this case study. Potential investors should consult their tax adviser about the implications of any products to their own particular circumstances.

## Getting the right advice

As with any financial strategy, using a Protected Loan to borrow and invest is not without its risks. One of the key risks of using a Protected Loan is that your return could be negative, after taking into account the performance of your shares and borrowing costs over the term. That's why it's important to read the Product Disclosure Statement to ensure you are fully informed.

**Speak to your Financial Adviser or call us on 1300 786 039 for more information about how you can mitigate the risk of margin calls in times of volatility.**

<sup>1</sup> The Share Roll In feature is not available to Superannuation funds.

### Important information

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