Understanding Your Margin Loan

There has been huge lack of understanding and a lot of misinformation regarding margin loans. Many people (including professional media representatives) do not understand the maths behind margin loans. This document is a plain English attempt to provide people with the truth about margin loans and hopefully empower them to discuss their situation with confidence. The terms that I use in this discussion are those that Colonial Geared Investments (CGI) use. Macquarie Margin Lending (MML) and other margin lenders may use different terminology but the principles are still the same.

Margin Loan Basics.

What is an LVR?

One of the features of a margin loan is the Loan to Value Ratio or LVR (sometimes referred to as the Loan to Security Ratio or LSR).

In practical terms it means that if you have $40,000 and you borrow an additional $60,000 and invest the full $100,000 in the market, your ***Loan*** to ***Value Ratio*** is

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$ 60,000
-------- = 60%
$100,000
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If the market rises by 10%, the loan remains at $60,000 but the investment rises to $110,000 meaning that your LVR is now $60,000/$110,000 = 54.45%

Similarly, if the market falls by10%, the loan remains at $60,000 but the investment value falls to $90,000 meaning that your LVR is now $60,000/$90,000 = 66.67%

Notice that in these examples, a rise or fall of 10% equates to a reduction in the LVR of 6.55% or an increase in the LVR of 6.67% respectively (approx. 3:2 ratio).

Read that again just to make sure you understand that:

> A **increase** in investment value results in a **decrease** in the LVR; and
> A **decrease** in the investment value results in an **increase** in the LVR.

What is the Base LVR?

Every investment that can be used as security on your margin loan (the same way as a house is used as security on a home loan) has a maximum lend ratio or borrowing limit. Higher risk shares will attract a lower maximum lend (anywhere from 0% to say 50%) whilst managed funds will attract a maximum lend of anywhere from %30 up to 80%. Index funds (even those not promoted by Storm Financial) usually have a higher maximum lends in the vicinity of 70% to 80%.

You should also be aware that the Margin Lender **can and will** change the borrowing limit as they see fit, when they see fit. This in itself can have major consequences that should become apparent later in this document.

The margin lender will calculate the Base LVR as a weighted average using the size of each individual investment, and the borrowing limit of each corresponding investment. Don't get too hung up on this. In the case of the Storm-badged funds, they all had an 80% borrowing limit so the Base LVR was also approximately 80%. I say approximately because there are a couple of other issues that come into play as well. I'll discuss those later.

Also interesting to note is that if you deposit cash into a CBA Accelerator Cash Account (in the case of CGI) the maximum lend for cash is 100%. More on that later.

With respect to your investments, if the securities fall enough so that your margin loan LVR increases above the Base LVR of your loan, then your loan is flagged as "being in buffer". This is NOT the same as a margin call LVR.

What is the "buffer"?

In the case of CGI, they provide a 10% buffer (MML have a 5% buffer).

What this means is that you will receive a margin call at an LVR of 90% (80% + 10% buffer) or 85% in the case of MML. So, the Base LVR + Buffer = Margin Call LVR.

If you play with the numbers you should also see that at these higher LVRs, a decrease in investment value more closely corresponds to a similar increase in your LVR, i..e. it is now almost a 1:1 ratio.

Now the BIG question: What is a Margin Call, and what needs to happen?

As discussed above, if the investments in your portfolio decrease in value enough to result in an LVR above the Margin Call LVR, you will receive a Margin Call.

When this happens, you have an obligation to remedy the situation. Critically, you are required to not only reduce the loan below the Base LVR (yes, you need to reduce the loan LVR by at least 10% (or 5% in the case of MML)!

This can be done in one of three ways.

1. You could add additional security (investments) to the portfolio to reduce the LVR;
2. Sell down some or all of the investments to reduce the LVR; or
3. Do nothing, in which case the margin lender holds the authority to sell down the investments as they see fit.

What was/is special about the Storm badged funds?

All the Storm badged funds are "index funds".

What that means is that they are designed to "track" the related index.

What that means is that if the market moves up or down by say 10%, the value of the index funds will also increase or decrease in value by the same percentage.

Essentially, the Storm model promised "average market returns" … nothing more, nothing less. Some media reports claimed that Storm clients were greedy because they were choosing high-risk high-return investments and that they got what they deserved. Clearly, an index fund cannot out perform the market!

Why do index funds enjoy a high borrowing limit compared to direct shares or other managed funds?

Index funds track the entire market because they invest in the entire market. For an index fund to "go bad", would require that the entire market "goes bad".

Whilst the entire market has fallen significantly since the market highs of late 2007, the credit crisis has **not** resulted in the value of every company listed on the Australian Stock Exchange (ASX) falling to nothing … not even our beloved banks!

Because the investments are diversified across every sector of the stock market, the banks deemed that they were significantly less risky and more liquid that some direct shares or also most other managed funds (try selling shares in ABC Learning or Centro Property Trusts, for example). This risk analysis was reflected as higher borrowing limits on all index funds.

Storm Financial negotiated even higher borrowing limits with CGI and MML on the understanding that **both parties** monitor the LVRs closely. This agreement was documented and formed part of the evidence that resulted in a Federal Court Judge affirming that the CBA did have a case to answer! Clearly then the letter that CGI sent to Storm clients was an attempt to absolve themselves of all responsibility for the debacle that followed.

It should be noted that the purpose of the increase in borrowing limits was not for the purpose of seeking larger investments for clients, it was to increase the safety margin for investors in case there was a significant market correction.

In the vast majority of cases, investors were geared on their margin loans to a level that rarely exceeded 55%. With a Margin Call LVR of 90%, the market would need to drop more than 35% and probably in excess of 40% in order to activate a Margin Call. This was factored into Storm's plans as an additional safety level in excess of the worst-ever market drops in history. The events of 2008 exceeded even these levels and is being referred to now as a "Black Swan Event".

Another point worth noting is that virtually every other financial planning office in Australia would often gear their clients to a level of 50% on investments that have a borrowing limit of 65-70%. Including the buffer, this meant that these other practices' clients were experiencing Margin Calls after a market fall of only 25-30%. I know from personal experience working in other practices that many of these margin calls occurred in the first quarter of 2008. Storm's safety margins kept everyone safe for at least another six months or more.

Is there anything else I need to know?

Absolutely.

There are some very interesting flaws in CGI's website information that made their ability to monitor margin loans significantly more complex.

Firstly, let's go back in history a bit and look how the vast majority of managed funds are placed in the context of a margin loan.

Most financial planners place investments directly within a platform for ease of monitoring and reporting (for the planner's benefit, NOT the client's benefit). This usually incurred additional ongoing platform management fees over and above the trail commissions paid to these planners from the fund managers. This fee was usually in the order of 1% of the managed investment. These platforms often rebated a "Dealer Cut" back to the dealer as an incentive to place more business.

The usual practice for the placement of the investment was that the entire amount of money would be placed with the platform, and then the planner's commission (usually around the 4.4% mark) would be deducted and paid to the planner.

Given the above discussion on LVRs, this meant that the margin loan immediately recorded an LVR greater than that intended.

For example, if you had $40,000 and borrowed $60,000 from the margin lender for a total investment of $100,000, you'd expect an LVR of 60%. But if the adviser's fee (at 4.4%) was then deducted from the investment you'd have a loan worth $60,000 but an investment of only $95,600 giving you an LVR of 62.76%. Also, the higher the LVR got as a result of a market fall, the greater the differential between your actual LVR and what CGI reported.

To avoid this disparity, CGI built in an additional buffer of approx 4% to allow financial planners to avoid having their clients get into Margin Call territory early as a result of their fee structure.

Storm's model didn't do this. Fees were always paid directly to Storm with the residual capital being used for the investment. Further, the planned LVRs were exactly correct because they didn't have to fudge an additional 4% to make it look good. Unfortunately, the CGI website continued to report this inaccuracy and as a result Storm clients inadvertently had been placed into a Base LVR/Margin Call LVR situation of 84% & 94% (approx) where it should have been 80% & 90% respectively.

Let's get this straight. What this means is that CGI would not have acted on a Margin Call until you hit at least 94%! That means that you have lost (through no fault of your own) an additional 4% of whatever cash you might still have had.

But wait, there's more!

Another curiosity has also raised its head now. As I mentioned above, the use of cash as security for a margin loan is quite acceptable and in the case of CGI, moneys deposited into an Accelerator Cash Account attract a maximum borrowing limit of 100%. What is also interesting (and fundamentally flawed is the realisation that even with a maximum lend of 100%, CGI still allowed a buffer of 10% meaning that you could effectively get a Margin Call at 110% (plus 4% adviser allowance plus other adverse market movements).

CGI relied on the Fund Managers (Colonial First State, Challenger and every other fund manager) to report unit prices in an agreed regular time frame. Despite this requirement, the data on CGI's website was often 2 or more days out of date in the case of Index Funds (and often more that 3 to 4 weeks out of date in the case of platform providers!). I know from first-hand experience that even if the data files were provided to CGI on time in accordance with the agreements, CGI's internal system in this regard was manual and required someone in their back office to physically upload the provided data files(often as a consequence of adviser complains that the data was old and out of date!)

It is quite conceivable that you could receive a margin call one day based on out-of-date data and that by the time any action was flagged by CGI, the market could have and did move significantly further down. You could now easily be in a negative equity situation. A negative equity position is one where the loan principal is now greater than the security/investment that supported it, and hence you should have seen an LVR in excess of 100%. I say "should have", because the CGI website couldn't handle percentages above 100%!

Another issue that we haven't discussed yet is the Margin Lender's capacity to change the maximum lend as it sees fit. Those of you who had Colonial First State (CFS) investments would have seen the borrowing limit for those funds dropped from 80% to 70%. You don't have to be a mathematical genius to recognise that this would suddenly drop even more people into margin call territory and the resultant sell-down!

CGI have been busy fixing their website and sanitising it to avoid further criticism.

Additionally, planners who placed business via a margin lender also received trail commissions from the margin lender!

Due to the nature of Index Funds, their transparency and liquidity, Storm could manage the funds directly without the use of a platform, thereby not incurring a platform fee and thus making the investment work harder for the client.

Further, Storm did not accept a trail commission from the Margin Lender, but instead negotiated that the benefit be directed back to the clients in the form of lower interest rates on the margin loans, again for the benefit of clients.

Those are the upsides, the downside is that in order to remain viable, Storm needed to charge a higher one-off initial fee. It can be demonstrated that this also was in fact a better pricing model for the benefit of the clients insofar as in the long term the investments would achieve better growth as a direct result of not being "white-anted" by layers of ongoing fees and charges.

Ok, so what has all that got to do with my Margin Loan?

In essence, the fee structure model, the Index Fund LVRs and other mechanisms were all put in place to provide safety in the structure and nature of the investment.

What should be apparent now is that the capability of CGI to adequately manage their margin loans in concert with Storm was severely hampered by inadequate and inaccurate information.

I will leave you to arrive at your own conclusions regarding the quality of product and service from CGI.

Suffice to say, the bank in this instance is not as squeaky clean as they would like us all to believe.

Disclaimer:

I have made every effort to check and double check the information provided in this document. As far as I am aware all the material presented herein is factual and can be backed up by documentary evidence.

If I have made any errors I unreservedly apologise for any distress that may result.

Any opinions expressed herein are mine and may or may not reflect the views of the SICAG committee and its members.

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