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A simple solution for gearing strategies

Geared Equity Funds

Warning: This information is intended to form general comments only and does not constitute advice. No investor should rely solely on this information when making investment decisions. This information has not been prepared to take account of investment objectives, financial situations or the particular needs of investors. Investors should consult their client adviser, who can assess their particular needs and circumstances when making investment decisions.

Borrowing to invest may not be a suitable strategy for you. While gearing has the potential to magnify gains, it will always magnify any losses suffered if the value of your investments falls. You may have to cope with potentially large fluctuations both up and down in the value of your investments.

Historical returns shown in this report are used for example purposes only and should not be considered as a guarantee or indication of future performance.

Executive Summary

Gearing involves using borrowed funds to whole or partly finance the purchase of investments in assets such as property, shares or an investment portfolio.

There are many different methods of adopting a gearing strategy including home equity based gearing, margin lending and installment warrants. This article specifically deals with the internally geared managed fund strategy, commonly known as Geared Share Funds.

Geared share funds offer a convenient and easy to manage solution for investors wishing to adopt a geared or leveraged exposure to the Australian share market.

Geared share funds have been in existence in the Australian marketplace since 1997 and have grown in popularity since then. The Australian geared equities large cap sector is represented by around forty different funds with close to A$1.5 Billion in funds under management (excluding structured products), with CFS and Perpetual being the largest participants.

This article does not concentrate on a particular product provider. Rather, this article details the general structure of geared share funds and how they might be utilised by investors.

How Does a Geared Share Fund Operate?

Essentially geared share funds are similar to ordinary managed funds, in the sense that they own and manage a portfolio of listed shares on behalf of the underlying unit holders or investors.

However, the main difference comes via the fact that the funds are 'internally' geared. Basically, the fund manager uses the assets (shares) the fund already owns as security for borrowings within the fund. These borrowings takes place within the product and the fund manager is responsible for obtaining and arranging the lending facility. Therefore, the investor is not required undergo credit checks or provide security to any lender.

These borrowed funds are then utlised by the fund manager to purchase additional shares for the fund portfolio. The fund portfolio then comprises both investor contributed funds plus funds that have been borrowed by the fund manager.

The geared share fund portfolio generates investment returns from the underlying shares (dividends and trading returns) and meets the loan interest and other fund administration costs from these returns. The underlying investor does not need to contribute further funds to maintain the borrowings within the geared share fund.

The investor's obligations are limited to the amount they invest, so there are no margin calls or other direct costs for investors.

The geared share fund will generally borrow money from a mainstream bank, on substantially more attractive terms than are available to retail investors. These lower borrowings costs (interest rate) available within geared share funds are one of the primary attractions of this type of gearing. Typically, the interest rate payable on the borrowings within the fund will be expressed as a margin above the prevailing Bank Bill Swap Rate (BBSW). For example, the interest rate payable may be 0.80% above the BBSW. As interest rates adjustments occur in the Bank Bill market, then the effective interest rate within the geared share fund also adjusts.

The fund trust deed will generally provide flexibility in terms of the level of debt (gearing) within the managed fund. For example, a typical gearing range within a geared share fund would be between 30% and 60%. The level of gearing is known as the Loan to Valuation Ratio (LVR). The portfolio manager then manages the LVR levels 'prudently' to suit prevailing market circumstances and the level of interest rates applying. It is typical for the portfolio manager to target a LVR level within the fund that ensures the borrowing costs are comfortably met by the investment income generated by the underlying portfolio.

In general, when borrowing costs are low relative to the forecast net income of the fund, the LVR will generally be high. Conversely, when borrowing costs are high relative to the forecast net income of the fund, the LVR will generally be low. Investors should note that the cost of borrowing could significantly reduce the income received from dividends. As a result, geared share funds normally pay relatively low distributions, with distributable income being largely capital gains.
In an environment whereby the portfolio manager believes that good buying opportunities exist in the share market, then they may well increase gearing levels within the fund from (say) 45% to 55% - using the additional borrowed funds to take advantage of these opportunities.

In an environment whereby the portfolio manager believes the share market is overvalued, then they may well take profits on underlying shares and reduce debt (gearing) levels within the fund. If the gearing ratio exceeds the upper threshold, the fund manager will take the ratio back to this limit or lower by selling Fund assets and repaying part of the borrowings within a reasonable period of time.

Therefore, geared share funds generally adopt a dynamic form of gearing to suit the prevailing market environment. Investors in geared share funds do not make ongoing decisions regarding the gearing levels - this is entirely left up to the portfolio manager to decide.

Geared Share Funds compared to other Gearing Options

Geared share fund comparisons against other forms of gearing are summarised below:

- Interest Rate - Lower than Margin Lending and Installment Warrants
- Loan Recourse - Limited recourse loan compared to full recourse lending that applies to home equity and margin lending. Investor's liability is limited to their invested capital
- SMSF Availability - Geared share funds are available investment options for SMSF portfolios. SMSF have restrictions on most other forms of gearing.
- Ease of Administration - Geared share funds have minimal ongoing investor administration requirements when compared to the monitoring required for other forms of gearing such as Margin Lending.

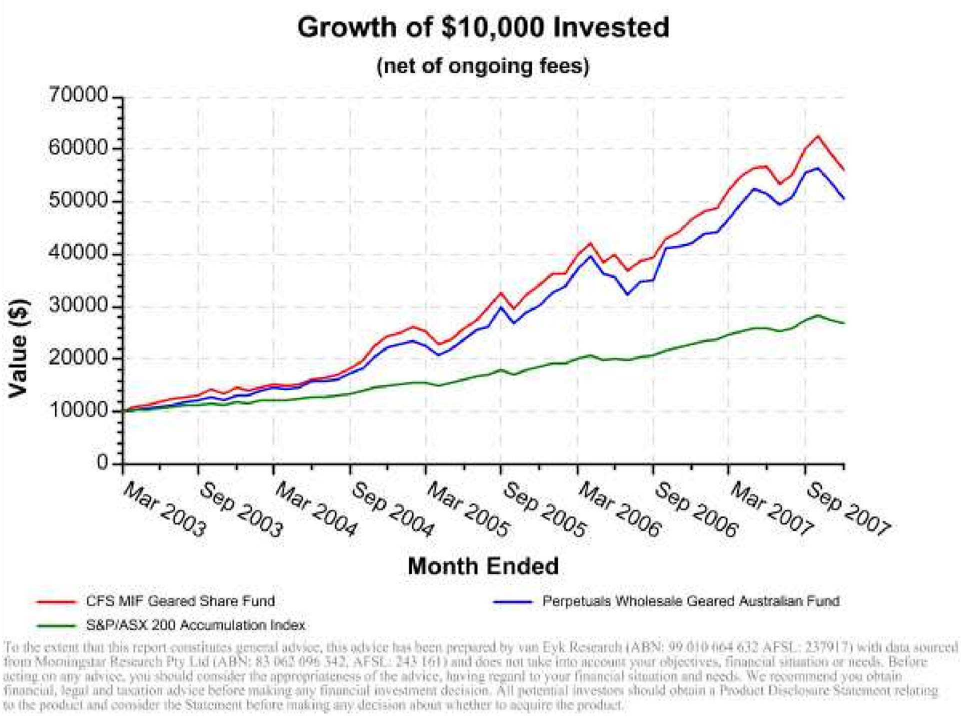
Performance Expectations of Geared Share Funds

Any investment strategy that involves gearing will magnify investment gains but also magnify investment losses. Geared share funds are no different in this regard.

For a geared share fund strategy to generate positive returns, the underlying investment market (i.e.: share market) returns need to at least exceed the borrowing and administration costs of the fund.

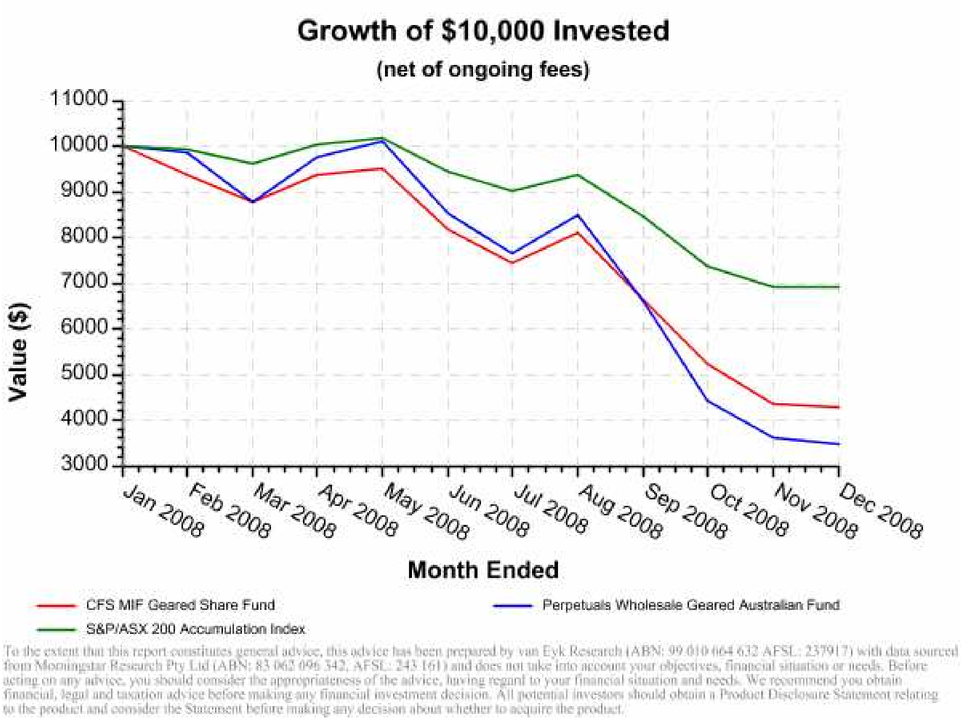
During periods of strong share market performance, as was experienced from 2003 through to 2007, a geared share fund strategy would have significantly outperformed the broader share market.

The following graph highlights the performance of two major geared share funds (Colonial First State and Perpetual) over this period, compared to the performance of the S&P ASX 200 Accumulation Index. The majority of this outperformance can be attributed to the geared nature of the funds.



During periods of poor share market performance, as was experienced throughout 2007, a geared share fund strategy would have significantly underperformed the broader share market.

The following graph highlights the performance of the Colonial First State and Perpetual funds over this period, compared to the performance of the S&P ASX 200 Accumulation Index.



Investors undertaking a gearing strategy, including the use of geared share funds need to be cognisant of the additional volatility of returns that gearing will provide. Adopting a long term investment view is an essential ingredient to operating a prudent gearing strategy.

Why use gearing?

- If the total return (income plus capital) is positive and exceeds the costs of borrowing, the gain to the investor could be significantly magnified;
- If the implied dividend yield is in excess of the cost of borrowing the geared strategies could generate substantial income for investors;
- Use of internal gearing will at times lower net borrowing costs for investors due to the fund manager's ability to operate as an institutional borrower and therefore borrow at competitive interest rates;
- Investors could gain increased franking credits received on income generated from borrowed funds;
- Variability of gearing may provide a partial natural hedge against falling markets as gearing levels tend to decline as share prices become more expensive relative to their fundamental value, or dividend yields fall.

Risks of gearing:

- The returns of the fund depend on not only the type of investments but also the level of gearing and the costs of borrowing (interest rates, economic conditions etc.);
- High fluctuation of share prices could force fund managers to change gearing levels more often and hence, generate extra trading costs. Also, through periods of high volatility, the LVR of some geared funds may change on a daily basis due to factors such as share market movements, changes in forecast net income, company applications, public announcements, withdrawals and changes in the opportunities to borrow;
- Falls in share prices could trigger a breach of an LVR limit (margin call) forcing investors to redeem assets at below their fundamental or market value. In certain circumstances withdrawals may be suspended until breaches of the LVR are rectified;
- If the total return is negative – and taking account of the costs of borrowing - the loss to the investor will be magnified. As a result, a gearing strategy will entail increased downside risk.

As outlined above a gearing strategy can increase your gains and your losses. Your capital is not guaranteed and may fluctuate significantly over time.

Because of this potential volatility, we advise that a minimum time frame of 5 years is appropriate for any gearing strategy. This will allow your capital to weather any short-term volatility and give it the best opportunity to grow.

Suitable market conditions

In order for a geared equity strategy to outperform an un-geared strategy, financial markets should satisfy three major criteria:

- Have potential for positive returns;
- Have volatility in line with historic levels over the last 10 years; and
- Have access to a relatively low cost of borrowing and/or have a relatively high implied dividend yield.

Clearly, investors should satisfy themselves that the entry point into the share market for any geared investment strategy (including geared share funds) is appropriate given the additional volatility that is experienced in utilising gearing. Gearing should only be undertaken by assertive or aggressive investors who are committed to investing in growth assets for the long term and who have sufficient capacity to absorb significant fluctuations in capital.

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