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LEVERAGE: WHERE ADVISERS FEAR TO TREAD

Julie Mckay

A customer meets an adviser for the first time. After a discussion, the adviser comes to understand two things about their new customer: they have big dreams but want timid investment options – what the financial industry calls 'risk averse'.

To be stuck on the horns of this dilemma is a common enough experience for advisers. They may try gently lowering the customer's aspirations while convincing them to accept some prudent risks – moving from a balanced to growth portfolio for example.

Both are important steps in building a relationship of trust. But, in the current investment landscape, it may not be sufficient to ultimately avoid dissatisfaction. Customers may baulk at lowering their sights too far or the small increase in expected returns from taking a little more risk might still leave the customer short of their goal.

Customers sometimes have unrealistic expectations, but advisers can be equally ambiguous about a changing investment landscape; particularly risk management.

Expectations Gap

The adviser's new customer might be a snappily dressed millennial, wondering how to make the giant leap onto the property ladder. Or they might be someone who crashed into their 45th birthday recognising the paucity of their retirement savings. Aspirations are as many and varied as customers themselves.

Either way, the gap between expectation and reality is yawning wider. This 'dream-killer' comes about as the result of an inescapable shift in time, inflation and returns.

This article does not need to recap the well-discussed issues of longevity. We are living longer. This means we will need a larger pot of savings to support our end-of-paid-work life. Even the best intentions to work well beyond retirement age may be thwarted by circumstances and health.

Central banks have kept inflation well within its cage. But average inflation hides some stark realities. For example, costs for child care, education, and health (key aspirations for many customers) are powering upwards.

Without making any prediction about asset class returns, there is a general understanding that returns on many accessible investments (equities, property, and bonds) are likely to revert to a long-term average; in other words, moderate single digit growth. Many commentators also agree that volatility will remain high for the near future.

And time matters in other ways. Those approaching retirement now face the possibility of zero or even negative real returns on portfolios (heavily weighted to cash and equivalents) traditionally recommended during such a transition phase. An erosion of capital (real or nominal) early in the retirement phase profoundly increases the likelihood of running out of savings.

Simply saving more may not be sufficient to overcome these headwinds. Taking prudent risk may be necessary and, in some circumstances, that includes borrowing to potentially boost investment returns.

Risk; the New Normal

This article focuses on borrowing to invest in financial assets (equities, other listed investments and managed funds which cover a broad range of asset classes) rather than buying an investment property.

This is not a view about the relative potential return of any particular asset class. However, it's worth reflecting on one key difference between direct property ownership and financial assets: divisibility.

- A portfolio of financial assets can start with thousands rather than hundreds of thousands of dollars.

- If needs, expectations or circumstances change, customers can sell portions of an investment portfolio.
- It's difficult to sell half a room in an investment property to access capital.
- Flexibility and liquidity are seriously underestimated risk management features in an asset.

Borrowing to invest is nothing new. Advisers and customers are familiar with concepts such as loan-to-value ratio (LVR). An LVR is the maximum a bank will lend against an asset, expressed as a percentage of the asset's value. Property for example typically has an 80% LVR. This means a bank will lend $80,000 on a $100,000 property. The remaining $20,000 is the customer's deposit.

An LVR is not an estimation of return potential. A 50% LVR does not imply that the asset is expected to earn returns any higher or lower than an asset with a 75% LVR. At best, an LVR is an estimation of how much the asset's value is expected to fluctuate (usually within a day for financial assets) - given the bank expects to be diversified and many customers with a variety of circumstances will each be borrowing to invest in different assets.

The quote

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Responsible Borrowing

It is well understood that customers should never borrow beyond their capacity to meet repayments – including the possibility of higher interest rates. Borrowing to invest may be unsuitable for other non-financial factors specific to each customer. An adviser's responsibility to assess suitability is different to a bank's responsible lending obligations.

In assessing suitability, an adviser aims for a higher standard – somewhat akin to starting with an assumption that borrowing is not suitable and finding factors (for example, reliable income) that contradicts that assumption.

In contrast, the bank's process essentially assumes a loan is suitable unless it detects a red flag (an ability to meet repayments being an obvious first hurdle).

Advisers have various rules of thumbs for suitability.

Many start with age. There is a widely-held belief that people close to or in retirement should not borrow. This is linked to an assumption about income; borrowing to invest is assumed to suit only people who have reliable income other than that generated by the investment. Similarly, borrowing to invest is considered suitable only for those with long term savings goals.

These guidelines may be appropriate and to clearly state again, borrowing within capacity is important. But a rigid adherence to rules of thumb can lead to errors of judgment.

Managing the expectations gap, discussed earlier, can be equally important. Further, inherent liquidity means an investment portfolio can be quickly adjusted to changing circumstances.

Most advisers are well versed in managing investment risks that are reasonably foreseeable but are at the outer limit of the bell curve (in other words, risks that are known but have a low probability of occurring). Such risks are typically managed by limiting the amount a customer borrows to no more than 50% of the portfolio and investing in a diversified portfolio. But risk is not one-dimensional and never constant.

With few exceptions, advisers purposefully avoid the long-accepted, proven investment wisdom of setting stop-loss and take-profit levels. These techniques are appropriate for all investment horizons and portfolios - not just the preserve of short-term professional trading.

Without recapping how to set appropriate levels, at its most basic, a stop-loss is a form of portfolio self-insurance. In other words, it is a prudent measure for any customer keen about preserving essential capital – that squarely incudes the 'big dreams; timid choices' customer. But stop-loss and take-profit levels mean potentially selling part of the portfolio during the investment timeframe. Fundamentally, advisers and customers avoid these techniques because they find selling difficult.

Wisdom Blind

It is true that too many transactions simply increase costs. But there is a big difference between churning a portfolio in the belief markets are predictable and a disciplined exit to preserve essential capital. It is also true that any return should be considered on an after-tax basis, including capital gains tax. Realising a tax bill takes away the chance to earn compound returns on that capital. However, deferring a tax bill by staying in a failing or flat-lined investment is a false saving.

The psychological biases that affect investment decisions are so hard wired that many deny their influence. At the top of the list when it comes to a decision to sell is 'regret avoidance'. The 'I'll just hold on until it bounces back' attitude has destroyed many investment portfolios. Similarly, a 'what if I sell and it keeps going up' approach has kept many customers stuck with inappropriate investments.

Related to regret avoidance is loss avoidance. Incurring a loss is painful; more painful than an equivalent gain. Compare the satisfaction of finding $50 against the pain of losing $50. For many people, the loss will loom much larger even though the amounts are the same. Customers will act irrationally to avoid the perceived pain of loss.

The last part of the trifecta is the endowment effect. Customers become attached to the things they own. This results in two potentially damaging decisions. Customers demand more to give up an asset they own than they would be willing to pay to acquire it. The spread between the market price and the customer's sale price keeps many holding an inappropriate portfolio.

Customers also tend to consider an investment as one whole, rather than being made of parts – at least the part that is the customer's capital and the part essentially borrowed from the bank. This makes sense for a non-divisible asset such as a home – customers don't think about the bank 'owning' the second bedroom. But this thinking can be fatal for an investment portfolio which has the only purpose of earning a return (in contrast to also being a roof over your head).

Bias plus Borrowing

Such natural human biases are particularly damaging when borrowing to invest. At its most basic level, a portfolio must be expected to earn returns in-excess of the after-tax cost of borrowing. If an investment has reached its growth potential (in other words, its value is expected to plateau), when borrowing to invest it is necessary to move (that means selling) into an investment with sufficient upside potential. Similarly, if customers hold onto falling investments too long, borrowing to invest will exacerbate capital losses.

When borrowing to invest, a medium to long term perspective is recommended for most customers and overtrading is rarely profitable in any circumstance. However, it is equally true that markets rarely run to a calendar schedule; a change in return expectations can occur well before the end of the customer's preferred investment timeframe. The predicament for advisers and customers is balancing these forces.

The biases discussed above are so hardwired into everyone as to be virtually impossible to avoid consciously and consistently. The only sure way to avoid the traps is to have predetermined rules. For example, given a target of borrowing 50% of the portfolio, if the ratio of loan to investment value rises to 60% (in other words, the assets fall in value), then sell enough to reduce the loan back to the 50% target.

This is an uncomfortable discussion because it means selling at a loss. Better to have the conversation during benign market conditions rather than wait until markets turn and irrational biases take over.

Some will suggest that customers can reduce the loan using other liquid assets or contribute additional security, thus avoiding the need to sell. This might be appropriate in some circumstances. However, this article assumes advisers take a 'whole portfolio' approach. In other words, other liquid assets, such as cash, are being held to satisfy the customer's desired asset allocations. The customer's cash reserve for unexpected personal expenses, for example, is not appropriate capital for investing.

Further, when borrowing to invest, cash is not a rational risk management tool. This can be viewed in two ways. The customer is either borrowing to invest in an asset (cash) that will never exceed interest costs or they are lowering the ratio of loan to portfolio value. The latter is easier to achieve by simply borrowing a smaller amount in the first place.

Rethink

The lesson many learned following the global financial crisis was that borrowing to invest was too risky and should be shunned. Closing the gap between customer's expectations and risk tolerance may be increasingly difficult without at least considering borrowing to invest in appropriate circumstances.

Most advisers are familiar with assessing suitability and how much to borrow. Some have worked through to the conclusion of such a strategy; where the customer achieves their goal and the loan is repaid. The persistent failure is in understanding how to manage such a strategy during the investment timeframe.

This includes a capital preservation strategy (potentially selling at a loss) in the face of a significant and prolonged market correction. Failing to plan for market events sufficiently extreme to result in a margin call even for the best-advised customer is, of course, planning to fail.

Anticipating the protests – never sell in a falling market; defer tax as long as possible; hold the course over the long term – advisers need to critically assess how psychological biases influence their own decisions.

Are such protests based on a rational, fact-based assessment of the market or a rule of thumb to avoid regret?

Customers express themselves in terms of needs and goals – buying a home, educating children, retiring with at least a moderate safety net. But advisers are really in the business of helping customers manage risks. They need to deploy the full array of risk management tools. That includes appropriate stop-loss and take-profit triggers - particularly when borrowing to invest. **FS**

The quote

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