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Borrowing to buy shares is less popular than borrowing for property

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More than 2.2 million Australians borrow to invest in property. However, borrowing to invest in shares is a significantly less popular strategy for a few reasons.

Shares are more volatile, borrowing costs are more expensive and the risk of margin calls make it risky. However, internally geared exchange-traded funds (ETFs), which are rising in popularity, offer investors a simple and cost-effective solution.

Borrowing to invest in property has proven to be a successful strategy for many Australians. Yet, its success isn't solely because of property per se. My analysis reveals that borrowing, or gearing, is responsible for delivering more than 45 per cent of total returns. In simpler terms, without borrowing, property investor returns would be 45 per cent lower. Hence, it's crucial not to recognise the power of gearing when investing – be it with property or shares.

When investors opt to invest in property, they commit to significant monthly repayments due to the large amount of borrowing required. However, investing in shares with borrowed funds offers a lot more flexibility. Investors can adjust their investment amount at any time, providing greater adaptability compared to a property investment.

There are two main distinctions between borrowing to invest in shares versus property.

First, shares exhibit higher volatility than residential property. Data supplied by the Real Estate Institute of Australia dating back to 1980 indicates that property investors face a chance of experiencing a negative return of at least 10 per cent approximately once every 30 years. In contrast, Australian sharemarket data spanning more than 100 years suggests that share investors can expect a negative return of at least 10 per cent roughly once every eight years. This comparison highlights that share investors are more likely to experience a double-digit negative return compared to property investors, making gearing risky.

Second, it is a lot more cost-effective to borrow to invest in property with interest-only investment mortgages attracting variable interest rates in the range of 6.5 and 7 per cent. However, variable interest rates that apply to share investing loans range between 8 and 10 per cent.

Typically, there are three borrowing options available to share investors.

Margin loans were widely favoured before the global financial crisis. However, since 2009, many financial institutions have stopped offering margin loans. Margin loans are secured by shares. Typically, lenders permit borrowing up to 60 to 70 per cent of a share portfolio's value. As noted above, variable interest rates range between 8 and 10 per cent. Perhaps the most significant feature of margin loans is the margin call risk. If the value of your shares falls, resulting in exceeding the maximum loan-to-value ratio, the lender will require you to reduce the loan amount either by selling shares or contributing cash. Margin calls can exacerbate losses.

Alternatively, if you have equity in your home or an investment property, you may be able to establish a separate investment mortgage to fund share investments. This offers two advantages over a margin loan. Firstly, the interest rates in respect to investment mortgages are between 1 and 3.5 per cent lower than margin loans. Secondly, because property is used as security for the loan, borrowers are not exposed to margin call.

Finally, internally geared ETFs have become popular in Australia with both BetaShares and VanEck providing ASX-listed options. While there are only a handful of internally geared ETFs listed on the ASX, ETF providers are introducing more options including diversified ETFs.

An internally geared ETF maintains borrowings inside the ETF product at a level of between 50 to 65 per cent of the ETF's value. Interest is funded from dividend income, so it does not affect your personal cash flow.

Internally geared ETFs offer several advantages over margin loans and investment mortgages because they use wholesale funding, interest rates are approximately 1 to 2 per cent lower than investment mortgages.

Separately, you do not face the administrative hassle of setting up a loan and – importantly – using an internally geared ETF does not affect your personal borrowing capacity, so it's preserved for home and investment purposes.

Investors can combat the relatively higher level of volatility in the sharemarket in two primary ways.

Investing money on a regular basis, for example monthly, helps spread timing risk. Dollar cost averaging over many years and decades means that sometimes you will invest in the market when its cheap and sometimes it will be expensive, but it all levels out in the long run.

Internally geared ETFs maintain loan-to-value ratios at between 50 and 65 per cent, as the managers must ensure that investment income will meet all borrowing costs. If the index that the ETF tracks falls by more than 35 per cent on one day, the ETF may need to sell stock to meet a margin call, which will accelerate losses. While sharemarket crashes of this magnitude are possible, they are unlikely. The probability of the market falling by 35 per cent is 0.6 per cent, or about once in every 160 years.

Borrowing to invest in shares is relatively more affordable than property because of higher income and imputation credits. As such, a geared share portfolio will tend to be positive cash flow, unlike property.

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