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Topic 1: Leverage and diversification

Instalments typically are seen as a way of gaining long-term geared exposure to the underlying shares, and very often are held by investors until maturity.

However, there is the potential to use instalments in profitable short term trading strategies.

In this course we will look at a range of strategies, both long and short term.

The table opposite shows four instalment strategies. The first three tend to be longer term investment strategies, while the dividend yield play is a more active, shorter term trading strategy.

Leverage comes about because the instalment costs less than the underlying share. Because the instalment price moves roughly in line with changes in the share price, a small movement in the share price results in a larger change, in percentage terms, in the instalment price.

Example

Assume XYZ Ltd shares are trading at \$20.00. You think that over the next year, the share price will rise to around \$25.00.

You choose an instalment (XYZIWA) with the following specifications:

- Term to expiry: 12 months
- Final payment: \$10.00
- Gearing level: 50% (\$10.00 / \$20.00)

The instalments are trading at \$10.90.

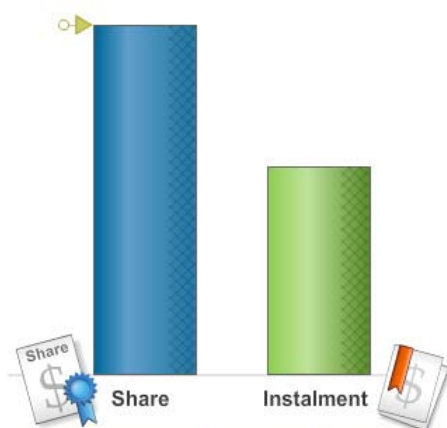
Twelve months later, at expiry, the XYZ share price has risen to \$25.00. The instalments are worth \$15.00 (the instalment's intrinsic value).

Table 1 compares the instalment's performance with the share's performance. The 25% increase in the share price has resulted in a 37.6% increase in the value of the instalment.

Table 2 compares the profit from a \$5,000 investment in the shares with the return from \$5,000 invested in instalments. The same dollar amount invested in instalments has produced a larger profit than the profit from the shares.

Strategy	Objective	Suitable type of instalments
Leverage and enhanced dividend yield	Maximise exposure to shares	• All instalments
Diversification	Obtain equivalent share exposure with minimal capital outlay	• Ordinary regular geared • Rolling regular geared • Self funding
Cash extraction	Unlock capital from existing share holdings	• Ordinary regular geared • Rolling regular geared • Self funding
Dividend yield play*	Generate a regular dividend income stream	• Conservative view: Regular geared instalments, expiry date >3 months • Aggressive view: Highly geared instalments, expiry date >3 months

* Excludes Self Funding Instalments



	Share	Instalment
Original price	\$20	\$10.90
Change in price	\$2	\$2
New price	\$22	\$12.90
% change	10%	18%

	XYZ share	XYZIWA instalment
Buy price	\$20.00	\$10.90
Sell price	\$25.00	\$15.00
Profit /(loss)	\$5.00	\$4.10
Return on investment (%)	25%	37.6%

	XYZ share	XYZIWA instalment
Dollar amount invested	\$5,000	\$5,000
Buy price	\$20.00	\$10.90
Number of units	250	458
Sell price	\$25.00	\$15.00
Profit /(loss)	\$1,250	\$1,877.80
Return on investment (%)	25%	37.6%

In this outcome, where the share price has moved favourably, leverage has increased your returns.

Leverage works both ways. If the share price moves unfavourably, holding the instalments will result in magnified losses.

Previously we showed what happens if the share price rises by \$5.00.

- The tables opposite show the outcome if the share price at expiry has fallen by \$5.00:
- The 25% fall in share price has resulted in a loss of 54.1% on the instalments.
- A \$5,000 investment in the instalments has produced a loss of \$2,702.20, compared to a loss of \$1,250 on the shares

If XYZ shares were to fall below \$10.00 by expiry, the instalment would be worthless and you would have incurred a 100% loss of your initial investment.

Gearing level

The instalment in the previous screen's example had a gearing level, or LVR (loan to valuation ratio) of 50%.

The size of the final payment determines the gearing of the instalment. The larger the final payment, the lower the initial outlay to buy the instalment, and the higher the gearing level.

The gearing level is calculated as:

$$\text{Gearing level} = \text{final payment} / \text{share price}$$

The more you are geared, the more your potential profits and losses are magnified.

Consider a highly geared instalment over XYZ shares, XYZIWB:

- Term to expiry: 12 months
- Final payment: \$17.50
- Gearing level: 87.5% (\$17.50 / \$20.00)

The instalments are trading at \$4.60.

	XYZ share	XYZIWA instalment
Buy price	\$20.00	\$10.90
Sell price	\$15.00	\$5.00
Profit /(loss)	(\$5.00)	(\$ 5.90)
Return on investment (%)	(25%)	(54.1%)

	XYZ share	XYZIWA instalment
Dollar amount invested	\$5,000	\$5,000
Buy price	\$20.00	\$10.90
Number of units	250	458
Sell price	\$15.00	\$5.00
Profit /(loss)	(\$1,250)	(\$2,702.20)
Return on investment (%)	(25%)	(54.1%)

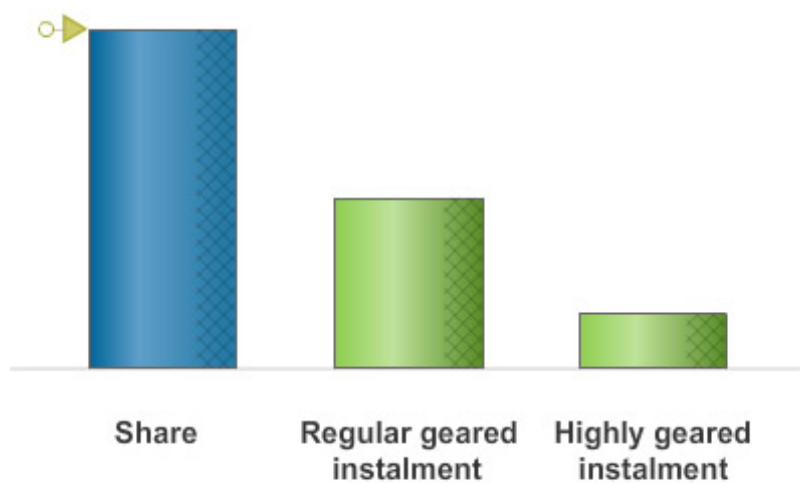


$$= 7/10$$

= 70% gearing level - highly geared instalment.

The risk profile of this instalment is much higher than the regular geared instalment. Increases in the XYZ share price will result in higher returns, but a fall in the share price is more likely to lead to a total loss on the investment. If the share price at expiry is below \$17.50, the instalment will expire worthless.

Highly geared instalments mean the investor is taking a highly leveraged position. Such a position presents the potential for significant levels of risk.



	Share	Regular geared instalment	Highly geared instalment
Original price	\$20	\$10.90	\$4.60
Change in price	-\$1	-\$1	-\$1
New price	\$19	\$9.90	\$3.60
% change	-5%	-9%	-22%

Topic 2: Leverage and diversification (continued)

Diversification

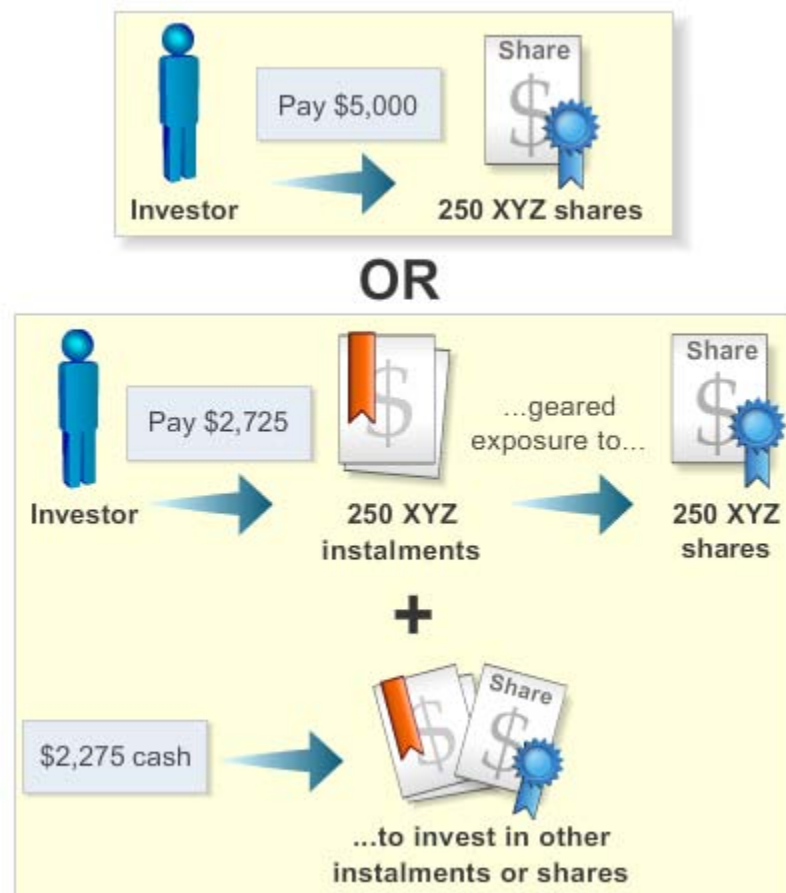
Diversification is a fundamental principle of investing.

Instalments enable you to spread your available funds more widely. By spending less on instalments, money saved can be invested on other shares or instalments.

For example, \$5,000 will buy you 250 XYZ shares at \$20.

If instead you bought 250 instalments at \$10.90, your commitment would be \$2,725. You would still have exposure to 250 XYZ shares - and you would have \$2,275 to invest elsewhere.

You need to understand the risk profile of each investment due to the leveraged exposure of instalments. Diversifying into several investments may reduce the overall risk of your portfolio.



Topic 3: Enhanced dividend yield

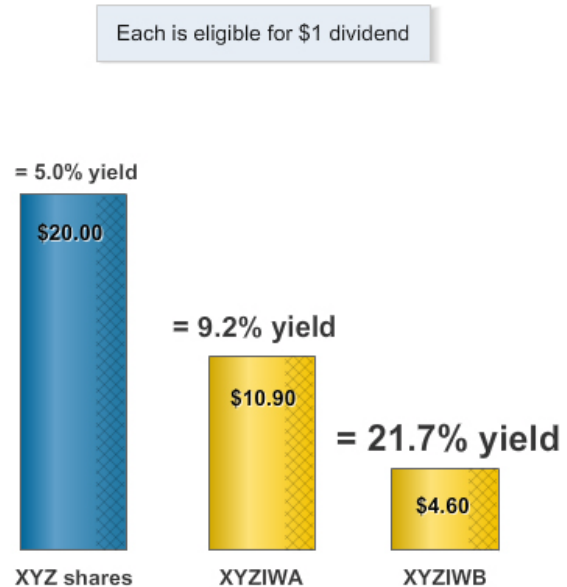
The instalment holder is entitled to the full dividends and franking credits paid on the underlying share.

You have paid less for the instalment than you would to buy the share, so the yield is higher on the instalments. The more highly geared the instalment, the higher the yield.

Example

XYZ shares are trading at \$20.00. Consider two instalments:

- XYZIWA instalments, with a loan amount of \$10.00, trading at \$10.90 (regular geared)
- XYZIWB instalments, with a loan amount of \$17.50, trading at \$4.60 (highly geared)
- XYZ is forecast to pay fully franked dividends of \$1.00 over the next 12 months.
- Go to the next screen to find out which of these investments has the highest dividend yield.



The dividend received on all three investments is the same, but because the instalments cost less, the dividend yield in percentage terms is higher for the instalment holders.

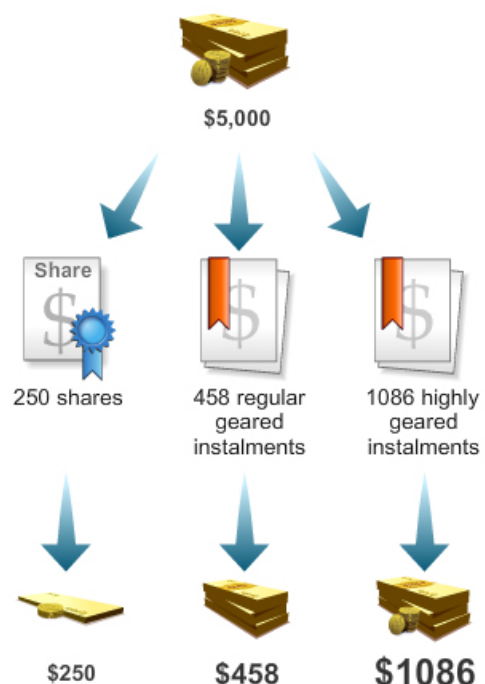
Because the XYZIWB warrant costs only \$4.60, the yield is higher than for the XYZIWA instalment costing \$10.90, which in turn produces a higher yield than the shares.

The highly geared instalment is the riskiest of the three investment options, with the possibility of magnified losses if the share price falls.

Looked at another way, a given dollar amount invested in instalments will produce more in dividends than the same amount invested in the underlying shares, as you can buy more instalments with your money.

Investing \$5,000 in shares or instalments will produce the following dividend income (for a \$1 per share dividend):

- XYZ shares - \$250
- XYZIWA instalments - \$458



- XYZIWB instalments - \$1,086

Assuming the dividends are franked, you will also receive more [franking credits](#) than you would from holding the underlying shares.

Franking credits and the 45 day rule

The Holding Period Rule (45 day rule) states that taxpayers must hold shares, or instalments, 'at risk' for a certain period of time to be entitled to the franking credits attached to dividends.

To be eligible you must hold the shares/instalments at risk for at least 45 days in the qualification period, which is the period starting the day after the purchase date, and ending on the 45th day (effectively 47 days). You must hold over the ex-date.

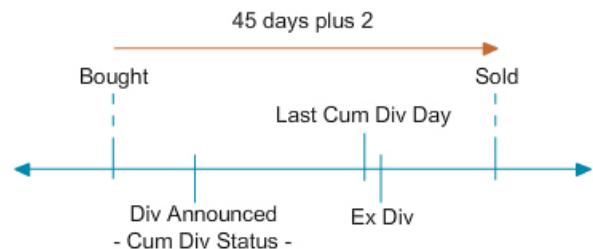
If you claim less than a total \$5,000 of franking credits in one financial year, you may be exempt from the rule.

For more detail, see your tax advisor and refer to the ASX website where the following papers can be downloaded: ['Taxation Treatment of Warrants'](#) and ['The Holding Period and Related Payment Rules: 45 Days to Offset'](#).

To be eligible for franking credits you must

Hold the share (or instalment) for a period of 45 days plus 2 (day of acquisition and disposal); or

If claiming less than a total of \$5,000 of franking credits, no holding period is required



Topic 4: Cash extraction

Unlocking the value of your shares

Another strategy is known as cash extraction. By making a 'shareholder application', you can swap your shares for instalments, receive a cash payment from the issuer to invest elsewhere, and maintain your exposure to the stock.

You may be sitting on shareholdings that are showing significant capital gains. A well-performed investment may now represent a large part of your overall exposure, and you may think it prudent to rebalance your portfolio.

Or perhaps you just want to invest in other shares.

However, selling your shares can have unwanted consequences:

- You forgo any future capital growth in those shares
- You may decrease your dividend income, and
- You may incur a large capital gains tax (CGT) bill.

You lodge your stock with the issuer, who places the shares in trust for you.

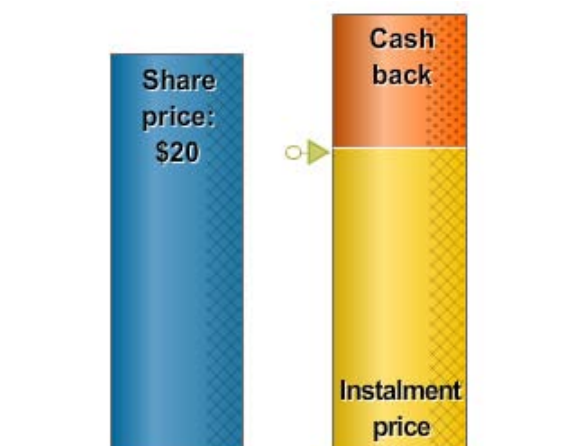
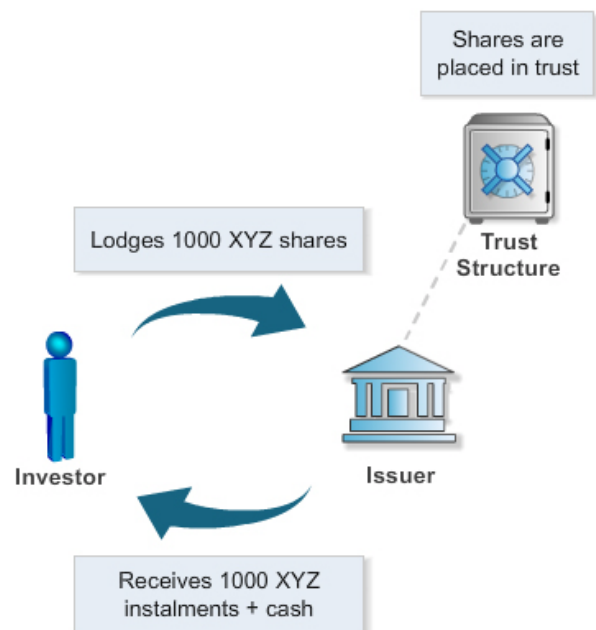
The issuer issues you an equivalent number of instalments, and a 'cash back' amount. The cash back amount is equal to the difference between the share price and the instalment price.

Since the issuer holds the shares in trust for you, there is no change of beneficial ownership. There may be no capital gains tax event triggered in the event the funds are invested. You should consult with your tax advisor.

Converting shares to instalments allows you to maintain your exposure to the underlying shares and their dividend stream. At the same time it releases cash to invest elsewhere.

You may also be able to claim an income tax deduction for the interest component that is priced into the cash back amount.

There are certain restrictions on what the money you receive from the shareholder



	Instalment price	Cash back amount
Original price	\$10.90	\$11.10
Change in price	\$4	-\$4
New price	\$14.90	\$7.10
% change	37%	-36%

application method can be used for. The instalment's PDS or your tax adviser may be able to assist you in this area.

Generally though, the money received from the shareholder application can only be used for other business or investment purposes.

Example

Assume you hold 2,000 shares in company BIG, trading at \$24.00.

The following instalment is available over BIG shares:

- Final payment: \$12.00
- Instalment price: \$13.40

You complete the application form and lodge your shares with the issuer.

The issuer places the shares in a trust, issues 2,000 instalments to you, and makes a cash payment to you.

Cash back amount per share = share price
- instalment price

$$= \$24.00 - \$13.40$$

$$= \$10.60$$

Total cash back amount = 2,000 x \$10.60

$$= \$21,200$$

The cash payment may be invested into a bank account, or you can use the funds to buy other shares or instalments.

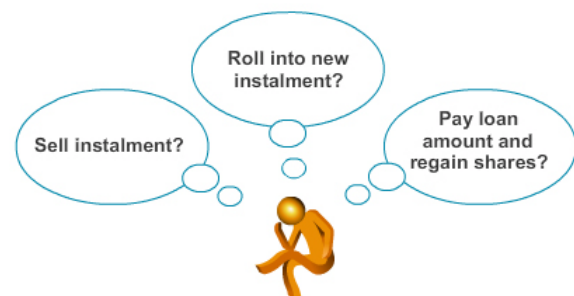
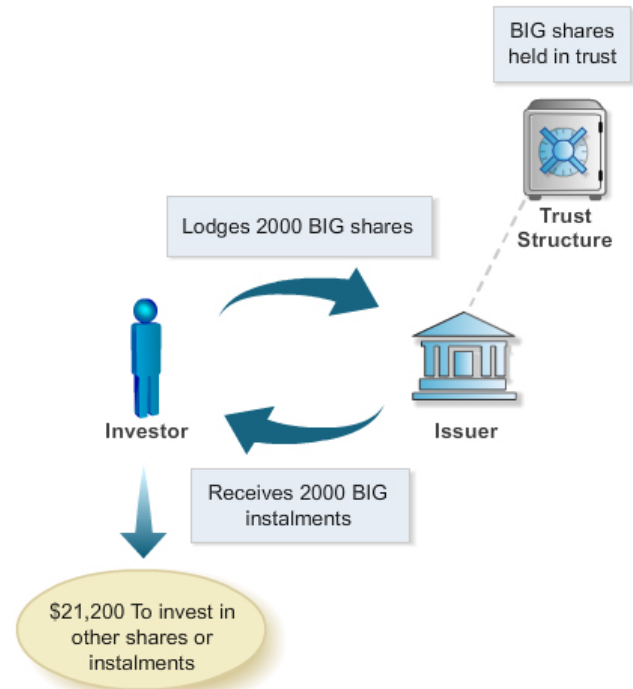
As expiry approaches, instalments obtained by cash extraction offer the usual choices to the holder.

You may:

- Make the final payment, and regain possession of the original shares (there may be no CGT implications)
- Sell the instalment prior to expiry (CGT may be payable), or
- Roll into a new instalment (CGT may be deferred). Consult with your tax advisor.

When implementing the cash extraction strategy, be aware of the expiry date and gearing level of the instalment you are converting your shareholding into.

Recognise also that while you are maintaining exposure to an equivalent number of shares, you have changed from



an unleveraged position to a leveraged one. Consider whether this strategy is suited to your financial situation and investment goals.

The Australian Taxation Office (ATO) has disallowed this method of purchasing instalments for self managed super funds, as it is deemed to create a charge over the fund's assets. For more information, refer to the ATO's ['Instalment warrants and super funds'](#).



Topic 5: Dividend yield plays

In Topic 3, we saw that instalments produce a higher dividend yield than the underlying shares.

The dividend yield play takes advantage of this feature of instalments, and can suit investors seeking a regular income stream.

You purchase instalments before the underlying share goes ex-dividend, with the intention of selling after the ex-dividend date. The objective is to benefit over a short period of time from the enhanced dividend yield.

You might use this strategy if you hold the view that the underlying share will maintain, or ideally increase, its value over the period you intend to hold the instalments.

For the strategy to succeed, the instalment price must drop by no more than the value of the dividend between the time of purchase and the time of sale - otherwise the dividend income will be outweighed by the loss in value of the instalments.

You might use this strategy if you are confident the underlying stock will perform well over the period of the strategy.

The 45-day rule is particularly relevant here as the dividend yield play aims to accrue the franking credits available.

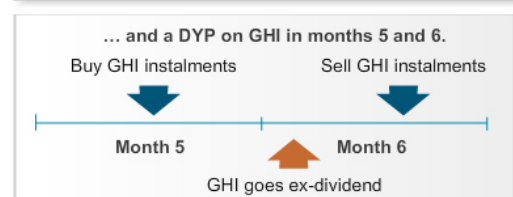
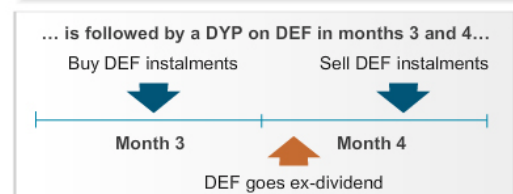
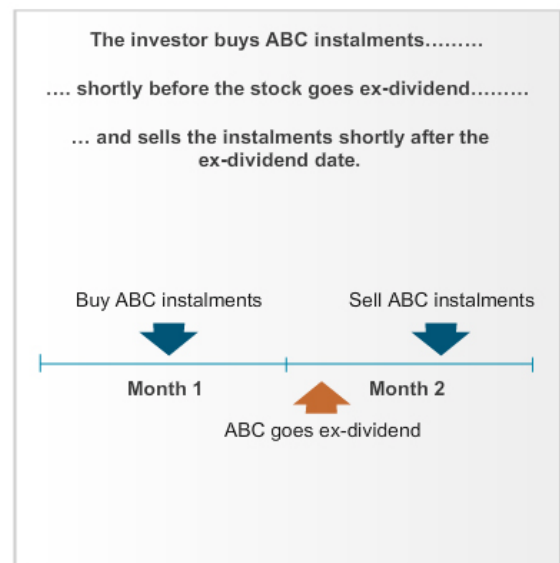
An active trader may implement successive dividend yield plays, completing the strategy in one stock and then moving to another.

In this way, the one capital investment may potentially be used to collect multiple dividend payments and franking credits. This technique may take advantage of the fact that different companies pay dividends at different times of the year.

Transaction costs such as brokerage should be taken into account when implementing this strategy. Also important to consider is the risk of a negative movement in the underlying stock.

Example

In September, company XYZ announces that it will pay a \$0.62 fully franked dividend in November with an ex-dividend date in October. XYZ shares are currently trading at \$24.39.



To take advantage of the geared exposure and enhanced yield they can provide, you buy instalments over XYZ. An instalment with a final payment of \$15.50 is trading at \$9.65. You spend \$10,000 to buy 1,036 instalments.

Seven weeks later, you sell the instalments.

The table opposite compares your returns with the returns generated on \$10,000 invested in XYZ shares over the same period.

The shares have performed strongly despite going ex-dividend. The instalments have generated higher returns, both in the form of income, and as capital growth.

The dividend yield play is a short-term trading strategy. The success of the strategy depends as much on the underlying share price remaining strong, as it does on the dividends you will receive.

	XYZ shares	XYZ instalments
Amount invested	\$10,000	\$10,000
Number of units	410	1,036
Buy price	\$24.39	\$9.65
Sell price	\$25.16	\$10.25
Trading profit	\$315.70	\$621.60
Dividends received	\$254.20	\$642.32
Dividend yield (%) – not annualised	2.5%	6.4%
Total profit	\$569.90	\$1,263.92
Percentage return on investment – not annualised	5.7%	12.6%

Main benefits

1. Increased dividend income stream and enhanced yield.
2. Leveraged exposure to a rise in the share price.

Main risks

1. The share price weakens, outweighing the value of the dividends received.
2. Leveraged exposure to a fall in the share price.
3. The more highly geared the instalment, the more damaging a fall in the share price.

Tip

To check on the ex-dividend date for a share, go to www.asx.com.au/dividends.