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CAPITAL

Does adding leverage reduce returns?

A recent academic paper found that adding leverage to an equity portfolio increased volatility but decreased returns for the vast majority of investors. The higher volatility was as expected, but the lower returns were a surprise, as investors use leverage with the aim of increasing their returns. Whilst the usual caveats apply in using one study to come to a definitive conclusion, there are some good reasons why this could be true and plenty of historical examples of how leverage can go wrong.

The two main factors to consider when adding leverage to a business or a portfolio are (i) the cost and (ii) the margin call risk. In the current environment debt is unusually cheap, though this wasn't the case prior to the Financial Crisis. During 2008, the ASX 200 saw substantial falls but the RBA cash rate was around 7% until October. This would have been an extremely painful time for those using margin loans, as the value of their leveraged share portfolios plummeted whilst they were paying over 10% interest on the debt.

This leads to the second factor, margin call risk. In 2008, investors combining more volatile stocks with higher margin ratio loans would have been repeatedly hit with margin calls. They likely had great returns on the way up, but they would have had little or nothing left once the sharp falls kicked in, assuming they didn't put in additional cash to back their positions. More recently the Archegos family office saw the same outcome, posting exceptional returns for years before being wiped out in the space of a few weeks.

At the macro level, margin debt is strongly correlated with the performance of equities. Margin debt rises when stocks have done well and then slumps when stocks have a substantial sell-off. Rather than buying low and selling high, those using margin debt (on average) buy high and sell low. This mistiming issue isn't uncommon for investors, it also shows up with the average return for managed funds being higher than the average return for the investors in them. Similarly, when investors redeploy between asset classes they typically reduce out of favour assets classes that subsequently outperform.

The potential pitfalls with leverage apply equally for company managers and directors. Having high debt levels works well when the economy is growing and asset prices are increasing above long run averages. However, having too much leverage in a downturn can result in bankruptcy or a distressed capital raising. Back in the Financial Crisis, overindebted companies like Allco, Babcock and Brown, and Centro didn't survive as they were hit with falling asset prices at the same time as the risk appetite of their lenders reduced.

This is an often forgotten aspect of leverage; that lenders typically reduce their risk tolerances during a downturn thus forcing more bankruptcies, distressed asset sales and distressed capital raisings. Borrowers often get upset when this occurs. However, had they locked in long maturity debt with loose covenants they might have been able to ride out the cyclical lender pullback.

Whilst bankrupt companies tend to be remembered, largely forgotten are the companies that had several rounds of distressed capital raisings during a downturn. Australian REITS and banks are two sectors that got this wrong during the Financial Crisis. By diluting shareholders to raise survival capital when share prices were near their lowest, returns for long term shareholders were slashed. Also ignored are the missed opportunities to buy competitors or assets at discounted prices. Only those investors/companies with cash or low levels of leverage could participate. Excessive leverage doesn't just get you into trouble in a downturn, it stops you from buying the cyclical bargains only available in a downturn.

Another leverage issue to watch out for is the combination of operational leverage and financial leverage. Commodity companies are a great example of operational leverage as their profits vary wildly based on the current price for their selected commodities. Fortescue previously combined both high financial and operational leverage and it had close shaves when the iron ore price collapsed in 2009 and 2016. (It has since reduced its financial leverage.) The volatility would have been even higher if a Fortescue shareholder had a margin loan as well!

Whilst this article has highlighted the downsides of leverage, it can be used well to increase overall returns. Private equity firms are one of the best users of leverage, with some studies finding that the private equity industry (as a whole) only generates outperformance over listed equities because of leverage. (Whilst some private equity firms have excellent operational skills that are used to substantially increase the profitability of their acquisitions, the high acquisition costs/acquisition premiums and the very high fees zero out the operational improvements.)

Several lessons can be taken from the private equity industry's use of leverage. First, they focus on buying businesses with relatively stable cashflows, so they have a good ability to service their debt throughout a business cycle. Second, the debt typically has three to seven year maturities and covenants that start with a decent level of flexibility, so the business isn't forced into a distressed capital raising by its lenders unless it substantially underperforms. Third, the leverage is used at an asset level, so an occasional business that fails doesn't destroy the portfolio returns. Fourth, there's typically a significant gap between the cost of the debt and the expected return on the investment. Fifth, there's usually some capital in reserve that can be injected into a struggling business if warranted.

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Disclosure