INVESTMENT GEARING

INTRODUCTION

There are a number of ways to increase wealth. Some involve more risk than others so an understanding of a particular wealth creation strategy is important before implementing any of these strategies. One of the most commonly strategies is gearing,

GEARING

Gearing refers to the process of borrowing money to invest, which increases your potential return because you invest more money than you could have using only your own available capital. It also increases the risk of investing as gearing magnifies negative returns because more money is invested, some of which is borrowed.

Negative gearing occurs when the expenses associated with an investment, including interest on the money borrowed, are greater than the income generated from the investment. This means that you are making an income loss on the investment, which is generally tax deductible. This however may create a cash flow problem if you do not have sufficient other income to meet the interest costs. The benefit is that the tax deduction reduces your overall tax liability and thus reduces the effect of the loss on your cash flow.

The objective of a gearing strategy is to have the long term, total return from the investment, including capital growth, be greater than the short term income losses. However, if there is little or no capital growth in the investment then you may be worse off than before you borrowed and invested the money.

There are a number of asset types which you can gear into. Property is the most popular however there are inherent problems with this type of investment, such as lack of liquidity, bad tenants and vacant periods.

An alternative investment is to gear into shares (both Australian and international) which provide greater liquidity and other taxation benefits. Further, you can invest into a managed fund for greater diversification than investing in one asset class. Each of these investment options have risks associated with the type of underlying asset you are investing in.

Gearing requires a long term investment time frame of a minimum of seven years and is ideal for people who have surplus, stable cashflow, an understanding of the risks involved, a long term investment time frame and who want to maximise the amount of capital invested.

Gearing strategies can be used to accelerate asset accumulation, reduce your tax liability and supplement superannuation savings at retirement.

When using borrowed capital to invest there are additional risks:

- As a higher level of capital is invested (some of which is borrowed and at some point must be re-paid) the potential for capital gains and losses are magnified.

  This increased risk of loss is a very important consideration in deciding to implement such a strategy.

- To obtain maximum benefit of a gearing strategy, the underlying investments should only target growth based assets. Investing in assets that only pay an interest equivalent return is pointless as you are only matching the interest you are paying to the lender.

  This means you may need to adopt a higher risk profile than you would under normal circumstances.

- You require income from other sources to ensure there is sufficient cashflow to meet interest costs. This requires security of employment. Loss of employment could cause cash flow problems, which might necessitate liquidation of all or part of the portfolio at an unfavourable time, risking realising a loss on an investment.

- If the interest rate is not fixed for the whole term of the investment, interest rates may increase which will increase interest costs and place potential further burden on your cashflow. Conversely fixed rate loans generally have specific conditions, including early re-payment penalties and less flexibility in terms of interest repayment.

Margin lending is setting up a portfolio into which you place a certain amount of your own capital, with the balance borrowed from a lender, under conditions that require the portfolio value to have a specific “margin” over the amount borrowed.

Where margin lending is used to facilitate the gearing, an additional risk is involved:

- The margin must be maintained. The margin is determined by calculating the difference between the market value of the investments and the amount of the loan. Where the margin falls below a defined limit, then a “margin call” may be triggered requiring additional capital to be added to the investment to re-establish the loan to equity ratio.

Actions you can take to minimise the risks associated with gearing:

- Establish and retain an appropriate cash reserve (of 5-10% of the value of the portfolio) to meet not only interest costs but also to provide potential funds to meet a margin call (under a margin lending facility).
- Should you not have a sufficient cash reserve, then you should identify other investments, which may be able to be lodged as security.
- As a last resort, identify which investments within your portfolio could be realised at short notice with minimal loss.
- Pay your interest costs from your cashflow, do not capitalise your interest as it increases the loan potentially at a higher rate than the growth in the value of the investments, distorting the loan to equity ratio.

- Look at flexible loan repayment options, ie: a combination of fixed and variable interest rates on specific portions of the loan.
- Do not rely on the income derived from the investments to meet the interest costs, you should have sufficient other income to pay the interest costs each month or year.

  If you can service interest costs from other sources, re-investment of dividends and other income from your geared investments can accelerate the growth in the value fo your portfolio.
- Put in place appropriate personal insurance cover to protect firstly against the loss of income and secondly against death or accident. This avoids having to sell a portfolio at what may be an inopportune time due to cashflow problems.

Where you are organising borrowed funds without the assistance of your financial adviser we recommend you discuss the issues with us prior to implementing a gearing strategy.

TAX IMPLICATIONS OF GEARING

Generally the income received on a geared investment is taxable and therefore must be included when calculating your assessable income for tax purposes. This does not apply to income that is either tax-free or tax deferred.

Interest on a loan is tax deductible to the extent that the loan is used to produce assessable income.

The Commissioner of Taxation must be satisfied that there was an expectation at the outset that the investment would generate a positive taxable return.

Borrowing expenses include items that arise at commencement or throughout the term of the loan. Examples are bank fees and legal expenses. These expenses are generally deductible where the borrowed money is used to produce assessable income. The deduction is allowed on a pro-rata basis over the life of the loan, or five years, whichever is the shorter period, beginning in the year in which the expenses were incurred.

You should consult your financial or tax adviser regarding tax deductibility of expenses.