Gearing

Borrowing for investment purposes is also known as 'gearing'. The aim of gearing is to increase your investment return by investing borrowed funds in addition to your own capital.

Benefits

- The loan enables you to increase the size of your investment portfolio.
- A larger portfolio enables you to increase the diversity of investments or buy larger assets such as property.
- You may be eligible to claim a tax deduction for some or all of the cost of the loan to help offset the cost of the borrowing or to reduce tax on other income.

How it works

Gearing involves taking out a loan to invest into growth investments such as shares or property. The aim of gearing is to increase the overall return of your investment whilst also reducing your income tax liability.

Borrowing gives you more money to invest which provides you with greater potential to diversify and build wealth. However it is important to remember that whilst investing more money gives you opportunity to increase capital gains, it also provides potential to increase losses if the investments do not perform well.

Interest and related borrowing costs are usually tax-deductible if the loan is used to acquire an income producing asset. If you are repaying the amount borrowed (the principal) as well as interest, only the interest amount is tax-deductible. Although the tax benefits of gearing can seem attractive, it is important that your primary aim for the loan is to maximise your wealth accumulation.

Gearing is often discussed as negative, positive or neutral, which refers to the cost of the loan (e.g. interest repayments and expenses) relative to the investment income generated (e.g. dividends, rent):

- Negative gearing – where the costs of the loan are greater than the income generated. Under current legislation, the shortfall is tax deductible against other income.
- Positive gearing – where the costs of the loan are less than the income generated. In this case the strategy is 'self-funded' because the costs of the loan are paid by the investment income and you are not required to meet these costs from your own cashflow. Tax is payable on the additional income.
- Neutral gearing – where the costs of the loan are approximately the same as the income generated.

Gearing is generally only appropriate for investors who have a growth oriented risk profile. For gearing to be effective, the overall return from investments should exceed the costs of the loan. This will typically only be achieved through investing in growth oriented assets such as shares and property. So you need to be comfortable not only with the risk of borrowing but also with the risk of investing in these asset types.

You should also meet all of the following criteria before considering gearing:

- have sufficient disposable income to comfortably meet loan repayments, even if interest rates increase
- have life insurance in place for a value equal to the outstanding loan, or have sufficient liquid assets to repay the loan or continue repayments in the event of illness or death, and
- have a strategy in place to repay the outstanding loan at some point in the future.

Gearing maximises returns but can also maximise losses

Gearing can maximise investment returns, as shown in the following example:

Betty has funds of $100,000 available for investment. She invests these into a growth oriented portfolio and obtains a total return in the first year of 8%, resulting in a return in the first year of $8,000.

If Betty also borrowed $100,000 secured against her home, the total amount for investment would be $200,000. If the investments return 8%, this amounts to a total return of $16,000. This represents a return of 16% on her original capital amount of $100,000.

However, gearing can also maximise losses in the event of a capital loss, as shown in the following example.

Betty has funds of $100,000 available for investment. She invests these into a growth oriented portfolio and obtains a capital loss in the first year of -8%, resulting in a loss in the first year of $8,000 (that is, the value of her investment falls to $92,000 after the first year).

If Betty also borrowed $100,000 secured against her capital, the total amount for investment would be $200,000. If the investments return -8%, this amounts to a loss of $16,000 in total. This represents a loss of 16% on her original capital amount of $100,000.

Gearing is a long-term strategy

Because of its magnifying effects, gearing should only be considered as a long-term strategy. Investors should have an investment time horizon of at least 7 years. If you have to cancel a gearing strategy sooner than the recommended time frame you may find that the values of your assets are lower than when you established the facility.

Wealth protection insurance is a necessity

Wealth protection insurance is important for everyone. However, wealth protection is particularly important when you implement a gearing strategy.

- Income protection insurance can help you meet interest repayments in the event that you suffer an illness or injury that prevents you from working for an extended period of time.
- Total and permanent disability (TPD) cover can help you repay the loan in the event that you are unable to work again.
- Term life cover can help your dependants repay any outstanding debt in the event of your untimely death.
- Critical illness cover can help you meet interest repayments in the event that you suffer a specified illness or injury.

Consequences

- Tax advantages from negative gearing should never be the sole reason for establishing a gearing strategy.
- You should ensure your employment and cashflow are secure so that you aren't forced to sell some or all of your investment portfolio at a time when the markets are down.
- Although gearing provides the potential for increased capital gains when markets are rising, it also has potential for increased losses when markets are falling.
- A rise in interest rates will increase the cost of borrowing and a decline in dividends or distributions will reduce your income. You should ensure you have sufficient cashflow to absorb interest rate increases and investment income decreases.
- The value of your investment portfolio may fall in value to a point where the sale proceeds are not sufficient to repay the debt. So even though you have been entitled to tax deductions over time, it is possible that you could end up carrying a debt once the investment portfolio has been sold.
- Legislation may change in the future in relation to tax deductibility of interest payments.
- An unforeseen event, such as injury or illness that prevents you from working, may make it difficult to meet interest repayments. This risk can be minimised by incorporating wealth protection recommendations, including Income Protection, Critical Illness Cover and Total & Permanent Disability Cover.
- Fees may be charged on investments that you purchase with the borrowed money. You should check the details in the fee section of your Statement of Advice and the Product Disclosure Statement (PDS) for your selected investment.

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