



WEALTH CREATION AND INVESTMENT

Gearing

Gearing involves using borrowed funds to make investments in assets such as property, shares or an investment portfolio. Gearing can be attractive to investors because loan expenses and interest costs can often be claimed as a tax deduction.

Negative gearing is a term which applies when the cost of borrowing, i.e. loan interest and other costs, exceeds the income generated from the geared investments. The loss can normally be used as a tax deduction by the investor to offset other taxable income such as salary. An investor considering a negatively geared strategy would expect to achieve sufficient capital gain from the investment in order to offset the after-tax income loss sustained as a result of negative gearing.

Gearing is utilised by investors due to

the potential for increased returns on the geared investment. Returns are magnified because the investment is larger than it may have been without the use of borrowed funds. Many investors will combine their own funds with borrowed funds to increase their investment portfolio.

However, it is important to understand that, like all increased returns, the potential to lose money also exists. This is illustrated in the example below

- An investor has \$50,000 to invest.
- He / She is considering borrowing \$100,000 to invest a total of \$150,000 in the share market.
- The table below compares the expected total returns on the investment, with and without gearing, under differing capital return scenarios.

	Capital Gain of 5%		Capital Loss of 5%	
	Ungeared	Negative Gearing	Ungeared	Negative Gearing
Your Capital	50,000	50,000	50,000	50,000
Borrowed Funds	-	100,000	-	100,000
Total Funds Invested	50,000	150,000	50,000	150,000
Investment Income	2,500	7,500	2,500	7,500
Interest Cost assume (8%)	-	(8,000)	-	(8,000)
Net ongoing cost before tax	2,500	(500)	2,500	(500)
Capital gain Est.	2,500	7,500	(2,500)	(7,500)
Net Gain/ Cost in Year Your Capital	5,000 50,000	7,000 50,000	- 50,000	(8,000) 50,000
Return on your Capital	10%	14%	0%	-16%

The table above illustrates the ability for investors to achieve higher returns on an investment of \$50,000 if it is geared. However, any investor considering a gearing strategy must also consider the increased risk involved. Downward movements in investment markets, or increase in interest rates, may have a significant negative impact on portfolio returns.

When considering a gearing strategy, an investor should be fully aware of their tax position. Negative gearing is not an investment technique that is suitable for all investors. Risks and rewards are magnified and surety of cash flow to cover shortfalls is crucial. Careful consideration of an investor's risk profile and circumstances is required prior to implementing a gearing strategy. Investors should obtain financial advice prior to adopting a gearing strategy.

Advantages and Disadvantages of Implementing a Gearing Strategy

The advantages of gearing include:

- **Wealth Accumulation** - The ability to add to your existing asset base and grow your wealth at a greater rate over the long term.
- **Tax Efficiency** - Interest, and related borrowing costs, may be tax deductible if the associated borrowings are used to acquire assets that generate assessable income. You may be able to reduce your tax liability if you are negatively geared and as such, gearing may be most suitable for people who pay tax at the highest marginal rate of tax.

The disadvantages of gearing include:

- **Magnify Losses** - Gearing can magnify losses in your investment portfolio as well as gains.

- **Additional Liabilities** - You remain liable for the principal borrowed irrespective of the performance of your investment portfolio.
- **Margin Calls** - You may incur margin calls if your investment falls in value.
- **Cash flow Requirement** - A negatively geared portfolio will require exogenous cashflow support.
- **Interest Rates** - If interest rates increase your interest payments will increase as so to will the need for cashflow.

Security

Borrowings will require security and potential options for providing such security include:

- Using the investments contained within your investment portfolio. This may be the case when you take out a margin loan.
- Using your existing assets, eg. your principal residence. This is the case when you take out a home equity loan.

As lenders can exercise security if you become unable to pay the interest on your loan, you may need to sell down your investments or other security to pay off your loan. In the situation where your principal residence was loan security, this could include selling your home if you were to default on the loan repayments.

Margin Loans

Margin loans require you to provide securities as collateral for the loan. Generally speaking you will be allowed to borrow only a portion of the market value of these securities. This is known as the loan to value ratio (LVR). If the LVR increases above predetermined thresholds, you will be required to make a margin call to return

the LVR to its original value.

A margin call can be made in the following ways:

- By providing cash to reduce the loan.
- By providing additional assets as security.
- Selling assets and using the proceeds to reduce the loan.

If you are unable to satisfy this margin call, the lender will sell a portion of the assets that you lodged as security to satisfy the requirement.

Insurance

Negative gearing strategies result in a cashflow shortfall as costs, including interest expenses, exceed income. Thus you will need to be confident that you are well able to maintain sufficient cashflow to meet such shortfalls.

As salary generally forms a significant part of an individual's cashflow, it is recommended that you have adequate personal insurance to repay your loan, or meet its interest costs, in the event of death, sickness or incapacitation.

Risks

As outlined above a gearing strategy can increase your gains and your losses. Your capital is not guaranteed and may fluctuate significantly over time.

Because of this potential volatility, we advise that a minimum time frame of 5 years is appropriate for any gearing strategy. This will allow your capital to weather any short-term volatility and give it the best opportunity to grow.

Other Considerations

Please note the following aspects of your gearing plan:

- Any decision to adopt a gearing strategy should principally be driven by the objective of creating wealth and not solely on a short-term attempt to minimise tax.
- Due to the high risk nature of a gearing strategy, we recommend that you review the suitability of your leveraged portfolio on an annual basis.
- A gearing strategy requires a long term investment horizon. Investment returns are volatile, and in order to withstand short term fluctuations, we recommend a minimum 5 year investment time horizon.
- If you are negatively gearing your investment portfolio, we strongly advise that you have a stable and reliable cashflow to meet the shortfalls, eg. salary from secure employment.
- It is important to structure the assets within your investment portfolio such that the potential for growth and income outweighs the cost of gearing. This usually implies investment into growth assets such as equities and property.

This strategy involves borrowing money to invest. The advantages include:

- Interest on the borrowings may be tax deductible provided the investment produces or is likely to produce an assessable income.
- The borrowings provide a larger capital sum to invest and earn returns.

For gearing to be worthwhile, the total after tax investment return must be higher than the after tax interest expense. Gearing

increases the risks of the investment because should values fall, not only will the initial capital and the borrowed funds lose value, but the full value of the borrowings must still be repaid.

Gearing should only be undertaken by assertive or aggressive investors who are committed to investing in growth assets for the long term and who have sufficient surplus cash flow to meet interest repayments.

If you would like to take advantage of our free consultation or would like to know more about our services please contact us on (07) 3832 6020,
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