

Understanding gearing

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Gearing is simply another term for borrowing to invest. While we may not enjoy being in debt, not all debt is bad. In fact, it can be a powerful tool used to build wealth and to enhance your investment performance.

Many of us have borrowed at one time or another for our larger purchases, like a holiday or a car. However, when done sensibly and with careful planning there are cases when borrowing to invest can be even more worthwhile.

Gearing is a sophisticated investment technique and is not suitable for everyone. We recommend you speak with your financial adviser.

Positive or negative?

Positive gearing: Positive gearing is when the interest payments and other investment costs are lower than the income you receive from the investment.

Example: Borrowing to invest in shares when the dividend income exceeds the expenses of the loan.

Negative gearing: Negative gearing is when the interest payments and other investment costs are higher than the income you receive from the investment.

Example: Negative gearing on a rental property occurs when the interest payable on the loan used to purchase the property plus other expenses (maintenance, etc) exceeds the rental income generated by the property.

The benefits and risks of gearing

Like all investment strategies, there are some risks associated with gearing.

| Benefits | Risks |
|---|---|
| <ul style="list-style-type: none">■ Gearing can be attractive because under current Australian taxation laws, you may be able to claim a deduction for interest and expenses, which can be offset against assessable income, such as salary, business income or investment income.■ Gearing allows you to increase your ability to create wealth by enabling a higher level of investment than would otherwise be possible. In a favourable market your earning potential can be multiplied.■ If you choose to invest your geared funds into selected shares, the dividend imputation system (DIS) will result in you receiving a tax credit on the dividends you collect (known as 'franked dividends') and, therefore, you are accountable for only a small amount of tax on this income. This can actually have a positive effect on your cash flow. | <ul style="list-style-type: none">■ Assets may not always provide the returns you expect. You should only borrow to invest if you expect the investment itself will be producing genuine, decent returns somewhere down the track.■ If you over-extend your borrowing, rising interest rates could restrict your ability to meet loan payments.■ There may be periods where your investment provides little or no income, or even losses.■ Gearing can multiply your losses.■ Should you wish to sell a geared asset and pay off your loan earlier than expected, penalties may apply.■ You may be forced to sell in an unfavourable market. |

How does gearing work?

Case study

Here's an example with a person borrowing \$100,000 to invest:

| | |
|---|---------|
| Interest cost at 6% pa: | \$6,000 |
| Investment income at 4% pa: | \$4,000 |
| Cashflow shortfall: | \$2,000 |
| Tax deduction on shortfall (tax rate 39%): ¹ | \$780 |
| After tax shortfall: | \$1,220 |

¹ Assumes marginal tax rate of 37% plus Medicare levy

When you borrow to invest, your gains are magnified because the borrowed funds were used to get the gain. So, using our negative gearing example from above, if you borrow \$100,000 and your investment appreciates by 10 per cent in the first year, you would be ahead \$10,000 – less the \$2,000 cashflow shortfall. It's a \$8,000 gain.

It works the same in reverse – with a 10 per cent fall in the first year resulting in a loss of \$12,000. You need to understand the full range of possibilities with a gearing strategy. You should only invest in quality growth assets with potential for solid capital growth over the long term, because it is capital growth which drives a gearing strategy. For a negative gearing strategy to be successful, your investments need to generate – over the long term – sufficient capital growth to more than cover the total cashflow shortfall (after tax) as well as tax on the capital gain.

Things to consider

Tax on selling your investments: If you sell your investments for more than what you paid for them, you'll have a capital gains tax liability. This will be a maximum of 49 per cent. But if your investments are held for 12 months or more, due to the capital gains tax discounting the amount of capital gains tax payable, will be halved. Another way to minimise this is by waiting to sell your investment until your tax rate is lower, such as when you retire.

Margin calls apply when you borrow via a margin lending arrangement. A margin call is when the market worth of your security falls. The result is the loan-to-valuation ratio (LVR) exceeds the allowance limits. In this situation you will usually have three options:

- lodge additional securities that you have
- pay back part of your loan, and/or
- sell your portfolio and draw on the proceeds to pay back part of the loan.

Your gearing loan provider will generally need the LVR to be returned to the arranged limits within a stated time period, usually within 24 hours. Although, when you borrow less than the maximum loan limit, you can decrease the risk of margin calls.

Gearing may not be suitable for all investors. Whilst it can lower your tax liability, the tax implications will depend on your personal situation as well as your attitude to risk and the type of investment chosen. You should always seek qualified financial advice.

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