Count
The confidence to look ahead

Gearing

Gearing can be an effective and tax-efficient way of building your investments over the long-term. While it can increase your investment returns, you need to be aware of the risks involved.

Snapshot

- Gearing allows you to increase your investment returns using borrowed funds tax-effectively.
- Gearing can also magnify your losses and force the sale of assets to meet interest repayments or margin calls.
- Accessing professional advice will help you understand the pros and cons and determine if this is the right strategy for you.

What is gearing?

Gearing is the strategy of borrowing money to invest. Just as you take out a loan to buy a home, you can also borrow money to invest in other assets, such as shares, property or managed funds.

Gearing enables you to boost your investment earning power by increasing the amount of money you have available to invest. While investing with someone else's money sounds like a great strategy (and it can be), there are risks involved – so it's not suitable for everyone.

Generally, to be effective a geared investment should:

- generate a reliable long-term income flow
- generate income that grows throughout the investment timeframe and becomes positively geared
- generate capital gains, ie. an increase in the value of your investments over time
- be highly diversified with a number of individual investments
- be considered for investment time frames of five years or more
- draw on stable and reliable cash flows to meet the pre-tax borrowing costs.

Who is gearing appropriate for?

Implementing a geared investment strategy is a long term commitment, suitable for investors with time horizons of five years or more. This allows enough time for you to benefit from the returns of growth assets and to ride out any short-term market fluctuations. If you are considering gearing, you will need to ensure you have sufficient excess disposable income to service your loan repayments and to cope with an increase in your loan repayments if interest rates were to rise (allowing for a 1.5% increase in rates is probably a safe buffer).

You should also consider taking out sufficient income protection, life, trauma, and total and permanent disability insurance so that if you are unable to work due to accident or illness, you or your dependants can either continue to service your loan repayments or the loan can be repaid in full.

What are the benefits and risks?

The main benefit of this strategy is that the amount you have available to invest is increased by the amount you have borrowed, so you earn investment returns on a larger amount. Depending on your circumstances, there may also be tax advantages associated with this type of investment.

Borrowing to invest is a sophisticated strategy and is not suitable for everyone. The main risk is that by increasing the amount you have invested, you increase your potential losses. If your investments perform poorly, you may be left paying off a loan that is larger than the value of your investments.

The table below summarises the main benefits and risks associated with borrowing money to invest or gearing.

Borrowing to invest	
Benefits	Risks
■ Magnifies your returns if your investment increases in value ■ Increases the amount you have to invest ■ Potential tax advantages – the costs of borrowing are generally tax deductible ■ You can achieve higher returns (after costs) than you could without borrowing	■ Magnifies your losses if your investment decreases in value ■ If interest rates go up, you may not be able to meet your interest repayments ■ You may incur penalties or fees if you repay the loan sooner than agreed ■ Net returns must be higher than your net interest costs for this strategy to be beneficial

Positive, neutral and negative gearing

Gearing may be classified into three levels – positive, neutral and negative. The category your geared investment falls into is determined by how much interest you pay on the loan, compared with how much income your investment earns.

For example, let's say you invest $150,000 in a managed fund, of which $50,000 is borrowed. The interest on your loan is 8% pa or $4,000 in repayments.

Positive gearing	If the managed fund produces income of $4,500, you will achieve a net cash flow gain of $500
Neutral gearing	If the managed fund produces income of $4,000, there is no net cash flow gain or loss
Negative gearing	If the managed fund produces income of $3,500, you'll see a net cash flow loss of $500

Gearing options

There are three main ways you can generate the capital required to gear your investments.

Home equity gearing

Home equity gearing is borrowing against the existing equity in your home. This allows you to release capital tied up in your home and use it to finance income-producing investments.

You can establish a home equity loan by setting up a redraw facility within your existing home mortgage or by arranging an additional line of credit. These types of lending arrangements offer flexible loan and interest repayment options.

Margin lending

A margin loan allows you to borrow up to a set percentage value (typically 50% to 70%) of selected shares and/or managed funds. The initial investment can comprise cash, approved securities such as shares and managed funds, property, or a combination of these.

Geared unit trust

Unlike other managed funds, with a geared unit trust (also known as a geared managed fund), the product manager uses the assets held within the unit trust as security for borrowing. The trust is then geared at a pre-determined level and the fund manager is responsible for all issues surrounding the borrowing. If you invest in a geared unit trust, your liability will be limited only to the amount you have invested with the trust.

Repaying your gearing loan

If you use gearing as part of your financial strategy, at some point the loan capital and interest will need to be repaid. The three main options for repaying your loan are:

- selling off a portion of your investments
- establishing a separate savings account to accumulate the loan capital
- paying out the loan capital over the term of the loan.

You will need to work with your financial adviser to ensure your financial plan takes into account the repayment of this capital.

What is a Loan to Value Ratio (LVR)?

The base Loan to Value Ratio (LVR) is the maximum amount you can borrow expressed as a percentage of your total investment value. The current LVR is the total amount you have borrowed on your variable and/or fixed rate loan expressed as a percentage of your total investment value.

What is a margin call?

A big consideration with margin lending is that you may be subject to a 'margin call' if the value of your investments goes down sufficiently to exceed the base LVR. For example, this could occur if markets fell significantly. If this happens, your lender may need sufficient funds from you to bring the loan back in line with the base LVR. If you receive a margin call, you may need to make a loan repayment, invest more money or sell some of your units or shares to reduce your gearing level.

Tax advantages

Gearing may also offer potential tax advantages, such as:

- interest payments on borrowings may be fully tax-deductible
- share investments may attract franking credits which can be used to offset tax payable on other income
- under negative gearing, any income losses incurred may be used to reduce your assessable income and overall tax
- you may be eligible to claim tax-deductible borrowing expenses, such as fees and legal expenses
- the ability to prepay up to one year's interest in advance and claim a tax deduction for these payments in the current year. Note that any income you receive from a geared investment must be included when calculating your assessable income, except if the income is tax-free or tax-deferred.

The importance of financial advice

Gearing can be a highly risky strategy so it makes sense to get professional advice upfront. Here are some ways your financial adviser can help:

- Assess your risk profile and the level of debt you can comfortably sustain.
- Suggest different gearing options including within managed funds which provides a level of certainty.
- Keeps track of your margin calls and develops smart strategies to help you manage them more effectively.

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