Understanding gearing

Client Fact Sheet

July 2012

What is gearing?

Gearing is simply borrowing money to invest. The borrowed money can be invested in a number of ways – shares, property, international investments, etc.

Borrowing money to increase your investments can be a way of speeding up your wealth creation, as you have more money working for you. This can have the effect of accelerating your capital gains. Borrowing money to increase your wealth may seem like a contradiction in terms, but can be one of the most powerful strategies available for wealth creation. Also, the strategy can be tax effective.

Gearing in practice

Gearing is generally only worthwhile where the after-tax return from investments is greater than the after-tax cost of borrowing (eg. loan interest, application fee etc).

To achieve an investment return that is in excess of the cost of borrowing, an investor is generally relying on capital growth to increase the value of their investment. The likelihood of this occurring over the longer term is greater than over the shorter term. If you are thinking of gearing, you should have at least a 5-year time horizon in mind.

The investor should also be thinking of investing in "growth" investments like shares or property. Investing in cash or fixed interest is unlikely to produce returns exceeding the interest costs.

What are the benefits of gearing?

Leverage – An investor may gain from an increased return on their investment through the process of gearing. By adding borrowed money to your own cash or investments, you increase the sum to be invested. The greater the total value of the investment, the greater the potential for capital gains. This concept is known as 'leverage'.

Tax deductibility – Provided the funds borrowed are used to invest in income-producing investments, the interest on that loan is generally tax deductible for the investor.

What types of gearing are there?

Positive gearing – occurs when the taxable income received from investing (eg. managed fund, rental property income, or share dividends) is greater than the tax-deductible borrowing and investment costs (eg. loan interest, property maintenance costs, or ongoing portfolio costs) within a financial year.

Neutral gearing – occurs when the taxable income received from investing is equivalent to the tax deductible borrowing and investment costs within a financial year.

Negative gearing – occurs when:

- an investor borrows money
- the borrowed money is used to invest in income producing assets, and
- within a financial year, the taxable income received from investing is less than the tax-deductible borrowing and investment costs of the investment/s.

Because the deductible costs are greater than the investment income, this generally results in excess deductions, which can be claimed against other taxable income received (eg salary) during the same financial year.

When considering a gearing strategy, an investor should be fully aware of his/her tax position.

Negative gearing is generally most tax-effective for taxpayers on the highest marginal rates of tax and is generally less tax-effective for those on lower tax rates or non-taxpayers. Investors should note that even if they intend to undertake a particular gearing strategy (positive, negative or neutral), fluctuations in interest rates, investment returns and ongoing costs can impact upon the actual level of gearing achieved.

Gearing reduces the investor's day to day cash flow

The investor is intentionally making an investment knowing that the income earned from that investment may not cover the ongoing costs involved. The investor should be confident that he or she can afford to fund this cashflow shortfall.

Investment income may be irregular. Share dividends can fluctuate widely. The investor needs to ensure that they have a stable and reliable income from sources other than the investment portfolio and that they are able to meet regular interest payments and other ongoing costs without difficulty.

Gearing in action

Gearing is utilised by investors due to the potential for increased returns on the geared portfolio, however it is important to understand gearing and investment also has the potential to increase losses. This is best illustrated by example:

Client A – example only

Client A has $50,000 to invest and she is considering borrowing $100,000 to invest a total of $150,000 in a managed share fund. The following example illustrates the effect of a potential 5% capital gain or loss on an ungeared investment of $50,000 versus a negatively geared portfolio of $150,000:

	Magnified gains 5% capital growth		Magnified loss 5% capital loss	
	ungeared	geared	ungeared	geared
Cash	50,000	50,000	50,000	50,000
Loan	–	100,000	–	100,000
Total invested	**50,000**	**150,000**	**50,000**	**150,000**
Income @ 3.5%	1,750	5,250	1,750	5,250
Less loan interest cost @ 7%	–	7,000	–	7,000
Net income	**1,750**	**(1,750)**	**1,750**	**(1,750)**
Unrealised capital growth @ 5%	2,500	7,500	–	–
Unrealised capital loss @ 5%	–	–	(2,500)	(7,500)
Total net return	**4,250**	**5,750**	**(750)**	**(9,250)**

Assumptions:

- Investment held for 12 months, but not sold.
- The example above excludes consideration of personal marginal tax rates, tax deductions, fees, capital gains tax and franking credits
- No specific lending products are represented

Clearly the potential benefits of gearing into growth assets can be seen. However, any investor considering a gearing strategy must also consider the increased risk involved. A downward movement in investment markets or increase in interest rates may have a significant negative impact on the portfolio return.

In summary, the main attraction in gearing is the potential to receive higher return on investment than may otherwise be possible without borrowing.

What loan facilities are available?

Amongst the financial arrangements that have been developed to cater for a geared investment portfolio, there are two primary types of loan facility. These are:

- Margin Loans
- Home Equity Loans

Margin loans

A financial institution lends an investor a percentage of the market value of the investments nominated by the investor and approved by the financial institution. The difference between the market value of the investments and the amount of the loan is the margin. The investor must contribute the margin.

A typical Margin Lending facility would operate as follows:	
Loan Amount	The financial institution may lend between 35 – 80% of the market value of a managed fund or share. Securities (including managed funds) are assessed on loan to valuation ratio (LVR). Financial institutions can alter or withdraw LVRs from individual investments from time to time. This may trigger a margin call.
Term of loan	There is generally no fixed term. Loans may be terminated on request, provided the loan is paid out (this may require sale of part or all of the secured investments).
Interest rate	Interest rates may be fixed or variable, i.e. they may be set for the duration of the loan or change in line with general interest rate fluctuations.
Payment of interest	• Interest is generally calculated daily and charged monthly. • Interest may be capitalised (ie. the interest owed may be added to the amount borrowed), provided there is sufficient equity to do so and it is permitted by the financial institution. • Where the interest is capitalised, future interest will be calculated on the total borrowings. • Interest is charged on the amount of money the investor draws for investment, not the loan limit. • The interest payable on a fixed rate loan may be paid annually in advance, as the rate is set for the agreed time period.
Security	All investments held and nominated as security when commencing a margin loan may be sold down by the lending institution in the event of default on the repayment conditions of the loan. You will be notified prior to any sell down of investments and given the opportunity to add to the level of security backing the margin loan. Investments used as security for a margin loan may be required to be registered in the name of the lending institution.
Margin calls	The investor will be required to restore the required LVR margin within a stated period by: • repaying part of the loan, and/or' • lodging additional investments acceptable to the lending institution as security, and/or • selling investments. If you do not meet a margin call, the lender can generally: • sell the investments, • pay out the loan, and • seek payment of any difference of the proceeds of sale and the loan from you. If you are unable to be contacted, part of the portfolio will be sold to restore the required margin.
Credit assessment	Generally the lending institution does not require detailed information about your financial position prior to the commencement of the loan.

Avoiding a margin call

The possibility of experiencing a margin call may be reduced if consideration is given to the following factors:

- Maintain a buffer between the amount actually borrowed and the maximum amount that is available to be borrowed.
  This may provide scope to manage short-term fluctuations in the value of the investment without having to sell a portion of the portfolio.
- Maintain a well-diversified portfolio, so that your portfolio is not reliant upon the fortunes of any one asset class, eg shares, property etc.

Maintaining sufficient accessible (non-geared) funds is essential when gearing, to cover the cost of potential margin calls.

Home equity lending

Investors may opt to borrow against the equity in their home to build an investment portfolio. Home equity is achieved when the value of the home exceeds the level of debt against the home. A proportion of this equity may be drawn for investment or personal expenses (eg holiday, car, swimming pool etc), thus decreasing the equity in the home. (Lenders vary in their requirements of the maximum amount of equity they will permit borrowers to withdraw.)

These borrowed funds may also be used for investment into managed funds, shares, and/or property. The maximum amount available for lending, interest rate and other ongoing costs liable to the investor depend upon the conditions of the loan held with the respective lending institution.

Provided the borrowed funds are used for investment into income-producing investments, a proportion (based on the amount of the loan that will be applied to investment purposes) of the loan interest and monthly account keeping fees may be tax deductible to you as the investor. It may be beneficial to establish a separate loan facility for investment purposes. Prior to setting up such a loan, you should seek specific tax advice to ensure the ownership and structuring of the loan and investments are appropriate to maximise tax efficiency.

Depending upon your risk profile, financial and personal circumstances, gearing via a home equity lending facility may be used in conjunction with a margin lending loan facility. This is commonly referred to as 'double gearing'. The combination of these two forms of lending provides significantly more funds available for investment. However, such a strategy increases the degree of risk associated with the investment portfolio.

What are the risks of gearing?

There are risks involved when using gearing as an investment strategy. It is essential to carefully consider these risks, and seek investment and taxation advice on your personal situation before implementing a gearing strategy.

Although gearing can magnify your capital gains, it can also magnify your capital losses. Even after taking investment advice and making what is considered to be a wise investment, it is possible that the value of the investment/s will fall. It should be remembered that gearing is not a short-term investment strategy and fluctuations in investment values will occur.

If engaging in margin lending, it is possible that you will be asked to pay back some or all of the loan amount borrowed, or to offer additional security, if the investment drops in value. This is known as a "margin call".

If engaging in home equity lending, the value of your home is assessed by the lending institution initially to determine the amount to be advanced. The security value of the property again becomes significant if the house is sold or you seek to re-finance. If the value of your property has fallen, it may not be possible to re-finance. Alternatively, a shortfall between the net sale proceeds and the outstanding loan would need to be met by you.

In both cases it is essential that the investor has other funds available should either of these situations occur. The gearing should ideally not need to be unravelled (investments sold) due to unforeseen circumstances, to ensure the appropriate investment time frame is observed.

Other risks involved are:

- the investment may not perform as expected,
- interest rates may rise,
- tax regulations may change adversely, and/or
- your personal or financial circumstances (such as job loss or divorce) may change.

You should consider taking out an Income Protection insurance policy in case of accident or illness. Income Protection insurance may replace up to 75% of the insured's gross personal exertion income in the event that the insured becomes sick or injured and cannot work for a specified period.

It is equally important to consider taking out Life, Total and Permanent Disability and Trauma Insurance to cover the loan amount and other costs in the event of death, total and permanent disablement or suffering a traumatic event. Traumatic events may include heart attack, stroke and some cancers – depending upon the terms of the insurance contract.

Prior to considering a gearing strategy, you should carefully consider your attitude towards loss of capital and the possibility of negative returns, as well as your personal and financial circumstances.

Need more information?

If there's anything else you need to know, please call your financial adviser, or our dedicated Customer Service team on 13 11 55 and ask for 'Super' between 8am and 6pm (Eastern Standard Time) Monday to Friday. We'll be happy to help.