Gearing – Costs and risks of 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.

Although gearing can deliver benefits, the risks associated with gearing may mean it is unsuitable for you. It is essential to carefully consider these risks before proceeding with a gearing strategy.

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 in growth investments such as shares or property.

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 the primary purpose of implementing a gearing strategy is to maximise your wealth accumulation.

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

- Negative gearing – where the interest payable on borrowed funds and any expenses incurred in relation to that investment exceeds the income received from the investment. The investor must have surplus income from other sources over and above their day to day living expenses to meet the shortfall.
- Positive gearing – where the expenses incurred in relation to the investment are less than the income generated. In this case the strategy is 'self-funded' because the costs of the investment are covered by the investment income and you are not required to meet these costs from your own cash flow. Additional tax will generally be payable.
- Neutral gearing – where the costs of the loan are approximately the same as the income generated.

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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 cost of the loan and other expenses over the life of the investment. 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 can magnify returns but will also magnify losses

Gearing can magnify investment returns, as shown in Example 1 :
Example 1

Starting Values	Geared	Non-Geared
Investor Equity	$40,000	$40,000
Amount borrowed	$60,000	$0
Total Investment	$100,000	$40,000
Market rises 10%		
Value of investment	$110,000	$44,000
Loan outstanding	-$60,000	$0
Investor's Equity	$50,000	$44,000
***GAIN* in Investor's Equity**	**25%**	**10%**

However, gearing will also magnify losses, as shown in Example 2:
Example 2

Starting Values	Geared	Non-Geared
Investor Equity	$40,000	$40,000
Amount borrowed	$60,000	$0
Total Investment	$100,000	$40,000
Market falls 10%		
Value of investment	$90,000	$36,000
Loan outstanding	-$60,000	$0
Investor's Equity	$30,000	$36,000
***LOSS* in Investor's Equity**	**-25%**	**-10%**

In addition, if the income return from the geared part of the investment (together with tax benefit) is less than the interest cost from the loan and any other associated costs, then this cash flow shortfall will reduce your overall return.

Gearing is a long-term strategy

Gearing should only be considered as a long-term strategy. This is because of the greater level of market volatility associated with the value of growth assets such as shares and property. 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.

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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 investment expenses such as interest repayments on your loan 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 due to ill health.
- 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.
- Note that wealth protection insurance will not protect your income where your income is reduced for reasons other than illness or injury.

Risks and Consequences

- Tax advantages from negative gearing should never be the sole reason for establishing a gearing strategy.
- You should ensure your employment and cash flow 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.
- An unforeseen event, such as injury or illness that prevents you from working, or a change in employment circumstances, may make it difficult to cover investment expenses including loan repayments. The impact on your investment portfolio can be reduced by incorporating wealth protection measures, including Income Protection, Critical Illness Cover and Total & Permanent Disability Cover.
- You should consider the impact of a rise in interest rates or a reduction in dividends, distributions, or rental income from the investment. You should ensure you have sufficient cash flow 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.
- If the income return from the geared part of the investment is less than the costs associated with the investment (including your borrowing costs), then this shortfall will:
  - Reduce your overall gain (where there has been a capital gain), or
  - Increase your overall loss (where there has been a capital loss)
- Legislation may change in the future in relation to tax deductibility of interest payments.

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