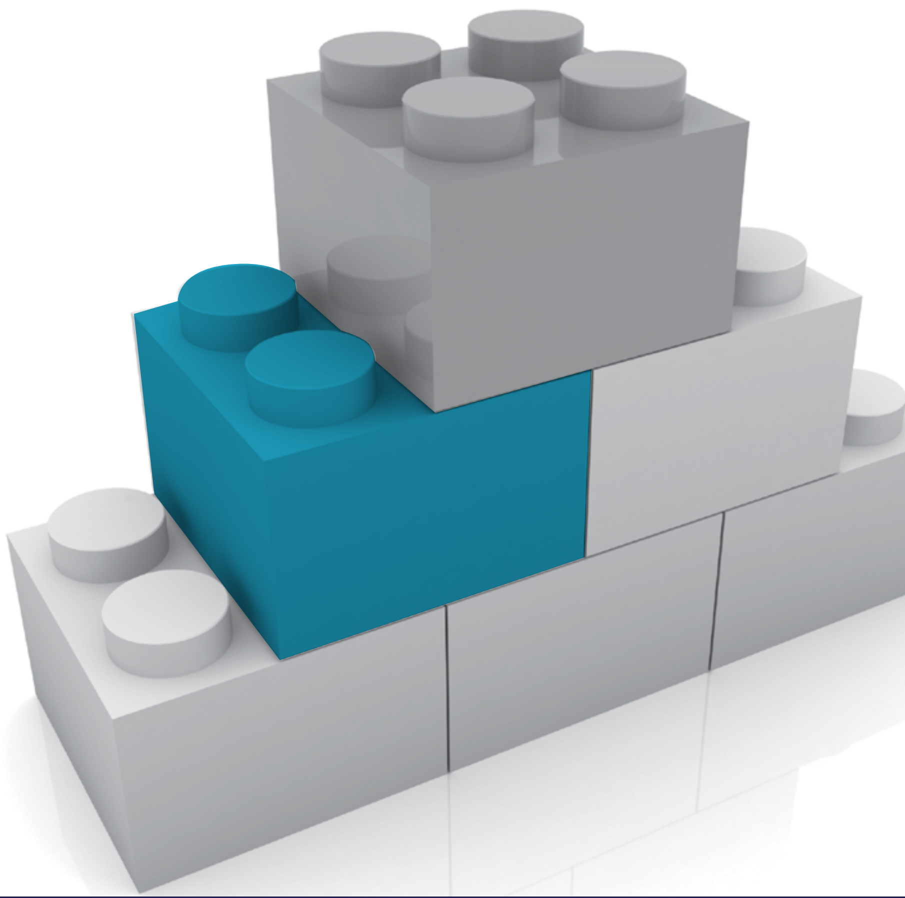
# Growing your wealth

## Gearing in plain English

### What is gearing?

In simple terms, gearing is borrowing money to invest. The investment could be in direct shares or managed investments, such as an equity trust, balanced fund or property. Gearing is, in essence, directed towards producing a larger investment return by using borrowed funds, often in addition to your own funds, so that financial goals can be achieved more quickly.

Gearing can be used as part of the overall investment strategy to help build your wealth. It gives you greater potential to generate wealth because you have more money in the investment market.



# How can we help you?

### Gearing can be used to accelerate your investment returns

Borrowing allows you to invest more money than if you invested only your own funds. Although gearing has the potential to increase capital gains in a rising market, it can also increase capital losses in a falling market. Any gearing strategy should be approached with caution.

### Gearing can help you keep all the profits

After you cover the borrowing costs and tax, 100 per cent of the growth and the income you earn on the investment are yours to keep.

### Tax advantages

When you borrow to invest in income-producing investments, the interest on your loan is treated as an expense for tax purposes. This generally means that you can claim the interest as a tax deduction.

# Who is gearing suited to?

Gearing is best suited to people who are comfortable taking extra risk with their investments and those who can cope with potentially large fluctuations, both up and down, in the value of their investments.

### Gearing is most appropriate if you:

- have a high level of comfort when it comes to investing
- have high disposable income
- are prepared to hold your investments for at least five to ten years
- can afford the interest repayments without relying on the investment, and
- have funds, other than borrowed money, that can be accessed at short notice, should the need arise.

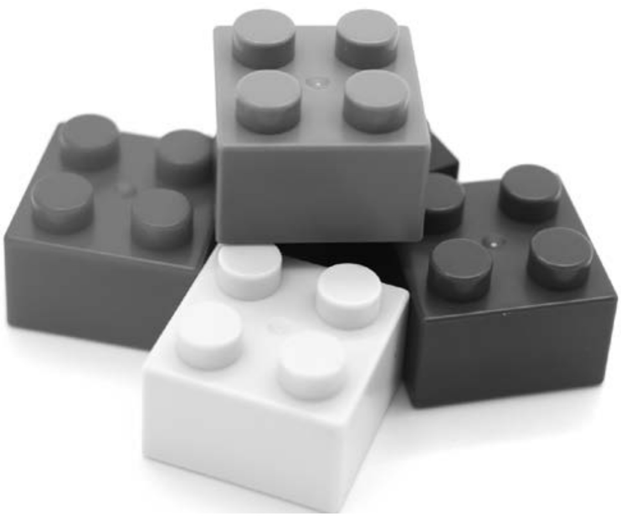
# How does it work?

Gearing aims to increase the investor's return by using borrowed funds in addition to their own capital. It is an effective strategy if the after-tax capital gain and income return of the geared investment exceeds the after-tax costs of funding the investment.

It is best to gear against growth-based investments, such as shares and property, and gearing should always be viewed as a long-term strategy. You need to be able to retain the investment and maintain loan repayments for at least five to ten years to obtain the benefits of long-term growth.

### The fundamental rule is that gearing an investment only makes sense if:

- the income received from the investment (after taxes and all expenses) is expected to increase in the future to cover the (after tax) cost of interest and give a reasonable return on the equity invested, or
- the market value of the investment asset (after taxes and expenses) is expected to increase at a rate that exceeds the negative cash flow (after tax).



## Eva's story

Eva has recently received an inheritance of $100,000 from her grandmother.

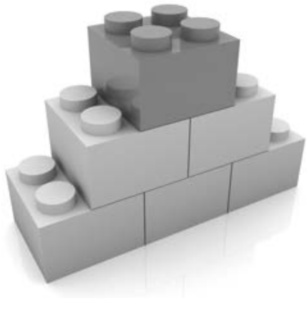
Eva is 35, has surplus income and is a growth investor. She would like to use a gearing strategy so she can accelerate her wealth accumulation for retirement. Eva would like to borrow $100,000 and invest in an Australian share fund.

The table shows that gearing accelerates Eva's equity gains when the market rises. It also shows that her equity falls more when her investment is geared and the market falls, compared with her non-geared investment.

| Eva's investment | Non-geared | Geared |
|---|---|---|
| Eva's equity | $100,000 | $100,000 |
| Amount borrowed | $0 | $100,000 |
| Total investment | $100,000 | $200,000 |
| **Market rises by 10%** | | |
| Value of portfolio | $110,000 | $220,000 |
| Loan outstanding | $0 | $100,000 |
| Eva's equity | $110,000 | $120,000 |
| **Market falls by 10%** | | |
| Value of portfolio | $90,000 | $180,000 |
| Loan outstanding | $0 | $100,000 |
| Eva's equity | $90,000 | $80,000 |

## Risks and implications

- Investment risk is magnified with gearing. There is a greater opportunity for capital gain but also greater exposure to capital loss.
- You may not only lose the value of your investment portfolio, but may also be required to repay the funds you have borrowed.
- It is important not to rely solely on the investment income to meet interest repayments, as investment income may be irregular and the interest payment may be due before the income is received from the investment.
- Should you have to exit the strategy due to illness, loss of income or increased interest costs, you may have to sell your investments to repay the investment loan. There may be break costs from the loans, as well as capital gains/losses incurred from the sale of the investments.
- For the strategy to be successful, the portfolio needs to earn income and growth in excess of the costs over the long term.
- To qualify for a tax deduction for the interest, the borrowing needs to be undertaken with the purpose of earning assessable income. If this is not the only motive then the interest deductions may be disallowed by the Australian Taxation Office.
- Where an investment portfolio is negatively geared, your cash flow is reduced because the investment income does not cover interest costs. This can result in difficulty in servicing the borrowing costs.
- If the cost of borrowing increases or investment income decreases, you may need to cover the additional cost of borrowing from other sources.
- Capital gains tax may apply when an investment asset is sold.
- Income protection and life insurance are recommended to ensure the loan can be serviced if you are ill and unable to work or repay the outstanding debt in the event of death.
- In the event that you default on your loan repayments, your assets or home may be sold by the lender to satisfy the debt.
- Changes in legislation may reduce benefits currently available for gearing strategies, in particular in relation to interest deductibility.



This information is correct as of April 2016

**FinancialPartners (Tas) Pty Ltd**
126 Hobart Road
Kings Meadows Tas 7249

**W** financialpartnersblog.com.au
**E** financialpartners@ampfp.com.au
**F** 03 6344 5900
**P** 03 6343 1007



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