financial solutions
VICTORIA - PTY LTD

A guide to investment gearing

Gearing is another term for borrowing to invest. It can be an excellent strategy to enhance your investment performance.

People gear investments so that they have more money working for them, providing the potential to create wealth more quickly. Negative gearing is when you borrow to invest and the interest cost of the loan exceeds the investment income.

You 'gear' when you buy an asset by borrowing money and repaying it over a number of years. In the case of gearing to buy an investment property, your investment will earn income to help you repay the loan and ideally generate capital gains as well. An added benefit is that the Australian Taxation Office will generally allow a tax deduction on the interest you pay on the loan.

Which investments should you use?

The key to gearing successfully is to choose investments which can provide you with a reliable income stream and sound capital growth. In the case of negative gearing, it's essential that the capital growth is more than the net after-tax costs of the exercise (the cost of the loan, less investment income, less the benefit of the tax deductions).

For this reason, people often choose to invest in shares in well-known and researched companies, or a number of different managed investments.

Gearing and franked dividends

A benefit that quality shares have over other investments is the dividend imputation system. This system can result in you receiving tax credits on the dividends you receive (known as 'franked dividends') and therefore being liable to pay a reduced amount of tax on this income. This can impact positively on your cash flow.

Minimise the risks

You can lessen the risks associated with gearing by following these simple rules.

1. Don't over-commit. Only borrow as much as you can comfortably afford to repay, remembering that there might be periods when your investments don't generate income.
2. Diversify your investments so that you aren't relying on just one or two investments.
3. Invest only in quality growth assets which have track records of reliable income streams and capital growth.
4. Invest for the long term to give your investments sufficient time to generate enough capital growth.
5. Insure your salary so that you don't have to sell your investments (possibly at a loss) if you or your spouse became seriously ill or disabled.
6. Fix the interest rate of your loan to protect your cash flow in case interest rates rise.

Tax on selling your investments

If you sell your investments for more than you paid for them, you can incur a capital gains tax liability. Under the current tax rules, this will be a maximum of 46.5% but will be less if the shares held for 12 months or more and you're eligible for capital gains tax discounting. This can also be reduced by waiting to sell your investments until your tax rate is less than it is now (for example when you retire). You should obtain tax advice from your tax adviser or accountant as to how best to acquire, dispose of and hold investments.

An important note about gearing and risk management

While gearing can potentially magnify returns, it can also potentially magnify losses if investments perform badly.

When considering the benefits of gearing, we strongly recommend you see your financial adviser to help you with your decision. As with any investment choice, gearing should be included within a personalised investment plan that takes into account your personal risk profile and your own financial situation.

How does gearing work?

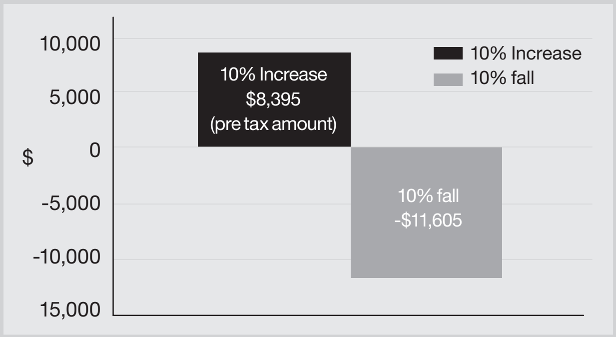
Case Study

Let's say Helen decided to borrow $100,000 to invest and her marginal tax rate is 46.5%. If her interest rate is 7% per annum and the investment income is 4% per annum (this is an example of 'negative gearing'), then the net after-tax cost of borrowing is $1,605 in the first year, as the table shows.

Cost of $100,000 loan @ 7%	$7,000
Investment income @ 4%	$4,000
Pre-tax cashflow shortfall	$3,000
Tax deduction @ 46.5%	$1,395
After-tax cashflow shortfall	$1,605

Now let's say Helen's investment portfolio suffered a 10% fall. Helen's loss (on paper) would be $10,000. When that is added to her $1,605 after-tax cash flow shortfall, Helen would be $11,605 worse off.

So, gearing not only has the potential to multiply your gains, it can also magnify your losses, as you can see in the graph below.



Let's assume Helen's Account increases in value by 10% ($10,000) in the first year. This would result in Helen having a pre-tax benefit of $8,395, after taking into account her $1,605 after-tax cashflow shortfall.

In other words, the borrowed funds have earned her a pre-tax amount of $8,395.

One of the keys to gearing successfully is to choose investments which can provide you with a reliable income stream and sound capital growth.

Contact Financial Solutions Victoria Pty Ltd for further information on 03 51532507 or visit www.finsolvic.com.au

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