GEARING – THE BENEFITS AND THE RISKS

Essentially, gearing is simply using borrowed funds to invest. The investment could be property, (commercial, residential, rural etc), a selection of shares or, in some instances, a total investment portfolio. Gearing can be attractive to investors as loan expenses and interest costs can be claimed as a tax deduction.

Negative Gearing is a term which applies when the cost of borrowing (the interest and costs of the loan) exceeds the income generated from the geared investment or investments. The loss or deficit can normally be used as a tax deduction by the investor to offset other taxable income such as salary. An investor considering a negatively geared strategy would have an expectation of achieving sufficient capital gain from the investment to offset the after tax income loss they will have sustained as a result of negative gearing.

Gearing is utilised by investors due to the potential for increased returns on the geared portfolio, however it is important to understand that like all increased returns, there is also a greater risk of a loss. 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 the share market. The return of investing the $50,000 vs the $150,000 Negatively Geared portfolio is as follows :

Example (A) - a 5% Capital Growth

	Ungeared	Negative Gearing
Total Amount Invested	$50,000	$150,000
Amount of Loan	-	$100,000
Total Investment	$50,000	$150,000
Income @ 5%	$ 2,500	$ 7,500
Less loan interest @ 8%	-	$ (8,000)
Net income	$ 2,500	$ (500)
Capital growth @ 5%	$ 2,500	$ 7,500
Total return	$ 5,000	$ 7,000
Client funds invested	$50,000	$ 50,000
Return on investment (A)	**10%**	**14%**

This illustrates a healthy increase in return from client A's investment of $50,000 if gearing is utilised. If, however, the market dropped by 5%, it would have the following effect:

Example (B) - a 5% Capital Loss

	Ungeared	Negative Gearing
Capital loss @ 5%	$ (2,500)	$ (7,500)
Total return	$ 2,500	$ (8,000)
Investment balance	$ 50,000	$ 42,000
Return on investment (B)	**0%**	**-16%**

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

When considering a gearing strategy, an investor should be fully aware of their tax position. Negative gearing is most effective for taxpayers on the highest marginal rates of tax and is less effective for those on lower tax rates or non-taxpayers. Like any capital growth investment, investors should be prepared to take a long term (say 5 to 10 years) view and not be too concerned about fluctuations in investment markets.

The investor should fully consider the potential downside of gearing an investment or portfolio and ensure that they have sufficient secure income to cover the cost of borrowing the funds. Consideration should also be given to the possibility of a portion of the loan having to be repaid or further security lodged with the lending institution if the chosen investment market suffers a loss. This is termed as a margin call and investors need to be fully aware that they may have to find extra cash to pay a margin call or sell assets in the portfolio to fund a call. A lender will closely monitor the investments in a gearing arrangement and will usually make a margin call within 24 hours of an investment market falling below accepted levels.

The investor should keep their affairs flexible enough to be able to cater for changed circumstances such as a job loss or divorce. 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 service borrowings without difficulty. The gearing should ideally not need to be unravelled due to unforseen circumstances. Consideration should be given to taking out an Income Protection Insurance Policy in case the investor has an accident or becomes ill.

Gearing is not an investment technique that is suitable for all investors. Risks and rewards are magnified and surety of cashflow to cover margin calls is crucial. Careful consideration of an investors risk profile and circumstances is required prior to recommending a gearing strategy to an investor.