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Financial Planning

Gearing

Borrowing to acquire an investment is known as "gearing". The concept involves leveraging investment returns by making a larger investment (than would otherwise be possible) with borrowed funds usually in addition to existing funds. Gearing can help increase wealth more rapidly as investment returns are magnified - however if the strategy is used imprudently it can lead to financial difficulties as negative investment returns are also magnified.

This paper outlines the principles that should be considered when borrowing to invest and the common borrowing pitfalls. It also explores the characteristics of various loan facilities.

Why gear?

If handled prudently, gearing can provide greater exposure to investment markets or a broader asset base, which means improved capacity to achieve capital growth and accumulate wealth.
An attraction of gearing is that interest charges paid on the outstanding loan are tax deductible if the investment is expected to produce income. If the costs are greater than the income from the investments the result is called, "negative gearing".

For more details on negative gearing, please refer to our "Guide to Negative Gearing".

Important considerations

There are several basic concepts that need to be kept in mind when considering a gearing strategy.

Cash flow and income must be sufficient to service the arrangement. Only people with a high, secure income should consider gearing. For people on lower incomes, the benefits of gearing may not be sufficient to justify the cost and risk of engaging in this strategy.

Interest charges must be met by the investor, so it is important that investors do not over commit to the point where they cannot afford to meet the interest charges. Should that occur, the lender would generally require repayment, sometimes with penalties. The borrower will generally have to sell assets to repay the loan. If the assets have fallen in value, further losses in addition to the aforementioned penalties could arise.

Some people borrow to invest without adequately safeguarding their income. No gearing strategy should be set up without comprehensive income protection insurance.

How does gearing work?

By borrowing to invest it is possible to "gear up" the rate of capital growth on the actual capital invested. This is because there is a larger asset base increasing in value. Also, income from the investments can be used to help pay the interest charges so that borrowing helps to convert income returns to "growth" returns. A properly structured gearing strategy should increase total returns on the capital outlaid if the underlying investments have a positive return.

To illustrate by a simple example, assume an investment is purchased for $100,000 cash:

Purchase Price		$100,000
Value in five years		$150,000
Capital Profit / (Loss)		$50,000
Percentage Profit / (Loss)	=	50%

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Alternatively, let's assume that to purchase the same investment, we use $50,000 of our own cash and we borrow the remaining $50,000:

Capital Profit / (Loss)		$50,000
Percentage Profit / (Loss)	=	100%

This simple example shows how profitability can be magnified when you invest using borrowed funds in addition to your own funds.

Caution - gearing can work in reverse

While gearing works well when the value of the investment is increasing, it works in reverse should the value of the investment fall.

If, in the above example, the value of the investment fell from $100,000 to $80,000, a very different result emerges:

Reduced Value		$80,000
Capital Loss		($20,000)
Percentage Profit / (Loss)	=	(-40%)

A 20% drop in the value of the investment results in a 40% loss of the investor's own capital because the lender must still be repaid in full and therefore does not share in the drop in value of the investment.

If the investor is forced to sell, all the costs involved in buying and selling the investment, including all loan costs, are lost forever. While gearing offers many benefits, it can cause problems if the investor is forced to sell at the wrong time or the investment does not achieve the required level of capital growth.

Borrow for long term investment

Any property or share based investments can be volatile and may decrease in value in the short-term. Hence, any gearing or borrowing strategy must be capable of absorbing short-term falls, so that the benefits of long-term capital growth can be obtained.

Borrowing to invest in real estate

Many real estate investors tend to "buy and never sell". This is done over the years by using the increasing equity in property investments as security for further loans that, in turn, help fund the purchase of even more property. Initially, equity built up in the home is used as security to help fund the first investment property and, over time, the process is repeated to enable the purchase of a second, third and fourth investment property. This is fine providing the investor does not get caught out by becoming over committed, particularly on the brink of a downturn in the property cycle. Real estate investment must be regarded as long term and it is essential to take into account the need to repay interest even if the property is producing no rental income.

Borrowing to invest in listed investments

Shares tend to be more volatile than residential property. While the upside potential for shares may be greater than for residential property, so too can be the downside risk.

Borrowing to invest in managed investments

Investors also have the choice of borrowing to invest in managed funds. In deciding whether to invest directly or through managed funds, the following should be considered:

Management involvement and control

Some people prefer the greater control associated with personally selecting, controlling and managing their own investment property or share portfolio.

Others prefer to be spared the hassles of direct investment and are happy to leave the responsibility to experienced and professional fund managers.

Liquidity

A directly held physical property investment may take time to sell in a difficult market. With a home unit or townhouse it is impossible to sell just the second bedroom or the kitchen to obtain some liquid funds. On the other hand, with managed and listed investments, it is relatively easy to realise part of the portfolio quickly if required.

Flexibility

With direct investments such as property or shares, the investor has greater personal control of buy and sell decisions, allowing more accurate timing of capital gains tax liabilities and offsetting of capital gains and losses. With managed funds, both listed and unlisted, the fund manager has control over the sale of the underlying assets and may choose to realise capital gains at any time. Managed funds are required to distribute taxable capital gains to unit holders in the year they are realised and this is a disadvantage for gearing purposes.

Investment costs

Investing in direct property can involve substantial initial and ongoing costs, particularly when stamp duty, legal fees and property management are taken into account. Purchasing and selling listed investments on the stock exchange may cost the smaller retail investor around 2.5% on the way in and 2.5% on the way out. Managed investments through unit trusts may incur up-front charges of up to 4% to 5% and ongoing management fees of up to 2% each year.

Criteria for evaluating loan facilities

Before proceeding with any loan, it is important to examine and understand all the factors involved in assessing a loan. The term, type and size of the loan, the interest rate, initial costs, and ongoing and future charges should all be considered.

Margin lending facilities

There are a number of margin lending facilities available to investors, each with its own particular strengths and weaknesses. However, they are all based on the same principles:

- The investor puts up a certain amount of cash or other assets eg. shares, unit trust investments.
- The lending institution then lends an amount of money on the basis of the investor's contribution eg. 1.5 times the value of the assets put up. The value of the borrowed funds must not exceed a certain proportion of the investment assets, eg. 70%.
- If the value of the investment assets falls to a point where the borrowed funds exceed the allowable proportion, the investor must put in more money or assets to restore it to the required level. This is called a margin call.

- In evaluating margin lending facilities, several key features should be considered. These include establishment costs, minimum and maximum loan amounts, interest rates and loan terms, early repayment policies and other terms and conditions.

Protected equities facilities

For those who wish to borrow to invest in shares and managed funds without the risk of capital loss, there is a range of lending facilities available that provide protection against such losses.

The basic concept is that an investor borrows money for a fixed term - generally 1 to 3 years. The interest rate charged on the loan includes the cost of 'protecting' the portfolio, which is effectively capital guaranteed. Therefore, should the markets take a tumble, the borrower will only lose to the extent of the after tax cost of setting up the facility and making the interest payments for the term of the loan.

The cost of protecting capital (whether built into the interest rate or separately itemised) will generally not be tax deductible. This is a complex area that has been subject to some change in recent years and tax advice should be sought in this regard from an accountant or registered tax agent.

Potential users of this facility should understand that there is a price to be paid for the security of knowing that your investments will not fall in value. This price is reflected in the higher interest rates that apply to protected equities facilities. For those investing for the long-term it may be that protection is an unnecessary cost that will only reduce the total returns from the gearing strategy.

The golden rules of borrowing to invest

1. Invest for the long term

This is absolutely critical. Borrowing for the short-term is not appropriate as time is needed to overcome volatility and for the gearing effect to work. A three year time horizon is generally the absolute minimum, with at least five years being preferable.

2. Invest in a balance of shares and property

Property investments may not perform as well as share investments, but are usually less volatile. Listed property trusts and property securities funds are a suitable replacement for direct property investments.

For those that are aiming at negative gearing it is the growth rather than the income that we are after. Shares and property generally distribute less income and experience greater capital growth in comparison to other asset classes.

3. Make sure there is reasonable cash flow from the investment portfolio

This will help insulate the gearing strategy against adverse circumstances. Should the investment grow over time the income return also should increase to help meet interest charges.

4. Some tax advantaged income helps

If part of the income return from investments is tax advantaged (ie shares with franked dividends) this may enhance the returns of the gearing strategy.

5. Do not over commit

Only borrow what is comfortably affordable. Always allow a buffer to guard against the possibility of being forced to sell investments to repay the loan.

6. Safeguard income

Make sure income and assets are adequately protected by taking appropriate disability, death and income protection insurance.

7. Minimise exposure to margin calls

Structure the gearing so that the likelihood of margin calls is kept to a minimum.

8. Do not invest in geared investments

It is not advisable to borrow money to invest in assets that are already geared. This adds an extra level of risk. Ungeared investments provide more cash flow and are less exposed to capital losses in adverse market conditions.

9. Risk Profile

Investors wishing to gear should only do so if they have an appropriate risk profile. This strategy is better aligned to aggressive investors rather than conservative investors.

10. Be conservative

Although you need to have an aggressive risk profile to consider a gearing strategy, it is important to take a conservative approach to the actual gearing strategy and level of borrowing in order to manage the risks of gearing. Adhering to the above principles will help.

11. Seek professional financial advice

Professional advice will help develop a gearing strategy designed to avoid the pitfalls, while maximising the benefits.

The importance of financial advice

Gearing can be an effective way of accumulating wealth and reaching your financial and lifestyle goals, but doing it alone is unwise. There are opportunities for the well informed but also pitfalls awaiting the unwary.

To improve the quality of your decisions you should consider professional financial planning advice.

Our office can help explain both the benefits and risks of gearing, the assets to consider gearing into and how you may benefit from the strategies outlined in this report.

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