



# Gearing

Most people are comfortable with borrowing money to buy property, but borrowing to invest in the sharemarket or managed funds could also be worth considering.

Gearing builds wealth faster – but it isn't for everyone, because there are risks involved. It is for this reason that you should seek professional advice.

## Benefits of gearing

Gearing gives you the potential to accumulate wealth faster than if you relied solely on your own funds to invest. As long-term returns on growth assets such as shares have generally exceeded the costs of borrowing to invest it will help you reach your long-term goals sooner.

It also has the potential to help you own a more diversified portfolio. With more funds to invest, you can avoid putting all your eggs into one basket.

Gaining tax concessions through gearing is one of the usual benefits of this form of investment. You can usually claim your loan expense as a tax deduction where the loan funds are used for business or investment purposes. This experience can be applied against your other taxable income received during the year (for example your salary). This reduces the overall after-tax cost of your borrowings.

## Risks of gearing

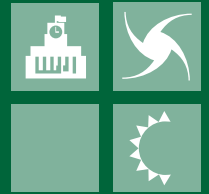
Gearing increases the returns of an investment, whether they be losses or gains. When you gear, you usually multiply your gains in a rising market, but also multiply your losses in a falling market.

At times when investment returns are negative, the value of your investment will fall. If this occurs, you may be required to pay back part of the loan or provide extra security by investing more money. This is referred to as a margin call and you are generally required to respond to it within 24 hours. Other risks include rising interest rates or changing taxation legislation. Using a home mortgage facility or internally geared managed fund negates the risk of a margin call.

## Types of gearing

**Margin loan** – A margin loan is, in effect, a mortgage arrangement where you borrow against investments that you already own up to a certain limit (70% generally being the maximum). Shares or managed funds purchased become the security for the loan. The disadvantages of such loans may include you having to contribute additional funds (to repay the loan principal), sell some of the shares or provide further shares as security, should the value of your equity fall. This is referred to as a 'margin call' and means that the margin between your own equity and the amount borrowed has increased.

**Geared managed funds** – Some fund managers offer funds using gearing as a strategy. The fund borrows within strict guidelines to increase the amount that it has to invest. The fund also receives the tax benefits, as would an individual using gearing. Therefore, in using such a product you are reducing the risk level by relying on specialist management expertise. You can greatly increase your potential gains as the amount to be invested is geared i.e. \$100 invested equates to \$160 (60% is usually the maximum gearing level) invested. However, like all investments, the higher the return, the higher the risk of a loss.



**Line of credit** – This involves utilising a current loan to purchase shares or managed funds. The advantages of this are that the interest rate is generally lower than that offered by margin loans and that the facility is already set up. Additionally, there are no margin calls to worry about.

**Negative gearing** – Negative gearing occurs when the interest on the borrowing within a year is greater than the investment income, which can produce a net tax reduction.

There are also other types of gearing – positive and neutral. The difference between them is cashflow. When your cashflow is positive (meaning your annual net cost of borrowing is less than the investment income) you are said to be positively geared. Neutrally geared means your interest bill on borrowings is equal to your investment income earned from the borrowings.

Furthermore, any interest pre-paid prior to June 30 for the coming financial year can generally be claimed as a deduction in the current financial year, subject to the 12-month rule. Essentially, if a pre-payment is for a period of less than 12 months the deduction can be claimed up front.

If your investment includes Australian shares, income from your investment (dividends) is likely to be at least partly “franked”. In other words, tax has already been paid on that income. Therefore, such income may generate a tax offset, reducing effective tax payable.

Capital gains tax payments are deferred until you sell the investments, enabling you to pay the tax when your marginal tax rate may be lower, such as when you retire. Income distributed when investing in managed funds may include some realised capital gains.

## Other considerations

To determine if gearing may be an appropriate strategy for you, you should consider the following:

- Do you have the resolve to ride out falls in investment markets and have a long term investment timeframe?
- Do you have a reliable income and expect this to continue for the term of the investment and the loan?
- Do you have an emergency fund to meet potential interest rate rises and/or margin calls?
- As you can't rely on the returns from your investment to pay the interest on the loan, are you prepared to use some of your income to pay the interest?

If the answer is **yes** to all of these questions, then gearing may be appropriate for you. We recommend you seek professional advice about gearing.

It is also important to consider appropriate income protection/disability insurance and life cover before undertaking a gearing strategy.

## Need further information?

Chifley Financial Services Limited is owned by Unions NSW, the Local Government Superannuation Scheme and the Energy Industries Superannuation Scheme. Chifley Financial Services provides its clients with comprehensive financial planning services.

If you have any questions about the material covered in this fact sheet, please contact Chifley on 1800 800 002 between 9am and 5pm on any business day.

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