

Focus On Gearing

Gearing is a hugely popular way to build wealth. Gearing simply means investing with borrowed money.

The magic of gearing is that it allows you to punch above your weight financially. It's a way to acquire more assets than you would otherwise be able to own.

You've probably heard that gearing can reduce tax. But the real power of gearing is that it allows you to hold assets that have the potential to grow in value over time.

Without raising a sweat, gearing can lead to quite marvellous financial gains. (See table right.)

But a word of caution. Gearing also carries the risk of losses should there be a stagnation or decline in the value of the geared asset.

No pain... Just lots of capital gain

You're familiar with the term 'capital gain'. This describes the increase in the value of a geared asset when you eventually sell it.

How gearing can accelerate your wealth

	Without a Margin Loan	With a Margin Loan
Own capital	\$50,000	\$50,000
Loan	\$0	\$50,000
Total investment at 30/6/2008	\$50,000	\$100,000
Market value at 30/6/2013 ^(a)	\$86,168	\$172,335
Loan interest payments ^(b)	\$0	-\$21,250
Loan repayment	\$0	-\$50,000
Net portfolio at 30/6/2013	\$86,168	\$101,085

a) Assumes total investment earnings = 11.5% pa

b) Loan interest payments assume a loan interest rate of 8.5% pa term = 5 year

Example:

You buy a share portfolio today for \$200,000 and sell it in 10 years time for \$500,000. The capital gain is \$300,000.

One of the great joys of realising a capital gain is that you only pay tax on half of the increase. This compares more than favourably with the tax you pay on the income you earn from your day job.

Obviously the more you gear, the higher the total value of your leveraged investment, the greater your potential for a huge capital gain when you eventually sell.

Bear in mind though, that while gearing can be an effective way of increasing returns, it also carries with it the risk of increasing losses.

The positives of negative gearing

When you borrow to buy an income producing asset such as an investment apartment, the cost of the interest is tax deductible.

When the tax deduction generated from the asset is greater than the income it produces, this is known as 'negative gearing'.

Example:

You pay \$30,000 a year in interest on a holiday let unit. Your net rental income is \$20,000 per year. The property is 'negatively geared' at an annual rate of \$10,000.

Negative gearing remains a useful way for high income earners to cut their income tax. But it only makes sense when there's an increase in the actual capital value of the asset.

'Positive gearing', by the way, occurs when the income earned from the investment actually exceeds the deductions. 'Neutral gearing' is when the deductions are equal to investment income.

Ideally, a geared investment should deliver a stable income. Most important, it should also offer the prospect of capital growth well above inflation over the medium to long term.

Gearing tips

- Seek professional advice to develop a strategy to maximise the benefits of gearing and minimise the potential hazards.
- Take a big picture view. Gearing is a long-term strategy.
- Bear in mind that while gearing magnifies the benefits of positive returns, it also magnifies losses.
- Make sure you can meet loan repayments if interest rates rise.
- Gearing should always be seen as a wealth creation strategy rather than a way to save tax.

To learn more about how you can benefit from gearing, contact your Infocus Money Management financial adviser today.

Group Head Office & QLD State Office
Level 1 Kawana House, 1 Innovation Parkway
Birtinya QLD 4575

Call 1300 infocus

or visit infocus.com.au

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