Understanding Series
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FINANCIAL PLANNING

Understanding Gearing

Preparation Date: 26 November 2007

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How to read this document

Managing your finances to meet your day to day requirements as well as your long-term goals can be a complex task. There are all sorts of issues you need to consider such as taxation, legislation, protecting your wealth and assets, associated costs and the inherent risks of investment. When undertaking a financial plan it is important that you understand how these issues will impact on you and what you should expect over time.

Your financial adviser will provide you with a Statement of Advice (SOA) which sets out the details of the advice and how it will meet your goals and objectives.

This document provides some additional information to help you understand the financial planning concepts discussed in the SOA in relation to **gearing**.

It is very important that you read this document to help you understand the benefits of the strategies recommended to you, and the associated costs and risks.

If you do not understand anything or need further clarification, please contact us.

Gearing

Gearing simply means borrowing money to invest. Gearing may be used to accelerate the process of wealth creation by allowing an investor to make a larger investment than would otherwise be possible. The borrowed money can be invested in a number of ways, including into direct shares, property and managed investments.

Gearing can be an effective strategy if the after tax capital gain and income return of the geared investment exceeds the after tax costs of funding the investment.

Gearing is only appropriate for growth based investments such as shares and property it should be viewed as a long-term strategy, that is, seven to ten year timeframe. You need to be able to retain the investment (and maintain the loan repayments) during short-term market declines, in order to obtain the benefits of long-term growth.

What is negative gearing?

Negative gearing occurs when the interest payable on borrowed funds and any expenses incurred to derive that income exceeds the net income received from the investment. The investor must have surplus income over and above their day to day living expenses to meet the shortfall.

Gearing is most appropriate for people:

- With an assertive or aggressive risk profile, who are prepared to accept investment volatility
- With a strong, secure cash flow (which is protected by an appropriate insurance policy)
- On higher marginal tax rates
- With a low level of non deductible debt
- With an investment time-frame of greater than seven years

The benefits of gearing

The potential benefits of gearing include:

- **Potential for increased capital gains and diversification.** Gearing increases the size of an investor's portfolio by allowing them to purchase additional investments with borrowed funds. Capital gains that are in excess of the after tax cost of funding the geared investment are added to the portfolio's overall return. By increasing the number of securities in an investor's portfolio, the volatility of the overall investment portfolio may be reduced due to greater diversification.
- **Taxation.** Tax savings should never be the primary reason for choosing an investment strategy, however there are some additional tax benefits associated with gearing.

  Under current legislation, interest payments on money borrowed to invest in income producing investments, together with ongoing expenses, can normally be claimed against your taxable income. In some cases investors may be able to pay the interest costs for up to 12 months in advance. Investors on high marginal tax rates will receive a higher tax deduction and investors on lower marginal tax rates can potentially make greater use of imputation credits and will incur a lower capital gains tax liability when

they sell their investment.

It is recommended that the investment income is predominantly sourced from Australian investments, which can provide greater leverage through the increased value of any franking credits that may be paid on Australian share investments. Interest paid on borrowings that are invested in international funds may not be fully allowed as a tax deduction. The relevant provisions in the Income Tax Assessment Act (ITAA) are referred to as the "foreign loss quarantining provisions" and are found in Sections 79D and 160 AFD of the Act.

Gearing facilities

The simplest, and perhaps most cost effective way to gear, is to borrow against the equity in property you already own (for example, your home) at prevailing mortgage rates. The main benefits of this type of funding include the absence of margin calls and no requirement to contribute funds to the investment. The lending institution will generally only require the regular payment of interest to fulfil your obligations.

Another way to access funding for investment gearing is via a margin lending facility. You are required to contribute your own equity, and, depending on the type of facility, to make a minimum loan balance outstanding. The lending institution will lend a portion of the value of specific securities or managed funds, with the usual maximum Loan to Valuation Ratio (LVR) being between 40 and 80 per cent. If your LVR exceeds these limits, a margin call will be made and you will be required to restore the initial LVR, by either lodging additional security or by reducing the loan amount.

The difference between drawn and undrawn debt

Borrowing further funds or using undrawn debt may impact on the appropriateness of a gearing strategy. The difference between drawn debt and undrawn debt is explained below.

Drawn debt refers to borrowed funds which have already been used. Interest is charged on drawn debt. If the interest is not paid, it will be added to the total amount of borrowed funds you owe.

Undrawn debt refers to borrowed funds which you have access to, but have not yet used or drawn down. Generally, interest is not charged on undrawn debt until the undrawn funds are taken out of the lending facility (for example, used to purchase investments).

Risks of gearing

The risks associated with gearing may mean it is unsuitable for some investors. It is essential to carefully consider these risks and to seek taxation advice before proceeding with a gearing strategy.

The specific risks associated with borrowing to invest (gearing) include:

- **Timing mismatch.** It is important not to rely solely on investment income to meet interest payments, as investment income may be irregular and the interest payment may be due before the income is received from the investment.
- **Negative gearing.** Negative gearing compounds the risks associated with standard gearing. In particular, negative gearing further reduces your cash flow because the investment income does not cover interest costs, which may result in a reduction in both cashflow and the ability to service the interest costs.
- **Reduction in capital value.** Although there are potential wealth creation benefits to be gained from gearing, these benefits are achieved at the expense of higher risk.

  It is important to note that although gearing has the potential to increase capital gains in a rising market, it can also compound a capital loss in a falling market. Any gearing strategy should therefore be approached with caution. The following table provides an example.

	Geared	Non-Geared
Investor equity	$40,000	$40,000
Amount borrowed	$60,000	$0
Total investment	$100,000	$40,000
Market rises 10%		
Value of portfolio	$110,000	$44,000
Loan outstanding	$60,000	$0
Investor's equity	$50,000	$44,000
Gain in investor's equity	**25%**	**10%**
Market falls 10%		
Value of portfolio	$90,000	$36,000
Loan outstanding	$60,000	$0
Investor's equity	$30,000	$36,000
Loss in investor's equity	**(25%)**	**(10%)**

- **Capital gains tax.** Capital gains tax may be payable when you sell your investments.
- **Fluctuations in interest rates.** If the income from investments does not change, but interest rates on borrowed funds increase, then you will incur additional costs that will need to be covered from other sources.
- **Growth-based investments.** A gearing strategy must invest a high proportion of an investment portfolio into growth assets such as property and equities to prove successful. These investments can be volatile over short-term periods, and it is for this reason that gearing is a long-term investment strategy.
- **Increasing your borrowing**. Increasing an existing loan and/or establishing a new loan may incur bank fees and/or government charges. Borrowing further funds could also

impact upon the gearing strategy and may require a re-assessment of its appropriateness to your circumstances.

- **Income Protection insurance.** Consistent income flow is the key factor to commencing a geared investment strategy. If your income should cease or reduce for any reason you may be unable to continue to meet the loan repayments. In this instance, you may be forced to sell the investment at the wrong time and realise a capital loss rather than the desired gain. Therefore your level of income needs to be adequately high and reasonably secure. To ensure that income is appropriately protected it is strongly recommended that income protection insurance is acquired by all parties involved in the gearing strategy

- **Defaulting on your loan.** If you default on your loan (i.e. do not pay your loan or interest repayments when they are due), the lender may compel you to make payments, impose a penalty for late payment, or ask for the loan to be repaid in full immediately. The lender may even sell assets that are being held as security for the loan.

- **Ending your loan.** If you decide to end or terminate the loan facility, it may be necessary to sell the geared investments or security held by the lender in order to do so. This means you could be selling investments at a lower price than what you paid for them, or too early for the gearing strategy to have provided significant benefits.

- **Margin lending.** With margin lending plans, margin calls may be made if the value of the portfolio reduces below particular limits. Please refer to the ‘The Effect of Margin Calls’ below.

The effect of margin calls

With a margin lending plan, you are allowed a limited fall in the value of your portfolio before a margin call is made.

A margin call is a requirement by the lender for the borrower/investor to provide additional funds to re-establish the lender's maximum loan to value ratio (LVR).

Generally, there is a margin of up to 10 percentage points (depending on the finance institution and the investments), in the increase in your LVR before you have to contribute additional capital (margin call) or reduce the loan amount.

An example of the effects of margin calls:

A fall in the value of your portfolio

Assume you have;

Owner's capital	$40,000
Borrowed funds	$80,000
Total value of your portfolio	$120,000

This represents a LVR of 66.67% ($80,000 Loan/$120,000 total value). This is also the lender's maximum LVR in the example above.

Once the LVR increases by 10% or more above the lender's LVR limit, a margin call would be made.

If, for example there was a 20% fall in the value of the portfolio, (ie, total value of the portfolio after 20% fall would equal $96,000) the LVR = 83.33% ($80,000 borrowings/$96,000 portfolio value). Therefore the LVR margin has increased by more than 10% above the lender's limit and a margin call would be made.

The maximum allowable LVR of 66.67% needs to be restored. This can be achieved by either:

(a) Lodging additional capital ie. contribute an additional $24,000.
This would increase the total value of the portfolio to $120,000 again ($96,000 + $24,000)
The new LVR = 66.67% ($80,000/$120,000)

(b) Reduce the loan amount by $16,000 from cash injection
Therefore, the loan value is now $64,000
The new LVR = 66.67% ($64,000/$96,000)

If the original loan was not the maximum allowable under our prudent gearing standards (ie, in the above example, say, $60,000 instead of $80,000), the original LVR would be lower than 66.67%. In the above example, the original LVR would be 60% (loan of $60,000/$100,000 total value).

As it is the margin above the lender's maximum LVR that determines margin calls, starting with an LVR lower than the maximum effectively reduces the likelihood of a margin call. Again, in the above example, if the lender's maximum allowable LVR is 66.67%, but your original LVR is 60%, it would take a 21.75% fall in the value of the total portfolio to trigger a margin call.