Quick Facts…

Gearing

Gearing is simply borrowing money for investment. The investment could be in property (residential or otherwise), a selection of shares or even a balanced investment portfolio. Gearing is, in essence, directed towards producing a larger investment return by using borrowed funds, often in addition to the investor's own funds.

However, the down side is that gearing can multiply your losses if your investments fall in value.

For a gearing strategy to be successful in the long term, the investments you acquire with borrowed money must generate a total return (income and growth) that exceeds the after tax costs of financing the investments (including interest on the loan).

There is a variety of ways you can borrow money to invest:

1. You can borrow against the equity in your home. This approach offers the benefit of a low interest rate and there are no restrictions on which investments you can buy.
2. You can take out a margin loan with a lending institution. With a margin loan, the investments you purchase are used as security for the loan. The lending institutions will typically lend you up to 70% of the value of approved assets.
3. You could invest in an internally geared share fund. These are funds that borrow to leverage an investment in Australian or global shares.

Gearing increases the risk profile of the investor's portfolio. The investor has greater opportunity for capital gain and greater exposure to capital loss because of market movements.

The investor should be in a position to cope, both emotionally and financially, with the volatility inherent in gearing.

Investors should have adequate financial resources and be in a position to:

> Gearing should be seen primarily as a wealth creation strategy rather than a way to save tax. If you invest in assets that fail to produce enough income or capital growth over the longer term, your losses could outweigh any reduction in your tax bill.

> Service the borrowings comfortably. The investors must fund from other income, the after tax difference between the cost of borrowings and investment income. This may require outlays of amounts in excess of this amount because of the timing of payments. Interest may be payable prior to receipt of investment income or the investor's tax refund.

> The cost of borrowing may increase, or the investment income may decrease, over the term of the investment. Unless the investor has ready access to additional funds, the investment may have to be sold at an inopportune time.

> If you take out a margin loan, you may need to meet a margin call if your investments fall in value. To reduce the likelihood of a margin call, you should maintain a conservative loan to valuation ratio. You should also hold significant cash to meet margin calls if required.

> To reduce your tax bill at the end of each year, you could consider paying interest in advance. Interest deductions for up to 12 months in advance can be claimed in the tax year they are paid. However, if you take a fixed rate loan, you may incur penalties if you repay the loan prior to the end of the fixed rate period.

> Investors should consider income protection insurance to make sure you are covered if you are disabled and can't earn an income. If the lending institution requires the entire loan to be paid back in the event of your death, you should ensure you have sufficient life insurance.