



# A guide to investment gearing

**Margin lending (or gearing) is another term for borrowing to invest and it can be an excellent strategy to enhance your investment performance.**



People gear investments so that they have more money working for them, in order to create wealth more quickly. **Negative gearing** is when you borrow to invest and the interest cost of the loan exceeds the investment income.

Most Australians 'gear' when they buy their home. They borrow money and repay it over a number of years. Borrowing to invest is a similar concept, except that the investments you buy will earn income to help you repay the loan and, in most cases, the Australian Taxation Office will give you a tax deduction on the interest on the loan.

However; you should note that tax advantages are not generally recommended as the main reason for choosing margin lending.

## How does gearing work?

Let's assume you borrow \$100,000 to invest, and your marginal tax rate is 48.5%. If the interest rate is 7% per annum and the investment income is 4% per annum (an example of negative gearing), then the net after-tax cost of

borrowing is \$1,545 in the first year (or \$29.71 per week), as illustrated:

Cost of \$100,000 loan @ 7%	\$7,000
Investment income @ 4%	\$4,000
Pre-tax cashflow shortfall	\$3,000
Tax deduction @ 48.5%	\$1,455
After-tax cashflow shortfall	\$1,545

Now, let's assume that the investment portfolio increases in value by 10% in the first year. That's a \$10,000 gain, and it means that you would be \$8,455 better off after taking into account your \$1,545 cashflow shortfall. In other words, you have created \$8,455 of wealth out of nothing.

Conversely, if your investment portfolio suffered a 10% fall, you would have a paper loss of \$10,000. When that is added to your \$1,545 cashflow shortfall, you will be \$11,545 worse off.

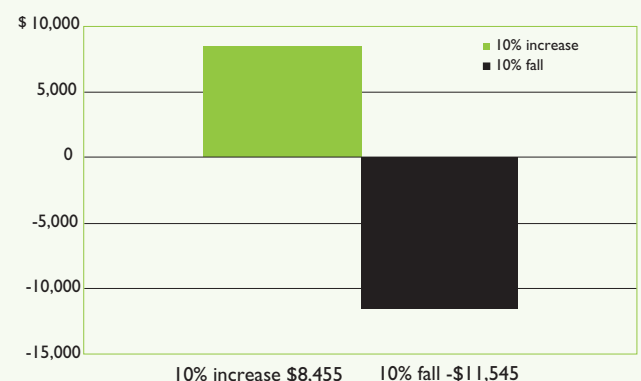
So, gearing not only has the potential to multiply your gains, it can also magnify your losses, as you can see in Graph 1.

## Which investments should you use?

The key to gearing successfully is to select investments which will generate a reliable income stream and sound capital growth. In the case of negative gearing, it is essential that the capital growth is sufficient to exceed the net after-tax costs of the exercise (ie the cost of the loan, less investment income, less tax deductions).

For this reason, many investors choose to invest in quality shares or a diversified managed investment when they embark on a gearing strategy.

**Graph 1: Understanding the effects of gearing**  
The effect of a 10% increase or fall in value on a geared portfolio



Source: ASGARD



## Gearing and franked dividends

An advantage that quality shares have over other investments is the dividend imputation system. This system can result in you receiving tax credits and therefore being liable for a reduced amount of tax on the dividends you receive (known as 'franked dividends'). This will impact positively on your cashflow.

## Minimising the risks

You can minimise the risks associated with gearing by following these guidelines:

1. Do not over-commit. Only borrow as much as you can comfortably afford to repay, taking into account that there may be periods when your investments do not generate income (especially with residential property investments).
2. Diversify your investments so that you are not relying on just one or two investments.
3. Invest only in quality growth assets which have proven track records of reliable income streams and capital growth.
4. Invest for the long-term to give your investments sufficient time to generate adequate capital growth.
5. Insure your salary so that you will not have to sell your investments (possibly at a loss) due to you or your spouse becoming seriously ill or disabled.
6. Fix your loan to protect your cashflow should interest rates rise.

## Tax on selling your investments

If you sell your investments for more than you paid for them, you will have a capital gains tax liability. Under the current tax rules, this will be a maximum of 48.5% but is likely to be only 24.25% if the shares are held for 12 months and you are eligible for capital gains tax discounting. This can be minimised by waiting to sell your investments until your tax rate is less than it is now (eg in retirement). Of course, if you never sell your investments, you will never have to pay capital gains tax on the profit.

## An important note about margin lending and risk management

While gearing can increase your potential for greater returns, it can also increase the potential for greater losses if investments perform poorly. Due to this risk, gearing may not be a suitable investment strategy for every investor. When considering the benefits of gearing, we also recommend you see your financial adviser. As with any investment decision, gearing should be included within a personalised investment strategy that takes into account your personal risk profile and your individual financial situation.

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