crest FINANCIAL SERVICES

Growing your Wealth

Gearing in plain english

What is gearing?

In simple terms, gearing is borrowing to invest. The investment could be in direct shares, managed investments or property. Gearing is, in essence, directed towards producing a larger investment return by using borrowed funds, often in addition to your own funds, so that your financial goals can be achieved more quickly.

Gearing can be used as part of the overall investment strategy to help build your wealth.
It gives you greater potential to generate wealth because you have more money invested.

Did you know?

Gearing can be used to accelerate the process of wealth creation...

Gearing strategies allow you to make a larger investment than would be otherwise possible with your own funds, increasing the potential for capital gain.
While any gearing strategy should be approached with care and under the guidance and advice of a qualified professional – this can be a very effective strategy to growing your wealth.

Gearing can help you keep all the profits...

After you cover the cost of borrowing and tax, 100 per cent of the growth and the income you earn on the investment are yours to keep.

Tax advantages...

When you borrow to invest in income-producing investments, the interest on your loan is treated as an expense for tax purposes. This generally means that you can claim the interest as a tax deduction.

Who is gearing suited to ?

Gearing is best suited to people who are comfortable taking extra risk with their investments and those who can cope with potentially large fluctuations, both up and down, in the value of their investments.

Generally gearing is most appropriate if you:

- have a high level of comfort when it comes to investing,
- have a high disposable income, with a regular pattern of surplus income in a typical year,
- are prepared to hold your investments for at least five to ten years,
- can afford the interest repayments without relying on the investment, and;
- have funds, other than borrowed money, that can be accessed at short notice, should the need arise.

How does it work ?

Gearing aims to increase the investor's return by using borrowed funds in addition to their own capital.
It is 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.

It is best to gear against growth-based investments, such as shares and property, and gearing should always be viewed as a long-term strategy. You need to be able to retain the investment and maintain loan repayments for at least five to ten years to obtain the benefits of long-term growth.

The fundamental rule is that gearing an investment only makes sense if:

- the income received from the investment (after taxes and all expenses) is expected to increase in the future to cover the (after tax) cost of interest and give a reasonable return on the equity invested, or
- the market value of the investment asset (after taxes and expenses) is expected to increase at a rate that exceeds the negative cash flow (after tax).

Think for a moment...

If you are considering a gearing strategy to grow your wealth, talk to us!

We will provide the right advice and work with you to ensure that you are comfortable with gearing and that it meets your particular circumstances and financial goals.

CASE STUDY

Eva's Investment	Non Geared	Geared
Eva's equity	$100,000	$100,000
Amount borrowed	$0	$100,000
Total investment	$100,000	$200,000
Market rises by 10%		
Value of portfolio	$110,000	$220,000
Loan outstanding	$0	$100,000
Eva's equity	$110,000	$120,000
Market falls by 10%		
Value of portfolio	$90,000	$180,000
Loan outstanding	$0	$100,000
Eva's equity	$90,000	$80,000

Eva's story

Eva has recently received an inheritance of $100,000 from her grandmother.

Eva is 35, has surplus income and is a growth investor. She would like to use a gearing strategy so she can accelerate her wealth accumulation for retirement. Eva would like to borrow $100,000 and invest in an Australian share fund.

The table shows that gearing accelerates Eva's equity gains when the market rises. It also shows that her equity falls more when her investment is geared and the market falls, compared with her non-geared investment.

What you need to know...

Researching and planning wealth growth strategies that are right for you is the first step towards achieving your financial goals.

'We build and maintain strong partnerships with our clients; built on foundations of credibility, honesty, trust and the delivery of exceptional customer service'...

In line with our mission/service statement, we firmly believe that it is our duty to make you aware of all aspects of any investment prior to entering into it.

Here are some things we would like you to consider when deciding if gearing is right for you:

- Investment risk is increased with gearing. There is a greater opportunity for capital gain but also exposure to capital loss.
- Should your investment portfolio lose value, you may be required to repay the funds you have borrowed.
- To qualify for a tax deduction for the interest, the borrowing needs to be undertaken with the purpose of earning assessable income. If this is not the only motive then the interest deductions may be disallowed by the Australian Taxation Office.
- Where an investment portfolio is negatively geared, your cash flow is reduced because the investment income does not cover interest costs. Cashflow from other sources would be necessary to fund the loan.
- If the cost of borrowing increases or investment income decreases, you may need to cover the additional cost of borrowing from other sources.
- Capital gains tax may apply when an investment asset is sold.
- Income protection and life insurance are recommended to ensure the loan can be serviced if you fall ill, are unable to work or repay the outstanding debt in the event of death.
- Changes in legislation may reduce benefits currently available for gearing strategies, in particular in relation to interest deductibility.

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