

GEARING

INFORMATION BROUGHT TO YOU BY **CENTRECAPITAL**

Gearing

Geared investments (or investments made from borrowed money) are generally designed to increase the potential for tax-deductible expenses (such as interest costs). The ultimate goal of this strategy is for the assets purchased with borrowed money to increase and create a profit upon sale after repayment of borrowed funds plus expenses. The assets purchased would normally be direct property or Australian listed shares.

Please note that there are **risks** when borrowing money to invest. Adding borrowed funds to your funds increases both your total investment and your potential for higher returns.

The main risk associated with such a strategy is that the asset you purchase with borrowed funds could fall in value, even to the point where selling the asset, if forced at an inappropriate time, doesn't completely satisfy the underlying debt. This will mean that, although you might receive extra tax deductions over time, you might actually lose capital (and carry over a debt) when you eventually sell the asset.

Using a margin lending or gearing facility to acquire a financial product or investment multiplies the effect of both rising and falling values. Therefore, in a falling market, losses on a portfolio invested in through a margin lending/gearing facility are greater. In a falling market, you will more than likely receive a margin call notice to reduce the loan balance by either depositing additional funds and/or disposing of all or part of your financial products/investments.



Whatever happens to the market value of your financial product/investment, you are still legally obliged to pay back the full amount you have borrowed and pay all interest charges on the loan.

Other risks involved are that the investment may not perform as expected, interest rates may rise, taxation regulations may change adversely or your financial circumstance may change.

The potential to make a higher gain by borrowing exists only because of the added risk you take in using borrowed funds in the first place.



Lump Sum Gearing

A simple example of how *Lump Sum Gearing* can work is as follows:

You buy a \$100,000 Investment with \$30,000 of your Money, borrowing the remaining \$70,000. If the Investment Value has increased to \$110,000 when you sell it, you have made \$10,000 on your initial \$30,000 Investment. A Return of 33%.

On the other hand if you had \$100,000 Cash to invest and when you sold the investment it was worth \$110,000, the return on your investment is only 10%.

This simple example does not take into account any borrowing or interest costs or any tax deductions.

The reverse situation is true if the investments fell by 10%. The investor that invested his cash would be down \$10,000 or 10% but the geared investor would also be down \$10,000 but that equates to 33% of his initial investment.

Regular Gearing

This concept can be used in conjunction with a Dollar Cost Averaging investment. It enables you to borrow funds each month to match your own contribution. All the benefits of gearing are therefore realised without the necessity to borrow large amounts up front.



8% which is 100% tax deferred than the actual income received by the investor after tax is 8% per annum. Tax deferral is a result of depreciation and other accounting entries in relation to the properties.

It is also possible to get access to a positive gearing strategy using Australian shares especially when they are paying high levels of franked dividends. For example if an investor is on marginal tax rate of 30% per annum and they receive a dividend of 10% (which is 100% franked) then they do not need to pay any physical cash tax on this as the imputation credit cancels out tax payable for the individual investor.

Talk to Centre Capital

To arrange a meeting with one of our financial planners or advisors, please email advice@centrecapital.com.au or call 1300 132 214. For further information, visit our website at www.centrecapital.com.au

Margin Lending

Under margin lending, the loan is secured against the investment. The lender provides a list of specific securities that it will accept, and the maximum lending percentage.

The risk with margin lending is that should the value of an investment fall to outside these acceptable parameters then you may be required to inject further cash into the facility to keep it in order. Should you not have the cash available you may be forced to sell the assets notwithstanding they may be worth less than what you paid for them.



Positive Gearing Strategy

Under a positive gearing strategy, the loan interest after tax cost is less than the after tax income of the investment.

Usually to develop such a strategy you are looking at assets such as commercial property which have tax deferred income. This means that the income is not necessarily taxable in the year that you receive it.

Lets assume the tax payers marginal rate of tax is 40%.

Interest rates are at 10% which means that after tax cost of the interest to the investor is 6% per annum as they receive a tax deduction of 4% (10% x 40%).

If they purchase a portfolio of commercial property yielding



The advice provided in this document is General Advice only and we have not considered your personal circumstances. Before making any decision on the basis of this advice you should consider if the advice is appropriate for you based on your particular personal circumstances.