Wealth Creation

Overview of gearing

Aon Hewitt Financial Education Series

The purchase of managed funds, property or shares using borrowed monies remains one of the most effective ways to accumulate wealth over the longer term as it allows you to make a larger investment than would otherwise be possible. Gearing can be an effective strategy if the income and capital growth on the geared investments are larger than the costs of funding the geared investment, after taking into account any tax that may be payable.

Is gearing appropriate for you?

Gearing is a long-term strategy. It should only be chosen if you are holding the investment and loan for at least 7 years. This is because you need to give the asset time to grow.

In addition, gearing has many risks in return for the potential of higher investment performance. As such, we only suggest gearing if you are comfortable investing in assets that may increase or decrease in value over the short-term. If you are not comfortable investing in an asset that may decrease in value then gearing is not for you.

You should also consider whether you can afford to make the annual interest payments. If your income were to reduce or stop, then you may be forced to sell the investment when it has gone down in value instead of up. This means you may need to use some of your own money to repay the rest of the loan. Therefore you must have adequate income to comfortably cover the interest payments and be reasonably secure.

Due to this, we strongly suggest you take out income protection insurance if you undertake a gearing strategy. Income protection insurance will not cover you if you lose your job or retire, but will provide you with up to 75% of your income if you are unable to work due to illness or injury. Your financial adviser can provide you with more information on income protection and your other insurance needs.

To summarise, gearing is appropriate for people:

- Who have a growth or high growth risk profile and 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 7 years.

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Advantages of Gearing

- Gearing allows you to invest earlier, as you don't need to save up the money. You simply borrow the investment amount.
- You also earn income and growth on the full investment amount, as compared to if you had to save the money.
- The interest is tax deductible if you invest in an asset that produces income, such as a rental property, shares or managed funds.
- Gearing magnifies returns. This is because you are earning a return on borrowed money. For example, if you have $100,000 and invest at 7% you will earn $7,000. If you then borrow an additional $100,000 you will earn $14,000 income. But you have still only contributed $100,000 of your own money.

Risks of Gearing

- **Gearing can magnify losses:** As gearing magnifies the potential return you may receive on your investment, it can also magnify the losses if your investment declines in value.
- **Risk of interest rate changes:** You need to ensure that you could manage the interest repayments if interest rates were to increase. We strongly suggest that before you start a gearing strategy that you check to see that you could still make the loan repayments if interest rates increased by 3%.
- **Importance of gearing into growth assets:** Gearing costs money. Each year you need to pay the annual interest on the loan. If the investment you have geared into isn't growing in value then you should reconsider the strategy.
- **Risk of loss of cash flow:** You should only borrow to invest if you have the financial ability to absorb the effect of potential falls in investment value, the ability to fund margin calls if using margin lending and/or the increased cost of interest payments. Another risk is that the income from the investment, (rent or dividends) may decrease or temporarily cease, which may place a burden on your cash flow.
- Gearing is generally not appropriate for people who do not have sufficient cash flow or income to meet the annual borrowing costs.

What investments can I gear into?

The most popular investment to gear into is property. When you purchased your home you probably used gearing, by borrowing the money from the bank or other lender. However as your home does not produce an income, you are not able to claim the interest on the loan as a tax deduction. You can also borrow to invest into shares or a managed fund.

Do I have to borrow a large amount?

No, there are different methods of gearing which allow you to borrow different amounts and use different assets as security. Your financial adviser can discuss this with you to ensure the most appropriate type of gearing is used and you do not over borrow. You can use instalment gearing starting with a loan of $5,000 and regular monthly borrowings of $500.

Types of Gearing

The different methods of gearing are as follows:

- Home Equity Borrowing
- Margin Lending
- Equity Loan
- Instalment Gearing
- Capital Protected Investments

Home Equity Borrowing

This is where you borrow funds using an existing property as security. In most cases this would be your home, although an investment property can also be used. This sort of borrowing generally has the lowest interest cost.

Margin Lending

Margin lending is where you use existing shares, managed funds, or cash as security to borrow. Margin lending varies from home equity gearing as the investments are used as security. As such, the loan to value ratio (LVR) or the amount of the loan as compared to the amount of your investments will change on a day-to-day basis. If your LVR drops too far you may be liable for a margin call, where you need to provide additional security, repay part of the loan or sell some of your investments to get your LVR back within acceptable limits.

Equity Loan

Equity lending is where you use existing shares, managed funds, or cash as security to borrow. Equity lending varies from home equity gearing as the investments are used as security**.** Unlike the margin lending, the equity loan facility do not have margin call and often setup as principal and interest loan program, where you accept a commitment to make regular repayments.

Instalment Gearing

Instalment gearing is where you invest over a period of time. For example, you borrow an initial $5,000 and contribute your own $5,000. Every month you keep borrowing an additional $250 and you contribute $250 of your own money. This can be a good way to get an introduction to borrowing as you can keep your loan amounts relatively small.

Capital Protected Investments

These types of investments generally allow you to borrow 100% of the purchase price and have a fixed term investment, for example 7 years. At the end of the term you are guaranteed to get back your original investment amount. If the investment has gone up, you will receive the gain, but if the investment has dropped in value you will not be liable for the loss.

These types of products are suitable for those with surplus cash who do not have, or do not want to, put up existing assets as security. The interest rates on these types of products are generally higher than for home equity or margin loans due to the cost of the capital protection.

Please refer to the fact sheets under the Wealth Creation Financial Education Series on each of these types of gearing for more information.