Gearing to Invest and Debt Recycling

This document contains factual and general information only to assist you in understanding financial planning concepts. It is designed to be used in conjunction with a Statement of Advice.

Gearing refers to borrowing funds for investment purposes.

Borrowing money to invest can let you get more investment assets working for you sooner.

Gearing should only be used to invest in assets with prospects for long term growth, like shares, managed funds, and property. There are also potential tax benefits from gearing.

Common examples of gearing to invest include buying investment property through a property loan, or investing in shares or managed funds either by borrowing against home equity or via a margin loan, which is a loan secured by investments.

Gearing is utilised by investors due to the potential for increased returns on the geared investment. Returns are magnified because the investment is larger than it may have been without the use of borrowed funds. Many investors combine their own funds with borrowed funds to increase the size of their investment portfolio.

Gearing may be appropriate for the investors who:

- Have strong cash flow
- Have a long term investment time frame of a minimum 7 years
- Are prepared to accept short term fluctuations in the investment returns
- Are on higher marginal tax rates

Properly managed, gearing to invest has many benefits. Gearing can be attractive to investors because loan expenses and interest costs can often be claimed as a tax deduction. However, gearing can also magnify losses.

Advantages	Disadvantages
Increases the size of an investor's portfolio	Long term investment strategy only
Can start an investment strategy earlier	Timing of interest payment and investment income is important
Can magnify gains and increase investment income	Can magnify losses
Can help diversify an illiquid portfolio	Can cause negative net assets position or loss of assets
Can help reduce volatilely with a well-diversified portfolio	Can require additional income to service the debt (Surplus cash flow needed)
Can be tax effective especially for high income earners	Difficult to unwind especially in the short term without negative effect

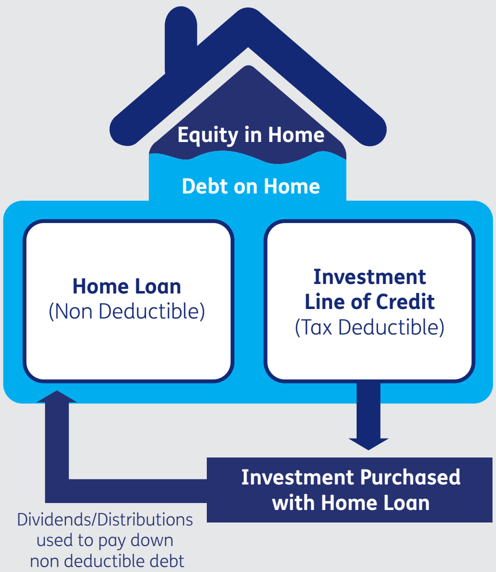
Debt Recycling

Debt recycling is used as part of an overall strategy to simultaneously create investment assets which create additional income and opportunities for capital growth, and shape a more tax effective debt structure. The interest costs for investment debt are generally tax deductible, while the interest cost on a home loan is not tax deductible.

For most Australians, your main asset will be your home. Debt recycling involves using some of the equity from your existing home for investment purposes. Any investment income from your geared investment as well as surplus cash flow can be used to reduce your outstanding home loan balance, thereby reducing your non-deductible debt and converting this into tax deductible debt.

This may also be a tax effective strategy for those with high marginal tax rates.

Gearing using a Line of Credit



Styles of Gearing

Throughout the long term life of a geared investment, it can be positive, neutral or negatively geared.

Positive gearing is where the income received from the investments is greater than the cost of borrowing i.e. loan interest and other associated costs. Over the long term, if the after-tax capital gain and income of geared investments exceeds the after-tax costs of the investment, then this can be an efficient wealth building strategy.

Neutral gearing is where the income from the investments equals the interest costs of borrowing. There is neither a tax advantage nor disadvantage. Success of this strategy relates to the long term growth of the investments.

Negative gearing is a term which applies when the cost of borrowing exceeds the income generated from the geared investments. Some investment expense may need to be met by salary income and not investment income alone. The costs can normally be used as a tax deduction by the investor to offset other taxable income such as salary. An investor considering a negatively geared strategy would expect to achieve sufficient capital gain from the investment in the long term, in order to offset the after-tax income loss sustained as a result of negative gearing.

Potential to increase losses and gains

It is important to understand that the potential to lose money also exists. There are extra risks to consider when gearing to invest. While performance of investments can vary and expenses can go up, gearing can magnify both losses and gains.

For example, an investor has $50,000 to invest, and is considering borrowing $100,000 to invest so they have a total of $150,000 in the share market. The table below compares the expected total returns on the investment, with and without gearing under differing capital return scenarios:

	Capital Gain of 5%		Capital Loss of 5%	
	Ungeared	**Negative Gearing**	**Ungeared**	**Negative Gearing**
Personal Funds	$50,000	$50,000	$50,000	$50,000
Amount of Loan	-	$100,000	-	$100,000
Total Investment	**$50,000**	**$150,000**	**$50,000**	**$150,000**
Annual Income @ 3% p.a.	$1,500	$4,500	$1,500	$4,500
Loan Interest @ 6% p.a.	-	($6,000)	-	($6,000)
Net Income	$1,500	($1,500)	$1,500	($1,500)
Capital Growth	$2,500	$7,500	($2,500)	($7,500)
Total Return	$4,000	$6,000	($1,000)	($9,000)
Client Funds Invested	$50,000	$50,000	$50,000	$50,000
Return on Investment	8%	12%	-2%	-18%

The table above, illustrates the potential for investors to achieve higher returns on an investment of $50,000 if it is geared. However, any investor considering a gearing strategy must also consider the increased risk involved. Downward movements in investment markets, or increase in interest rates, may have a significant negative impact on portfolio returns.

When considering a gearing strategy, an investor should be fully aware of their tax position. Negative gearing is not an investment technique that is suitable for all investors. Risks and rewards are magnified and surety of cash flow to cover shortfalls is crucial. Careful consideration of an investor's Investment Profile and circumstances is required prior to implementing a gearing strategy. Investors should obtain financial advice prior to adopting a gearing strategy.

Types of Loans used in gearing strategies

Line of Credit

One effective way of gearing is borrowing against the equity you have built up in your home. Line of credit loans are a common facility to borrow funds. You are then required to make interest payments to your loan provider. Lines of credit loans are generally interest only and the interest is calculated on the loan balance daily.

Margin Loans

Another type of gearing uses a margin loan to obtain the funds for investment. Margin loans require you to provide some of your own equity as collateral for the loan. The equity may be investments or securities such as managed funds or shares. Generally speaking you will be allowed to borrow only a portion of the market value of these investments or securities. This is known as the loan to security ratio (LSR) or loan to value ratio (LVR). If the LSR increases above predetermined thresholds i.e. the loan amount exceeds the value of the investments by a certain limit set by your lender, you will be required to make additional payments to return the LSR to its original value or below the margin call threshold.

Margin Calls

A margin call is made by your lender when the balance of your loan is more than the value of your investment by a certain amount. This can happen in the situations when the investment market falls reducing the value of your investment portfolio.

Once a margin call has been made, you will be required to respond to the lender within a certain timeframe. It may be as short as 24 hours. If you are unable to meet the margin call, the lender will sell a portion of the assets that you lodged as security to meet the amount of the margin call. It is important to have necessary arrangements in place should you receive a margin call at any time.

A margin call can be cleared in the following ways:

- Providing cash to reduce the loan
- Providing 'lender approved' additional assets as security
- Selling assets and using the proceeds to reduce the loan

Margin lenders usually allow a 'buffer' so that small falls in the value of your investment portfolio due to the market movement do not result in a margin call.

The lenders usually maintain a list of 'approved' investments. This list may change from time to time and therefore, the LSR may change if a particular investment which is used as security is removed from the list by the lender. A margin call may result if the LSR exceeds the allowable limit. If a margin loan account is 'in the buffer', you are not required to take any actions, however, further funds may not be borrowed until the account is restored to below the buffer LSR.

When will you receive a Margin Call?

The example below shows the situation where a 20% fall in the market value of your investment immediately after the commencement of a gearing strategy can lead to a margin call. Let's assume that the lender allows loan to security value of 70%.

	Before 20% market fall	After 20% market fall
Market value of investment	$100,000	$80,000
Loan limit		
(LSR 70% allows you to borrow a maximum $70,000 from lender)	$70,000	$70,000
Buffer allowed by lender 10%	$10,000	$10,000
Loan balance (amount you borrowed)	$70,000	$70,000
LSR	70%	88%

In this case, the investor is required to restore the LSR to lender's allowed limit of 70% by implementing one of the three options detailed above to clear the margin call. For example to provide additional cash to bring the LSR back to loan LSR would be $20,000. Once you have exceeded the buffer you must return the LSR to the maximum loan LSR not the buffer amount.

Insurance

Gearing strategies can result in a cash flow shortfall as costs, including interest expenses can exceed income received. Therefore you will need to be confident that you will be able to maintain sufficient cash flow to meet such shortfalls. As salary generally forms a significant part of an individual's cash flow, it is recommended that you have adequate personal insurance to repay your loan, or meet its interest costs, in the event of death, sickness or incapacity.

Important Information

Current as at November 2020. This information is of a general nature only. It does not take into account your particular financial needs, circumstances and objectives. You should obtain professional financial advice if you have not already done so before acting on this information. You should read the Product Disclosure Statement (PDS) before making a decision to buy or sell a financial product.

Any case studies, graphs or examples are for illustrative purposes only and are based on specific assumptions and calculations. Past performance is not an indication of future performance. Superannuation, tax, Centrelink and other relevant information is current as at the date of this document. This information contained does not constitute legal or tax advice.

CVD_0112 11/2020