

understanding gearing

Gearing is a wealth accumulation strategy where borrowed funds are used to purchase investments. It is a strategy which increases your exposure to investment markets and can be an effective way to grow more wealth over time.

With a geared portfolio, you are able to access the funds you need to take advantage of investment opportunities. By adding borrowed funds to your own capital, you have a larger pool of funds to acquire more assets and better diversify your portfolio.

Although gearing assists in wealth accumulation and can help you achieve your financial goals, it is not a strategy without risks. Just like other investment strategies, gearing is subject to the same risks associated with investing. Whilst there is potential for higher returns, the multiplier effect of gearing also means that there is potential for greater losses if investments fall.

Gearing is therefore not a strategy that is suitable for everyone. It is important that you consider your individual goals, financial circumstances and tolerance to investment risks before considering the use of borrowed funds for investment.

WHAT ARE THE BENEFITS OF GEARING?

- Gearing helps you build wealth and increases your access to investment opportunities.

- Having more to invest allows you to better diversify your portfolio and spread your exposure across a wider range of investments.
- Interest on the loan may be tax deductible.

HOW GEARING WORKS

Gearing leverages your exposure to investments to take advantage of growth in financial markets. By using a loan to increase the size of your portfolio, the returns on your investments are magnified by the additional investment exposure. Likewise, any loss on investments will also be magnified by the loan.

For gearing to work, the investments you acquire needs to generate after tax returns (income and growth) which exceeds the after tax cost of borrowing. It is a strategy that is normally attractive for growth assets such as shares and property as these investments have the greater potential to generate income and capital growth above the cost of borrowing.

There are various types of gearing facilities that can provide you with an investment loan. If you have an existing investment portfolio, you are able to borrow against this investment to expand your portfolio (known as a margin loan). Alternatively, you may be able to draw on the equity in your property to purchase other investments.

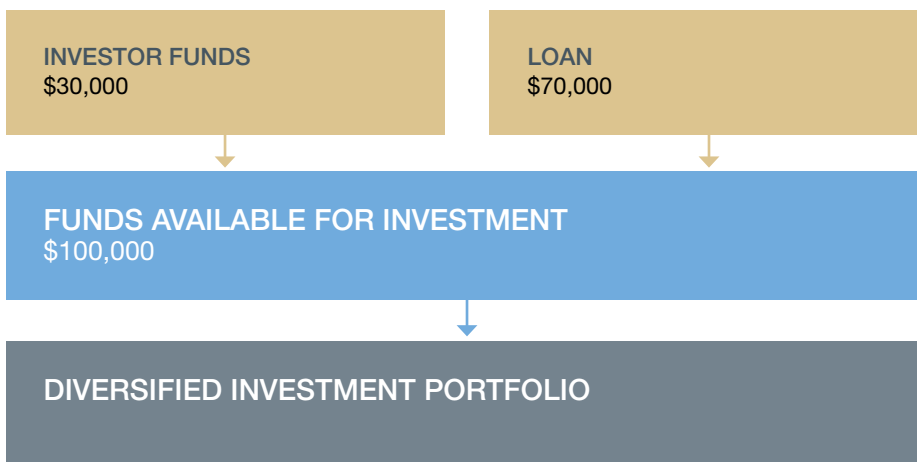
WHAT IS NEGATIVE GEARING?

Negative gearing refers to a portfolio position where the interest paid on your investment loan exceeds the amount of income generated by your portfolio. The interest above your portfolio's investment income is generally tax deductible against your other income, but cannot be used to offset your capital gains.

Tax deductions also extend to interest that is paid in advance. Prepaying interest (up to 12 months in advance) can be a useful strategy to manage income in the current financial year if income during this period is unusually high.

WHAT SECURITIES CAN I BORROW AGAINST?

A margin lending facility will generally lend money against the top 300 ASX listed shares as well as hundreds of managed investment funds. Investment loans and home equity loans may be even more flexible and offer even more investment choices. Your loan provider will be able to provide you with a complete list of acceptable securities.



This article by Frank Camilleri (above), National Technical Manager.

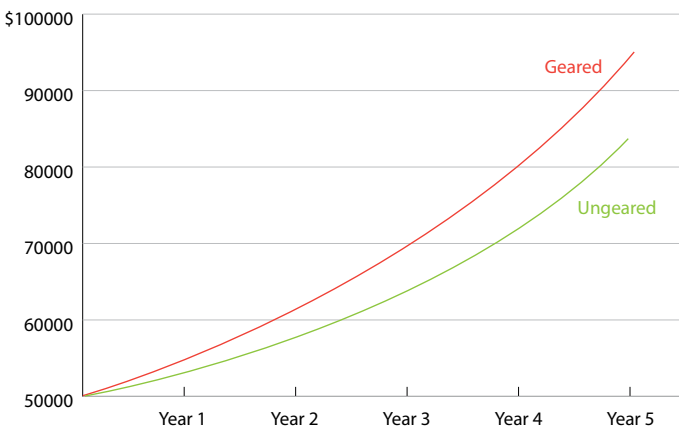
CASE STUDY

Mary uses \$50,000 of her own capital and borrows \$50,000 through a margin lending facility to invest in a diversified portfolio.

The table below shows how Mary's geared portfolio helped her build more wealth compared to investing personal capital alone. The accompanying graph highlights this difference over the five years assuming 12% per annum capital growth and a 9% annual interest expense.

Table 1: Mary's Net Portfolio Position

	Ungeared Portfolio	Geared Portfolio
Cash Invested	\$50,000	\$50,000
Investment Loan	-	\$50,000
Total Invested	\$50,000	\$100,000
Portfolio at End of 5 Years*	\$85,000	\$170,000
Equity Value	\$85,000	\$120,000
Gross Return	\$35,000	\$70,000
Less Interest Expense*	-	(\$22,500)
Net Unrealised Gain	\$35,000	\$47,500
% Net Return over 5 years	70%	95%



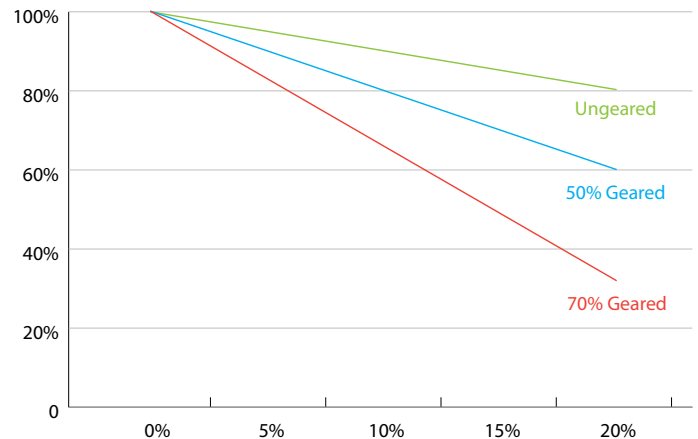
WHAT ARE THE RISKS OF GEARING?

A geared portfolio enhances your returns in a rising market but also magnifies your losses in a falling one. If your portfolio falls in value, the losses on a geared portfolio will be larger than on an ungeared portfolio. The graph below highlights the net equity position of a portfolio using 50% and 70% borrowed funds versus a portfolio without borrowings.

In addition, if a margin lending facility is used, you may also receive a margin call if your loan exceeds a set proportion of the portfolio's value (known as the loan to valuation ratio or LVR).

A margin call is a request by your loan provider to bring the LVR of your portfolio back within the approved limit by making a cash deposit, registering additional security, or selling a part of your portfolio. If you are unable to meet a margin call, you may be forced to sell some of your investments at an inopportune time.

Gearing also entails risks associated with interest rates. As interest rates rise, the cost of servicing your geared portfolio will also increase. You will need to ensure that you remain comfortable with any potential increase in interest payments.



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