Understanding gearing

This document provides general information to help you understand the financial planning concepts related to **gearing**.

This document has been published by FYG Planners Pty Ltd, Australian Financial Services Licensee /Australian Credit Licensee No. 224543 ABN 55 094 972 540 Contact Information: Address: Level 2, 39-41 Alexander Street, Burnie 7320 - Phone: (03) 6440 3555 for use in understanding general financial planning concepts related to gearing.

HOW TO READ THIS DOCUMENT

Managing your finances to meet your day to day requirements as well as your long–term goals can be a complex task.

There are all sorts of issues you need to consider such as taxation, legislation, protecting your wealth and assets, associated costs and the inherent risks of investment.

When undertaking a financial plan, it is important you understand how these issues will impact you and what you should expect over time.

Your financial adviser will provide you with a Statement of Advice (SOA) which sets out the details of the advice and how it will meet your goals and objectives.

This document provides some additional information to help you understand the financial planning concepts discussed in the SOA in relation to **gearing**.

It is very important you read this document to help you understand the benefits of the strategies recommended to you and the associated costs and risks.

Please contact your adviser if you do not understand anything, or need further information or clarification.

Gearing

Gearing simply means borrowing money to invest. Gearing may be used to accelerate the process of wealth creation by allowing an investor to make a larger investment than would otherwise be possible. The borrowed money can be invested in a number of ways including direct shares, property and managed investments.

Gearing can be 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.

As long as the net gains from your investments over the long term outweigh the costs of borrowing, gearing will **magnify those gains**. Gearing is considered to be an effective long term strategy because experience has shown over the long term, growth based investments can deliver the higher potential returns required. However, investments suitable for gearing are generally more volatile than others and can also lose value. During a period when investments are losing value, gearing will **magnify those losses**. Therefore, any gearing strategy should also be prudent enough to protect the investor from being forced to sell investments at a low point in investment markets.

Gearing is only appropriate for growth based investments such as shares and property and should be viewed as a long–term strategy, being a seven to ten year timeframe. You need to be able to retain the investment (and maintain the loan repayments) during potential short–term market declines in order to obtain the benefits of long term growth.

Negative gearing

Negative gearing occurs when the interest payable on borrowed funds and any expenses incurred to derive that income exceeds the net income received from the investment. The investor must have surplus income from other sources over and above their day to day living expenses to meet the shortfall.

Gearing is most appropriate for people:

- with an assertive or aggressive risk profile, who are prepared to accept investment volatility
- with a strong, secure cash flow (which is protected by appropriate levels of insurance)
- on higher marginal tax rates, and
- with an investment time–frame of greater than seven years.

The benefits of gearing

The potential benefits of gearing include:

Potential for increased capital gains and diversification

Gearing increases the size of an investor's portfolio by allowing them to purchase additional investments with borrowed funds. By increasing the number of securities in an investor's portfolio, the volatility of the overall investment portfolio may be reduced due to greater diversification.

Taxation

Tax savings should never be the primary reason for choosing an investment strategy however, there are some additional tax benefits associated with gearing. Under current legislation, interest payments on money borrowed to invest in income producing investments, together with ongoing expenses, can normally be claimed as deductions against your taxable income. In some cases investors may be able to pay the interest costs for up to 12 months in advance. The higher your marginal tax rate, the greater the tax saving you will receive from tax deductions. Investment income predominantly sourced from Australian investments may provide an additional benefit through the value of any franking credits.

Gearing facilities

A straight forward and perhaps most cost effective way to gear is to borrow against the equity in property you already own (for example, your home) at prevailing mortgage rates. The main benefits of this type of funding include:

- cheaper interest rates compared to other loan types,
- the absence of margin calls and;
- no requirement to contribute funds to the investment.

The lending institution will generally only require the regular payment of interest to fulfil your obligations, in which case, the level of debt remains constant. Mortgage loans such as a **home equity loan** and **line of credit** are commonly used for this purpose.

Another way to access funding for investment gearing is via a **margin loan** facility. You are required to contribute your own equity which will be used as security for the borrowing. The lending institution will lend a portion of the value of specific securities or managed funds, usually between 40 and 80 per cent. If the margin loan outstanding is greater than the lender permits, a margin call will be made. See the Margin calls section further below.

In some circumstances, it may be appropriate to use **double gearing**. This strategy involves borrowing funds from a loan such as a home equity loan or line of credit and using those funds to purchase investments. The investments are then used as security for further borrowing via a margin loan. A double gearing strategy increases both the total amount of your debt and the amount you invest. As a result, a double gearing strategy involves more risk as any **investment gains and investment losses will be magnified significantly more than a standard gearing strategy**. Double gearing is only appropriate for investors who have a strong surplus cash flow, are willing to take on extra risk in pursuit of higher potential returns and are comfortable with significant fluctuations in the value of their portfolio.

With this strategy, it is important to bear in mind any losses within your investment portfolio may affect your ability to repay the original borrowing (via a home loan or line of credit) which is often secured by existing property or your home.

THE DIFFERENCE BETWEEN DRAWN AND UNDRAWN DEBT

Borrowing further funds or using undrawn debt may impact the appropriateness of a gearing strategy. The difference between drawn debt and undrawn debt is explained below.

- **Drawn debt** refers to borrowed funds which have already been used. Interest is charged on drawn debt. If the interest is not paid when it falls due, it will be added to the total amount of borrowed funds you owe.
- **Undrawn debt** refers to borrowed funds which you have access to but have not yet used or drawn down. Generally, interest is not charged on undrawn debt until the undrawn funds are taken out of the lending facility (for example, used to purchase investments).

Risks of gearing

The risks associated with gearing make it unsuitable for some investors. It is essential to consider these risks carefully and to seek taxation advice before proceeding with a gearing strategy.

The specific risks associated with borrowing to invest (gearing) include:

Timing mismatch

It is important not to rely solely on investment income to meet interest payments as investment income may be irregular and the interest payment may be due before the income is received from the investment.

Negative gearing

Negative gearing compounds the risks associated with standard gearing. In particular, negative gearing further reduces your cash flow because the investment income does not cover interest costs which may result in a reduction in both cashflow and the ability

A reduction in capital value

Although there are potential wealth creation benefits to be gained from gearing, these benefits are achieved at the expense of higher risk. It is important to note although gearing has the potential to increase capital gains in a rising market, it can also **compound a capital loss** in a falling market. Any gearing strategy should therefore be approached with caution. The following table provides an example.

	Geared	Non-geared
Investor equity	$40,000	$40,000
Amount borrowed	$60,000	$0
Total Investment	$100,000	$40,000
Market rises 10%		
Value of portfolio	$110,000	$44,000
Loan outstanding	$60,000	$0
Investor’s equity	$50,000	$44,000
Gan in investor’s equity	25%	10%
Market falls 10%		
Value of portfolio	$90,000	$36,000
Loan outstanding	$60,000	$0
Investor’s equity	$30,000	$36,000
Loss in investor’s equity	(25%)	(10%)

Capital gains tax (CGT)

CGT may be payable when you sell your investments. When you use gearing to buy more investments, you may have more tax to pay when you sell them.

Fluctuations in interest rates

If the income from investments does not change but interest rates on borrowed funds increase, you will incur additional costs that will need to be covered from other sources.

Growth–based investments

A gearing strategy must invest a high proportion of an investment portfolio into growth assets such as property and equities to prove successful. These investments can be volatile over short–term periods – that is, in the short–term there may be some years in which the investments do not perform well or even lose value. It is for this reason gearing is a long–term investment strategy.

Increasing your borrowing

Increasing an existing loan and/ or establishing a new loan may incur bank fees and/or government charges. If you later decide to borrow or draw down further funds, this could affect the gearing strategy and may require a re–assessment of its appropriateness to your circumstances.

Income Protection insurance

Consistent income flow is a key factor in commencing a geared investment strategy. If your income should cease or reduce for any reason you may be unable to continue to meet the loan repayments. In this instance, you may be forced to sell the investment at the wrong time and realise a capital loss rather than the desired gain. Therefore your level of income needs to be adequately high and reasonably secure. To ensure income is appropriately protected in the event of illness or injury, it is strongly recommended income protection insurance is acquired by all parties involved in the gearing strategy.

Defaulting on your loan

If you default on your loan (i.e. do not pay your loan or interest repayments when they are due) the lender may compel you to make payments, impose a penalty for late payment or ask for the loan to be repaid in full immediately. The lender may even sell assets that are being held as security for the loan.

Ending your loan

If you decide to end or terminate the loan facility, it may be necessary to sell the geared investments or security held by the lender in order to do so. This means you could be selling investments at a lower price than what you paid for them or too early for the gearing strategy to have provided significant benefits, and

Margin lending

With margin lending plans, margin calls may be made if the value of the portfolio reduces below particular limits. Please refer to the 'Margin calls' below.

Margin calls

Within a margin lending facility, you are allowed a limited fall in the value of your portfolio before a margin call is made. A margin call is a notice from the lender requiring the borrower/investor to provide additional funds to re–establish the lender's minimum Security Value to Loan Ratio (SVLR). This is usually done by lodging additional security or reducing the loan. Typically, you will be required to respond to a margin call within a very short time frame – a few days or even 24 hours. It is important to have arrangements in place so a margin call can be dealt with if it arises while you are away.

Important terms

Security ratio

Margin lenders maintain a list of approved investments. When held as security, the lender allows you to borrow a maximum proportion of the value of those investments. The maximum proportion you are able to borrow is generally called the security ratio and is expressed as a percentage (%).

Security value

This is expressed in dollars ($) and is calculated by multiplying the market value of an approved investment by the lender's security ratio for that investment. Where more than one approved investment is held as security for the margin loan the security values of each approved investment are added together to get the total security value. The total security value is generally the **maximum amount the margin lender will allow you to borrow**.

Security Value to Loan Ratio (SVLR)

This compares the security value of the investments held as security with the amount borrowed. It is expressed as a percentage (%) and is generally calculated by taking the security value of your portfolio ($) and dividing it by the amount borrowed under the facility ($). A SVLR of less than 100% means the amount borrowed is higher than the security value. This generally results in a margin call.

The margin lending 'buffer'

Margin lenders often allow a buffer so small fluctuations in market values do not result in a margin call. The buffer is usually stated as a percentage of the market value of your portfolio. The percentage is used to calculate a dollar amount. The buffer is usually 10% however some lenders also have a buffer of 5% for listed securities. **A margin call is only made when the amount you owe exceeds the security value by more than the buffer**.

Unless a margin call position arises, you are not obliged to take any action to restore the security value to loan ratio to 100%, though it may be in your interests to do so. Whilst you are in the buffer, you will not be able to draw down additional funds or make further purchases and the chance of a margin call increases.

How does a margin call position arise?

A margin call position arises when the security value of your portfolio falls below the amount you owe under your margin lending facility by more than the buffer. The SVLR for your portfolio should be maintained at or above 100%.

The table below shows an example of how a margin call position can arise due to a 20% fall in the market value of a managed fund portfolio (assuming a security ratio of 70%).

Proposed Investments	Before	After
Market value	$100,000	$80,000
Loan amount	**$65,000**	**$65,000**
Owner's capital	$35,000	$15,000
Security value	$70,000	$56,000
SLVR	107.7%	86.2%
Buffer—10% of security value	$7,000	$5,600
Security value plus buffer	**$77,000**	**$61,600**

In the 'After' position, a 20% fall in the value of the managed funds portfolio has placed the facility in a margin call position. This is because the value of an investment portfolio plus the buffer is now less than the amount owing. The position needs to be restored so the security value is equal to or greater than the loan amount.

If a margin call were made in this situation, you could take one of the following steps to restore the SVLR to at least 100%:

1. reduce your loan amount or deposit cash into your cash management account. For example, using cash of $ 9,000 to reduce the loan to $56,000 would increase the SVLR to 100%
2. sell some securities and apply the net sale proceeds against your facility. If $30,000 of the portfolio was sold down and the funds used to reduce the loan to $35,000 the SVLR would be restored to 100%, and/or
3. provide additional approved shares or managed funds as security. By adding $13,000 of approved managed funds as security the SVLR would be increased to 100%.

These situations are illustrated in the table below.

Proposed Investments	1. Reduce Loan	2. Sell Investments	3. Add security
Owner's capital	$15,000	$15,000	$28,000
Loan amount	$56,000	$35,000	$65,000
Market value	$100,000	$40,000	$93,000
Security value	$56,000	$35,000	$65,100
SVLR	100.00%	100.00%	100.2%
Buffer—10% of security value	$5,600	$3,500	$6,510
Security value plus buffer	$61,600	$38,500	$71,610

The steps outlined above show the minimum required to restore the position and it is prudent to restore the SLVR to greater than 100% to reduce the possibility of future margin calls.

As it is the margin above the lender's SVLR that determines margin calls, starting with higher SVLR by borrowing less or using more approved investments as security reduces the likelihood of a margin call. Again, in the above example, if only $50,000 was borrowed it would take a 23.61% fall in the value of the total portfolio to trigger a margin call.

CHANGES TO THE SECURITY RATIO MAY TRIGGER A MARGIN CALL

Margin lenders maintain a list of approved investments. When held as security, the lender allows you to borrow a maximum proportion of the value of those investments. The maximum proportion you are able to borrow is generally called the security ratio.

From time to time, the lender's list of approved investments and/or the security ratio can change. You should therefore be aware you may be required to meet a margin call if the lender:

- **removes any investments** you hold from their approved list, or
- **reduces the security ratio** of any approved investments you hold.

Borrowing within superannuation

Legislation allows for superannuation funds, including Self Managed Superannuation Funds (SMSFs), to borrow money for investment purposes and provided certain conditions are met.

In addition to the wealth creation advantages, implementing a gearing strategy within your SMSF may benefit you via investing in a concessionally taxed environment (lower rate of tax on income and capital gains when compared to your marginal tax rate).

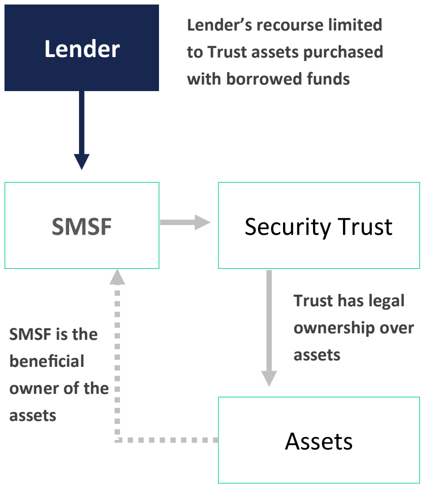
This strategy also provides the SMSF the ability to further diversify their assets. A SMSF now has the opportunity to invest in direct property (i.e. residential and/ or commercial) where it previously may not have had the funds. Assets within the SMSF may have additional asset protection from bankruptcy.

The legislation states the SMSF receives beneficial ownership of the asset while the security trust holds legal ownership until the loan is repaid. Since the SMSF has beneficial ownership it is entitled to the income derived by the asset (e.g. rental income from a property).

If the SMSF acquires a business real property (or other growth–based asset) from a related party or other individual, CGT may apply. If the individual then meets the definition in the legislation of being able to make a personal tax deductible contribution to superannuation, they could potentially reduce their personal CGT liability.

The structure involves the superannuation fund borrowing and using the funds to purchase an asset that is held on trust. The superannuation fund will have the beneficial ownership of the asset while the trust holds legal ownership, which is transferable to the superannuation fund on the receipt of a final instalment.

The loan must be established so the lender's recourse against the fund is limited to the asset purchased with the borrowings (i.e. remaining superannuation fund assets are protected).



The asset purchased with the borrowed funds must be an asset the superannuation trustee could acquire and hold directly under the Superannuation Industry (Supervision) (SIS) Act 1993. Except in limited circumstances, the SMSF cannot acquire assets from related parties.

Assets purchased by the SMSF must also satisfy the in–house asset rules. The in–house asset rules have been amended to allow an investment in a related trust which meets the above borrowing exception and will only be an in–house asset here the underlying asset would itself be an in–house asset if it were held directly.