GEARING

Gearing, also known as borrowing for investment purposes, involves using borrowed funds in addition to your own capital to potentially increase your investment return.

Affluens WEALTH

A Suite 3.02,
7-9 Irvine Place
Bella Vista NSW 2153
P 1300 038 746
E wealth@affluens360.com.au
W www.affluens360.com.au

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Benefits

1. Expand your investment portfolio's size.
2. Enhance diversification or acquire larger assets like property.
3. Potentially claim tax deductions on the loan's cost to offset borrowing expenses or reduce other income tax.

How it works

Gearing entails taking out a loan to invest in growth-oriented assets such as stocks or real estate. The primary objectives are to boost your overall investment return while minimising your income tax liability. Borrowing provides more capital for investment, enabling diversification and wealth-building opportunities. However, it carries the risk of increasing losses if investments perform poorly. Interest and related borrowing costs are generally tax-deductible when used to acquire income-producing assets. While the tax benefits of gearing can be attractive, the primary goal should be wealth accumulation.

Types of Gearing

- Negative gearing: Loan costs exceed income generated, with the shortfall tax-deductible.
- Positive gearing: Loan costs are lower than income generated, making the strategy self-funded, but tax is payable on the additional income.
- Neutral gearing: Loan costs and income generated are approximately equal.

Gearing suits investors with a growth-oriented risk profile, as it's effective when the investment return exceeds loan costs. This typically requires investments in growth-oriented assets like stocks and property. You should also meet specific criteria, including sufficient disposable income, life insurance, and a loan repayment strategy.

Long-Term Strategy

Gearing should be considered a long-term strategy, requiring an investment horizon of at least seven years. Exiting prematurely may lead to lower asset values.

Wealth Protection Insurance

Implementing a gearing strategy necessitates wealth protection insurance:

- Income protection covers interest repayments during extended illness or injury.
- Total and permanent disability (TPD) covers loan repayment in case you can't work.
- Term life cover helps dependents repay outstanding debt upon your death.
- Critical illness cover aids in interest repayments in the event of specified illnesses or injuries.

Key considerations

- Avoid solely relying on tax advantages for gearing decisions.
- Ensure job security and cash flow to avoid selling investments during market downturns.
- Be mindful of potential losses in falling markets.
- Prepare for rising interest rates and declining investment income.
- Be aware that your investment portfolio's value may fall below the debt owed.
- Stay updated on potential future changes in tax deductibility.
- Plan for unforeseen events like illness or injury.
- Verify investment-related fees associated with borrowed money in your Statement of Advice and Product Disclosure Statement (PDS).

References

You may wish to refer to the following websites for further information about gearing:

- www.moneysmart.gov.au
- www.ato.gov.au
- www.serviceaustralia.gov.au

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