

Create wealth by magnifying your returns

Gearing into investments is a very popular strategy, more so here than in other countries (probably because of the Australian negative gearing tax benefits that allow investors to offset investment tax losses against other taxable income). Changing demographics means that people are doing things later in life – marrying, buying their first home, having children, etc.

People are spending more money on 'lifestyle'. Consequently, a lot of professionals are income rich but asset poor, although the recent residential property boom has boosted many people's asset bases. Gearing is a perfect strategy for income rich people, because it gives them more market exposure and a bit of a tax break to boot. And you don't need a lot of cash to start with.

More exposure

Gearing allows you to gain greater exposure to investments from a relatively small deposit base. For example, if you have \$10,000, you could use the cash and buy \$10,000 of shares or you could use CFDs (contracts for difference – more about these later) and buy \$100,000 of shares. Assume the shares increase in value by 10% in the first year (ignoring dividend income for this example). Let's look at the difference.

No gearing

\$10,000 of shares increase by 10% = \$1000 gain.

Gearing

\$100,000 of shares increase by 10% = \$10,000 gain. Less interest on \$90,000 at 8% = \$7200. Therefore, the net gain is \$2800 (or 28% of your initial investment of \$10,000).

As you can see, this investor has made nearly three times more by using gearing.

Tax benefits

If you borrow money to invest (ie to earn assessable income), you will be allowed to claim a tax deduction for the interest cost. This essentially reduces the after tax cost of debt. For example, assume the loan interest rate is 8.00% and you are on the highest marginal tax rate (ie 48.5%). Using the above example (where you borrowed \$90,000) you would be able to offset the interest expense of \$7200 against other taxable income. Therefore, your tax bill would reduce by \$3492 (being \$7200 * 48.5%). Therefore, the after tax gain would actually be \$6292 (\$2800 + \$3492 tax savings), which is significantly more than \$1000 produced under the non-gearing scenario.

In shares

The most common gearing product used in share investing is margin lending. Margin lending facilities are offered by many banks and broking houses. They lend a proportion of the shares' value (usually 50–80%). Current interest rates for margin lending facilities are around 8%. If the value of the shares falls, you will have to reduce the loan in line with the value reduction (the 'margin call'). You can also lend against managed funds.

A more aggressive product is a CFD. CFDs are similar to margin loans, but they often lend a higher proportion of the shares' value (up to 95% in some cases). Therefore, \$10,000 in cash will allow

you to purchase up to \$200,000 of shares (by borrowing \$190,000). Interest rates for CFDs are similar to margin lending.

In property

Today, almost one in eight Australians own one or more investment properties. I think many people feel comfortable investing in property, because it's a tangible asset. You can see it, you can renovate it and you can easily assess its value. Furthermore, no matter what happens (almost), its value will never be zero. A company can be wound up and your shares may be worth nothing. However, with property, you will always have the land.

In terms of deposit required, there are now many options. Most lenders will at least lend 80% of a property's value. Many will lend up to 95% and some will lend up to 100%. In fact, there are a few lenders in Australia that will lend 105% (which means you can buy an investment property with no deposit whatsoever). Interest rates for investing in property are approximately 1.5% lower than margin lending facilities.

It's not for everyone

Borrowing money is not for everyone. Some people feel uncomfortable about having debt. There is really no right or wrong here. You need to feel comfortable, whatever you do. If debt is foreign to you, start out slowly and borrow a low proportion of the asset value. As you become more comfortable, you can be more aggressive.

It's important to prepare a financial budget to ensure you can service the debt – and don't forget to factor in potential interest rate increases.

Do the numbers

Like any investment, it's always important to do thorough research. Make sure you approach any investment without emotion and just focus on the clear facts. Consider the likely return on investment and your ability to finance any new debt that you take on. Debt is a good servant but a bad master. As long as you have control, it will help you create wealth faster. However, if you lose control (by borrowing too much), then you could do more harm than good.

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