

Aspects of Financial Planning

Negative Gearing

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Negative gearing is a wealth accumulation process. Quite simply, it involves borrowing money to invest. The principle behind negative gearing is that, in after tax terms, the growth in the value of your investment, plus the income you receive from the investment, will exceed the cost of borrowing the money to finance that investment.

Methodology

To negatively gear an investment, the borrowed money must be invested in an income producing investment. If the amount of interest you are paying on the loan is greater than the amount of income you receive from the investment, you are negatively gearing your investment.

Why Negative Gear?

Borrowing money to invest is a wealth accumulation strategy. If you invest borrowed money, you actually have more funds working for you than if you accumulate funds over time via a traditional savings strategy.

Negative gearing also provides opportunities for tax savings. The interest payments on the loan used to purchase the investment portfolio will be largely tax deductible. These tax deductions will be greater than the tax you may have to pay on income produced by the investment portfolio. The excess deduction may also be claimed against other taxable income that you receive during the same year (such as your salary).





What are the Risks Associated with Gearing?

There are a number of risks associated with negative gearing. First, there is the risk that interest rates will increase. If this occurs, the loan repayments will also increase. For this reason, it is essential that, if you are considering gearing, you have surplus income over your spending requirements, and that you are not solely relying on the income produced from your investments to meet your loan repayments.

It follows then, that it is important that your income continues to be received. For most people, this income is coming from salary. If this salary were to cease, the ability to make loan repayments is likely to be at risk. It is possible to protect yourself against loss of income as a result of ill health, by insuring yourself. We therefore recommend that any individual entering into a negative gearing strategy have adequate income protection insurance.

Second, negative gearing is a long-term strategy, and should only be considered by those who have at least a five-year investment time frame in mind, but longer is better. Markets can be volatile and unpredictable and it is necessary to have the time to ride through downturns. Though it is not possible to be absolutely certain that your employment prospects will be guaranteed over the long term, it is necessary for you to feel comfortable that you will continue to be able to meet the cashflow requirements of loan repayments which must be made as part of a negative gearing strategy, over the long term. Should you be forced to sell investments to wind up the strategy, you may have to do so at a loss, if investment markets are experiencing unfavourable conditions. Therefore, a long-term time frame is important.

Third, each asset invested in will have risks specific to it, which will depend on whether it is a sharemarket or property asset, whether it is Australian or international, and so on.

What Investments are Appropriate for Gearing?

For gearing to be an appropriate strategy, the investments selected should have the capacity to produce both growth and income over the long term, such as shares and property. Australian shares provide added tax incentives, through the imputation rebate system. This makes negative gearing into Australian shares particularly attractive from a taxation perspective.

We do not believe that gearing into interest investments will produce satisfactory returns. We believe that gearing into a mix of local and international equities is the most appropriate portfolio. However, investment portfolios should not be constructed with tax as the only consideration.





Who Should Consider Gearing as an Investment Strategy?

The answer to this question can really only be provided after thorough analysis of your circumstances. However, as a rule of thumb, the following categories of people should consider gearing as a means of wealth accumulation:

- High income earners with substantial excess income over their requirements
- Those with a long term investment horizon
- Those who would like to accumulate wealth in an alternative environment to superannuation
- People who have sought or are prepared to seek professional financial advice.

Conclusion

It is essential to remember that, though the principles behind gearing are not complex, it is a strategy which requires thorough analysis. This should be done by a professional, who will examine your entire financial situation, to establish whether gearing is the most appropriate of the available wealth accumulation strategies in your circumstances.





Centric Wealth Advisers Ltd may be able to be of assistance

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Centric Wealth recommends that you obtain financial and tax or accounting advice based on your personal situation before making an investment decision.

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