DIFFERENT WAYS TO BECOME WEALTHY

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WHAT IS A GEARED INVESTMENT?

In a geared investment, part of the amount used to buy the asset has been borrowed. If, for example, an investment of $100,000 comprises $40,000 of the investor's own funds and $60,000 borrowing, the investor's equity is 40% and the level of gearing is 60%.

Gearing can also be achieved by using futures, options or warrants.

WHY GEAR?

The main advantage of a geared investment is that a 10% increase in value of the investment asset increases the value of the investor's equity by more than 10%. Investor's return from the investment is increased or geared up. Unfortunately gearing has a similar effect if there is a *loss* in value. A 10% fall in the value of the investment will mean a greater than 10% fall in the value of the investment will mean a greater than 10% fall in the value of the investor's equity as looses are also geared up.

Gearing increases the investment risk as it increases both the profit from good investments and the loss from the bad investments, thus it is not appropriate for cautious or conservative investors. If things go well gearing will increase the return from the investment, but it is the potential increase in the return worthwhile if the investor cannot sleep at night worrying about their investments?

Gearing only makes sense if the investment return (after tax and all expenses) from the investment exceeds the cost (after tax and all expenses) of the loan. This generally requires using growth investment such as shares and property.

EXAMPLE:

Investor funds	$40,000
Borrowed funds	$60,000
Total investment	$100,000

A 10% increase in the value of investment asset would increase its value from $100,000 to $110,000. The borrowing would remain $60,000, so the investor's equity would increase from $40,000 to $50,000, as increase of 25%.

A 10% decrease in the value of the investment asset, however, would reduce the value of the investment asset to $90,000, reducing the investor's equity to 30%, a reduction of 25%. Not only has the investor's equity of $40,000 been reduced by 25%, but the level of gearing has increased to 66.7% (loan remains $60,000 on investment assets valued at $90,000). If the lender is only prepared to lend up to 65%, for example, the investor would be required to make a margin call. This could be satisfied by:

- providing a further $2308 in assets as security for the loan, increasing the value of the security to $92,308 so the loan is 65% of the asset.
- Repaying $1,500 to the lender to reduce the loan to $58,500 (65% of $90,000),
- Realising $4,286 of the investment asset and using this amount to reduce the loan. The loan would then be $55,174, which would be 65% of the value of the remaining assets of $85,714.

WHAT IS NEGATIVE GEARING?

An investment is said to be negatively geared if the interest payable on the borrowing exceeds the income (rents, dividends or interest) received from the investment (after expenses), giving a negative cash flow. If the income received from the investment exceeds the interest payable on the borrowings the arrangement has a positive cash flow. The investment is then said to be positively geared. The fundamental rule is that gearing (both negative and positive gearing) an investment is profitable (and hence makes sense) only if:

- The return from the investment, including both income and capital gains, after tax and expenses, is expected to increase because of the borrowing.
- The increase in the return after tax and expenses is expected to exceed the cost of borrowing after tax and all expenses, or
- The gain from the whole arrangement is expected to be large enough to make it worthwhile

This will generally require:

- Income from the investment (after income and other taxes and all expenses) which is expected to increase in future to cover the (after tax) cost of borrowing, or
- A market value of the investment (after income, capital and other taxes and all expenses including sale expenses), which is expected to increase at a rate which exceeds the negative cash flow (after tax).

Purely deferring income tax to a later year or reducing tax now in return for taxable capital gains later, does not, on its own, justify negative gearing. It can only be justified if the amount of tax payable later will be lower (because the tax payer will be on a lower marginal tax rate), or if the tax payer can get a significant benefit from the delay in payment and the whole arrangement makes enough money to make it worthwhile.

In a tax-effective negative gearing arrangement, the negative cash flow will be tax deductible against the taxable income.

(to be continued)