WHY NEGATIVE GEAR?

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Essentially, if gearing an investment increases the return to the investor, then negative gearing, which represents a higher level of gearing, will increase the return further. But it is not that simple. Gearing also increases losses from poor investments and can increase other risks. A simple example which ignores expenses and tax is set out below.

EXAMPLE:

An investor has several investment options, based on an initial investment amount of $40,000:

- investing $40,000 with no gearing
- investing $80,000 with positive gearing by borrowing $40,000 or
- investing $120,000 with negative gearing by borrowing $80,000

	Ungeared $	**Geared $**	**Negative gearing $**
Equity invested	40,000	40,000	40,000
Borrowed	-	40,000	80,000
Total invested	40,000	80,000	120,000
Income received	1,600	3,200	4,800
Less interest paid	-	(2,800)	(5,600)
Net income or cash flow	1,600	400	(800)
Capital growth	2,000	4,000	6,000
Total return	3,600	4,400	5,200
Equity invested	40,000	40,000	40,000
Return on amount invested	9%	11%	13%

ASSUMPTIONS:

Income from investment is 4%
Capital growth is 5%
Interest on borrowing is 7%

The investment gives a return of $3,600 or 9% when ungeared, but these increases to $4,400(11%) or $5,200 (13%) when geared or negatively geared. It is important to note what would happen if the market value goes down by 5% rather than increasing by 5%.

	Ungeared $	**Geared $**	**Negative gearing $**
Capital loss	(2,000)	(4,000)	(6,000)
Total return	(400)	(3,600)	(6,800)
Equity remaining	39,600	36,400	33,200
Return on amount invested	(1%)	(9%)	(17%)

The negatively geared investment has lost $6,800 (or 17%) and only $33,200 of the original $40,000 equity remains.

There are other reasons for the gearing (or negative gearing) of investments:

- borrowing enables an asset such as an investment property or a business to be purchased without having to wait until the whole of the purchase price has been saved, or
- borrowing enables a better and/ or more attractive property or business to be purchased, or a larger investment to be made, which may give a better investment return or be cheaper to administer.

It is interesting to note that borrowing to buy a property to live in or as an investment, or to buy a business, is widely accepted as normal practice, whereas borrowing to buy part of a business (i.e. shares or share trusts) is seen as risky. In fact the principle is the same in each case.

CHECKLIST ON GEARING

Gearing is designed to increase the return from investment, but it also increases the uncertainty. By definition a negatively geared investment has negative cash flow before tax, although the cash flow before tax, although the cash flow may, in some cases, become neutral or positive after tax is taken into account. Gearing is usually attractive only for growth assets such as shares and property – over the long term these investments can be expected to give the higher rates of income and capital gains which make it attractive to borrow funds to make the investment. However, loans often have fees payable on establishment and /or repayment, share prices are volatile, and property is expensive to buy and sell. Thus, investment in these growth assets, particularly when the investment is geared, should only be made for a period of at least five years or, preferably ten years or longer.

RISK ASSOCIATED WITH GEARING

- *Investment income risk* - if the investment income is lower than expected or does not grow as expected, the negative cash flow will be larger than expected and continue for longer. Negative cash flow needs to be covered by income from other sources (usually salary)
- *Risk of capital loss* - if the capital value reduces, and the investment is sold, the proceeds may not cover the loan. The remaining loan balance may need to be repaid from other assets.
- *Interest rate risk* - interest rate on the loan may rise, increasing the negative cash flow needing to be covered from other sources. This risk can be managed by using fixed rate loans.
- *Income risk* - income from other sources (generally salary) is needed to cover living costs as well as the negative cash flow. Salary may be reduced if overtime, sales or other bonuses are reduced or income ceases because of redundancy, sickness and injury, or death of the investor or their partner. Income and living costs can change following the ending of a relationship, separation or divorce. Many of the risks arising from a reduction in income can and should be fully covered by insurance – the insurance can be held either personally or within superannuation. Insurance should cover death, permanent disablement and temporary disablement. Insurance should cover the investor, but it should also cover the partner as a significant change in the partner's circumstances will normally also significantly change living costs and the surplus cash flow available to cover negatively geared investments. It is strongly recommended to have Income Protection insurance before committing into investment in order to make sure the cash flow will be maintained at the event of temporary disablement.