Strategy 8

Use borrowed money to build wealth

If you want to achieve your long-term goals sooner, you may want to borrow for investment purposes.

What are the benefits?

By using this strategy, you could:

- Multiply your investment profits, and
- Take advantage of a range of tax concessions (see FAQs on page 29).

How does the strategy work?

This strategy, commonly known as gearing, involves borrowing money to make an investment.

Gearing can enable you to build your wealth faster than if you relied exclusively on your own capital. The downside is that it can enhance your losses if your investments fall in value.

For gearing to be successful in the long term, the investments you acquire with borrowed money must generate a total return (income and capital growth) that exceeds the after-tax costs of financing the investment (including interest on the loan).

It is therefore generally recommended the borrowed money is invested in quality share or property investments (either directly or via a unit trust).

This is because shares and property have the potential to grow in value over the longer term. They also typically produce assessable income (which means you should be able to claim the interest on the investment loan as a tax deduction).

There are a number of ways you can establish a gearing strategy:

1. **You can borrow against the equity in your home.** This approach offers the benefit of a low interest rate and there are no restrictions on which investments you can buy.
2. **You can take out a margin loan.** This type of loan typically enables you to borrow up to 75% of the value of approved share and unit trust investments. For example, if you have $25,000 and you want to purchase an approved investment with the help of a margin loan, you may be able to borrow up to $75,000 and make a total investment of $100,000. It's also possible to use a margin loan to gear on a regular basis. This is known as instalment gearing (see Glossary on page 30).
3. **You could invest in an internally geared share fund.** These are funds that borrow to leverage an investment in Australian or global shares.

To work out whether gearing suits you (and which approach you should use), we recommend you seek financial advice.

Note: Before you use a gearing strategy, you should ensure you have a suitable timeframe (preferably five years or longer) and understand the risks. For example, if your investment falls in value, your financial situation could be significantly worse than if you hadn't used a gearing strategy.

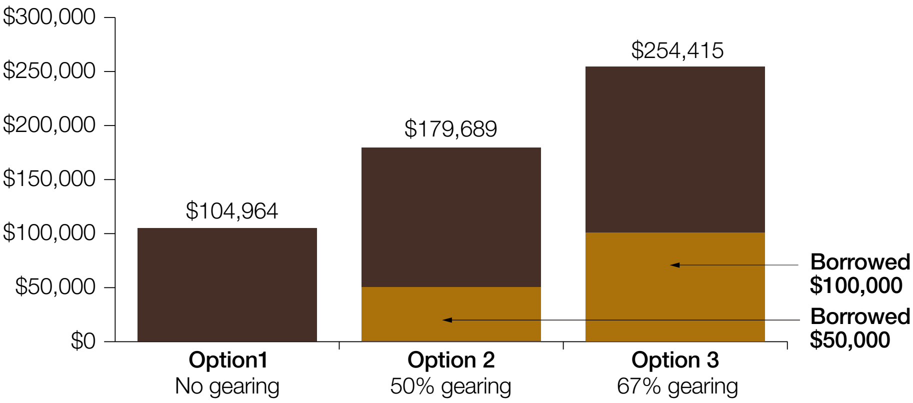
Case study

Jenny has $50,000 invested in an Australian share fund (via a unit trust) and would like to use gearing. After speaking to her financial adviser, she considers the following three options:

- Maintaining her investment at its current level of $50,000,
- Doubling her investment by borrowing $50,000 (ie a 50% gearing ratio), or
- Increasing her investment even more by borrowing $100,000 (ie a 67% gearing ratio).

In options 2 and 3, Jenny will use an interest-only home equity loan with an interest rate of 7% pa. The following graph illustrates the potential outcome of the three options after 10 years.

Investment value after 10 years



Assumptions: Investment return is 8.5% pa (split 4% income and 4.5% growth). Investment income is franked at 75%. Interest on the loan is 7% pa. Jenny's marginal tax rate is 39.5% including a Medicare levy of 1.5%. These rates are assumed to remain constant over the investment period. With options 2 and 3, where investment income and tax advantages are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax advantages are re-invested.

Clearly, the higher the gearing ratio, the greater the potential gains. It must be remembered, however, that Jenny still has an outstanding loan in options 2 and 3 of $50,000 and $100,000 respectively. If she withdrew a portion of her investment after 10 years to repay the outstanding debt and pay Capital Gains Tax (CGT) on the amount withdrawn, the value of her investment is shown in the table below.

Investment value after repayment of loan

No gearing	50% gearing	67% gearing
$104,964	$125,907[1]	$146,850[1]

As you can see, Jenny's financial position could improve by using a gearing strategy if the value of her investments rises sufficiently.

1 After CGT on the amount withdrawn.

Tips and traps

- Gearing should be seen primarily as a wealth creation strategy rather than a way to save tax. If you invest in assets that fail to produce enough income or capital growth over the longer term, your losses could outweigh any reduction in your tax bill.
- If you take out a margin loan you may need to meet a margin call if your investments fall in value (see Glossary on page 30). To reduce the likelihood of a margin call, you should maintain a conservative loan-to-valuation ratio. You should also hold significant cash (or other liquid assets) to meet margin calls if required.
- Pre-paying up to 12 months' interest on a fixed rate investment loan can enable you to bring forward your tax deduction.
- You should take out income protection insurance to make sure you are covered if you suffer a temporary or permanent illness or injury that doesn't allow you to work and earn an income.
- If the lending institution requires the entire loan to be paid back in the event of your death, you should make sure you have sufficient life insurance.