SHOULD YOU BORROW TO INVEST?

PERPETUAL PRIVATE INSIGHTS

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In the last edition of Catalyst, many of you told us that you were interested in learning how to grow your wealth tax effectively using *'other people's money'*.

Let's take a look at negative gearing, one of the most popular ways in which to leverage your investment portfolio through borrowing (a method in which you use other people's money) to build your retirement savings.

With tax time approaching, now may be an appropriate time to look at how you could use negative gearing within your investment portfolio.

An introduction to gearing

Gearing means borrowing to invest in an asset, such as property, shares or managed funds, to increase your investment exposure and accelerate your potential investment returns.

You can use two approaches to borrow to invest – recourse and non-recourse loans.

Recourse loans, usually used to buy investment properties, require you to pay back the full loan amount, even if there is still money owing after the property is sold.

A non-recourse loan, also called a margin loan, is often used to invest in shares or managed funds, the difference being that the amount at risk is limited only to the value of the shares acquired using the loan.

However, if the value of your share or managed fund portfolio falls, you may be required to put in further money, called a margin call, to ensure your non-recourse loan remains at the agreed Loan-to-Value ratio (The Loan-to-Value ratio is a financial term used by lenders to express the ratio of a loan to the value of an asset purchased. The term is commonly used to represent the ratio of the borrowings as a percentage of the total appraised value of the asset).

What is negative gearing?

The amount of income you earn from an investment, relative to the costs of investing, determines if it is positively geared or negatively geared.

A negatively geared investment is one where the income received from the investment is less than the costs of investing.

For an investment property, this means that the rental income is less than the costs associated with maintaining the property, such as loan interest, council and water rates, body corporate fees, insurance and repairs.

A portfolio of shares or managed funds is negatively geared when the dividend income or distributions received are less than the loan interest.

What are the benefits of negative gearing?

Using negative gearing to invest offers many long-term benefits, as it can help you to:

- **Build your wealth faster**. Negative gearing allows you to invest using a mix of your own money and borrowed money, giving you much larger investment exposure. This means you can potentially accelerate your investment returns, relative to investing only with your own money.
- **Diversify your portfolio.** Having more money to invest through borrowing gives you access to a wider choice of investments, which can help to broaden your investment portfolio and can make it less risky. Within property, you can select from residential, commercial and industrial sectors, while an investment in shares or managed funds allows you to spread your portfolio across many different countries, sectors and individual companies.
- **Build your wealth tax effectively**. Negative gearing can be a tax effective way to invest, especially if you're in a high-income tax bracket. Being able to offset the 'losses' from your investment against your taxable income may allow you to reduce the overall tax that you pay, while also building wealth.
  However, it's not all about tax. For example, a negatively geared investment property only makes sense where there is the potential for sound capital gains over the long term. It's also important to remember that your rental income could increase at a higher rate than your associated costs, which means the property may become neutrally or even positively geared over time.

A tax effective strategy

To calculate the tax benefit of negative gearing, you simply take the tax loss on your investment, and then multiply that by your marginal tax rate (plus medicare levy).

For example, if the deductible expenses on your investment property are $95,000pa and you receive rental income of $70,000pa, then the annual tax loss on your property is $25,000.

If your taxable income is $250,000pa, the annual tax benefit that you would receive is $11,750 pa ($25,000 x 47.0%)*.

*This is a simplistic scenario that may not capture all the complexities of a real-life gearing strategy. Personalised tax advice should always be sought before embarking on a gearing strategy.

What you need to consider before getting started

While negative gearing could help you to generate higher investment returns through borrowing, it's not a free lunch.

Here are some questions that you should ask yourself before thinking about borrowing to invest:

- **Am I comfortable with the level of debt and risks involved?**
  Gearing can be an effective strategy when the assets acquired with the borrowed funds are increasing in value, because you are being exposed to greater gains.

  However, the opposite is also true – you become exposed to larger losses when the assets fall in value. That's why gearing may be considered a higher risk strategy. If you're not comfortable with this risk or the level of debt required to gear an asset, you should think very carefully before proceeding.

- **What if there is a change in legislation?**
  There is a potential risk that legislation could change to limit the tax benefits associated with negative gearing. As we said earlier, it's not all about tax, but it is always important to consider how legislative change could impact your investment strategy.

- **Do I have a long-term investment horizon?**
  With a negative gearing strategy, you're essentially banking on future capital growth to generate an investment return, given your investment costs are higher than the income received.

  This capital growth may take time to eventuate, perhaps five to seven years (or more!), and so this timing needs to be something to which you can commit. The ability to have a long-term investment outlook is a key aspect when considering if a gearing strategy is appropriate for you.

- **Will I have sufficient cashflow to maintain the investment?**
  All geared investments have ongoing costs that need to be met before you potentially receive any tax refund or capital growth. For shares or managed funds, this is the interest on your margin loan, while for an investment property, this is loan interest as well as maintenance costs, utilities and insurance.

  While interest rates are currently at record lows, a long-term investment horizon also increases the likelihood of higher interest rates during your investment period. That's why it's important to ensure you can absorb increased costs over this time period.

  You should also review your personal insurance to make sure any additional costs associated with your geared investment are covered, should you be unable to work for an extended period due to injury or illness.

Getting started with gearing

If you're thinking about borrowing to invest to grow your wealth, one way to 'dip your toe in' is through an internally-geared managed fund.

All the borrowing is done within the fund, often at wholesale rates, which means you're not personally responsible for any ongoing borrowing costs. This allows you to receive additional exposure for every dollar that you invest, relative to what you would have received using an ungeared fund.

While you won't receive a personal tax deduction for investing into an internally-geared fund, they do offer an easy and relatively low-cost way for you to determine if building wealth through gearing is right for you.