What is Gearing?

Borrowing for investment purposes is also known as 'gearing'. It allows you to make a larger investment than would otherwise be possible by giving you access to borrowed funds. While a larger investment creates an opportunity for higher returns, it also exposes you to greater losses, making this approach unsuitable for some investors.

Gearing can apply to any investment including shares, managed funds and property. Gearing is generally suited to people:

- With a high tolerance to investment risks,
- With a strong, secure cash flow (protected by appropriate levels of insurance), and
- With an investment timeframe greater than seven years.

Styles of gearing

Gearing is often described as negative, positive or neutral, which refers to the cost of the investment, e.g., interest repayments and other investment expenses, relative to the investment income generated, such as dividends and rent.

- Negative gearing – where interest payable on borrowed funds and any expenses incurred in relation to the investment exceeds the income received from it.
- Positive gearing – where expenses incurred in relation to the investment are less than the income generated by it.
- Neutral gearing – where the costs of the loan are approximately the same as the income generated.

Over the lifetime of a geared investment, the style of gearing applied can change, e.g., it commences as a negatively geared investment which becomes positive geared as market conditions and income from the asset improve.

Benefits and risks of gearing

Gearing to invest provides an opportunity to:

- Increase capital gains and diversification - It increases the size of your portfolio by allowing you to purchase additional investments with borrowed money. You can diversify your portfolio by investing in a range of assets with differing risks and returns.

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- Access tax deductions - There may be some additional tax benefits associated with negative gearing. Interest payments on money borrowed to invest in income producing investments, together with ongoing expenses, can be claimed as deductions against your taxable income. When negatively geared, the deduction can be used to reduce your other assessable income.

However, these benefits need to be considered alongside the following risks:

- The cost of borrowing may increase significantly due to interest rate changes.
- Income from investments may reduce, as dividends, distributions or rental income from geared investments can fluctuate. A reduction in income can make it difficult to service the outstanding loan. If you are unable to meet loan repayments, you may be forced to sell some or all of the investments. This can happen when market conditions are unfavourable.
- Unforeseen events, such as injury, illness or unemployment, may occur, making it difficult to cover investment expenses and loan repayments.
- Negative gearing compounds the risks associated with gearing as investment income does not cover interest costs or investment expenses.
- Capital gains tax (CGT) may be payable when you sell your investments.
- If you have a margin loan, and the value of your investment falls below a minimum threshold set by the lender, the lender can request you make an immediate additional cash deposit, or sell underlying investments, so that it is brought up to the minimum threshold.
- Defaulting on your loan, i.e., do not pay the loan or interest repayments when due. The lender can compel you to make payments, impose a penalty for late payment or ask for the loan to be repaid in full immediately. This can include automatic sale of assets held as security for the loan.

What is gearing?

Case study

Gearing magnifies losses and gains

An investor has $50,000 of personal funds to invest and considers borrowing $100,000 so they have a total of $150,000 in the share market.

	Market rises 10%		Market falls 10%	
	Ungeared	**Geared**	**Ungeared**	**Geared**
Investor funds	$50,000	$50,000	$50,000	$50,000
Amount borrowed	$ -	$100,000	$ -	$100,000
Total investment	$50,000	$150,000	$50,000	$150,000
Annual income of 3%	$1,500	$4,500	$1,500	$4,500
Loan interest of 6%	$ -	-$6,000	$ -	-$6,000
Net income	$1,500	-$1,500	$1,500	-$1,500
Capital growth	$5,000	$15,000	-$5,000	-$15,000
Total return	$6,500	$13,500	-$3,500	-$16,500
Overall return on investor funds based on strategy used	13%	27%	-7%	-33%

In the table, geared investments when markets rose 10% allowed an investor to access an additional overall return of 14% (27% less 13%). However, if market's fall 10% the loss experienced by using geared investments is negative 23% (difference between negative 7% and negative 33%).

While there is a potential to grow wealth from gearing, these benefits are achieved at the expense of higher risk. It is important to note that gearing has the potential to increase capital gains in a rising market, it can also compound a capital loss in a falling one. Any gearing strategy should be approached with caution and it may not be suitable for all investors.