



Guide To...

Use borrowed money to build wealth

Once you have inefficient debt under control, you should consider borrowing money for investment. This is a wealth creation strategy known as 'gearing'. A gearing strategy can magnify the value of your investment since:

- You have more money invested than if you hadn't borrowed.
- You may benefit from a number of tax concessions.

The down side is that gearing can increase your losses if your investments fall in value. It's recommended that borrowed money is invested in shares or property (either directly or via a managed fund) because they produce an assessable income. This means you should qualify for a tax deduction on the interest on the loan. Shares and property also have the potential to grow in value over the long term and therefore should increase the chances of the gearing strategy being successful.

How does the strategy work?

The investments you acquire with the borrowed money must generate a total return (income and growth) which exceeds the total interest repayments and costs on the loan (after tax). There is a variety of ways you can do this, for example, you can borrow against the equity you have in your home. This offers the benefit of a low interest rate and there aren't restrictions on the investments you acquire.

Another gearing method is to take out a margin loan with a lending institution. With this loan, the investments you purchase form the security for the loan. The lending institution will typically lend you up to 70% of the value of approved assets.

For example, if you have \$30,000 and you want to invest in an approved asset with the help of a margin loan, you may be able to borrow up to \$70,000, thus making your total investment \$100,000.

The benefits

- Gearing increases the amount of money you have invested and therefore boosts potential returns.
- Negative gearing can help you to reduce the overall tax you pay.

Tips and Traps

- Gearing should be seen primarily as a wealth creation strategy rather than a way to save tax.
- Therefore the focus should be on acquiring high quality investments with the potential for long-term capital growth (e.g. shares and property).
- Your geared investments should produce assessable income so that the interest cost is tax deductible.
- Maintain a conservative loan to valuation ratio to reduce the likelihood of a margin call on a margin loan. You should also hold sufficient cash to meet margin calls if required.
- Consider instalment gearing as a way of reducing risk and maintaining flexibility.

- You can manage interest rate risk by taking out a fixed rate investment loan. These loans can also allow you to prepay interest up to 12 months in advance to bring forward your tax deductions.
- Another way of gearing is to invest in an internally geared share fund.
- Take out income protection insurance to cover the risk of you being temporarily disabled and unable to earn an income.
- Consider additional life insurance if the lending institution requires the entire loan to be paid back in the event of your death.

If you have any queries in relation to the content of this material, please do not hesitate to contact Kate Kimmorley the Principal Financial Adviser at Kimmorley Financial Management on (07) 5591 1725.

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