

Borrowing to invest

Borrowing to invest, or gearing, is an investment strategy usually considered by more experienced investors and those with a higher risk appetite. This is because, while gearing can increase the value of your portfolio faster than otherwise possible, it will also magnify your losses in a market downturn.



The principle behind a successful gearing strategy is that the value of your investments will increase faster than the after-tax cost of servicing the debt. However in volatile markets, a decline in the value of your portfolio may no longer provide adequate security for the loan and you will have to find an alternative source of funds to repay the loan.

The following tables show the benefits and risks of gearing an investment in Australian shares:

If the share price doubles

	5 year term	
Chris' own capital	\$100,000	\$100,000
Loan	\$0	\$75,000
Total initial investment	\$100,000	\$175,000
Total income received ¹	\$10,000	\$17,500
Less interest costs ²	\$0	-\$26,250
Increase in portfolio value	\$100,000	\$175,000
Total return	\$110,000	\$166,250
Less loan amount	\$0	-\$75,000
Net value of shares	\$200,000	\$275,000

If the share price halves

	5 year term	
Chris' own capital	\$100,000	\$100,000
Loan	\$0	\$75,000
Total initial investment	\$100,000	\$175,000
Total income received ¹	\$10,000	\$17,500
Less interest costs ²	\$0	-\$26,250
Increase in portfolio value	-\$50,000	-\$87,500
Total return	-\$40,000	-\$96,250
Less loan amount	\$0	-\$75,000
Net value of shares	-\$50,000	\$12,500

¹ 2% pa yield from investment

² 7% pa interest rate on loan

Note: The examples above assume interest costs of 7% p.a. and income from the shares of 2%. For simplicity income is not reinvested in the above. The example does not consider tax or franking credits.

Time in – not timing

'Timing the market' by consistently selling high and buying low is very difficult.

Unfortunately, markets are unpredictable and taking this strategy leaves investors prone to missing out on market rebounds – not to mention the tax implications on profit-taking.

Tax-effective investing

When you receive money from most investments, or crystallise a capital gain by selling an asset, you are generally required to pay tax on that income or gain. It's important to consider the impact of tax on your investment and how tax-effective investments can improve your returns.

A tax-effective investment is one which offers a taxation benefit to you and could include investment bonds, negative gearing, superannuation and pensions and Australian shares.

Investment bonds

Simply put, an investment bond is a tax paid investment. This means that the tax on investment earnings is paid by the investment bond issuer at 30%.

While funds are invested, there is no need for the investor to include any earnings in their tax return.

After ten years from the start date of the investment, or when the life insured passes away, (regardless of the time invested), the growth and earnings are free of any personal tax liability to the investor upon withdrawal.

Negative gearing

If you borrow to make an investment you can claim a tax deduction. If the expenses exceeds the income this is known as negative gearing.

While many investors are familiar with negative gearing on property, it is also available on shares purchased where costs such as interest and bank fees associated with the loan may be tax deductible.

Superannuation and pensions

To encourage people to contribute to their super and build their retirement nest egg, the Government has provided a series of generous tax concessions making super one of the most tax-effective investment strategies available.

These concessions include:

- Super contributions – either salary sacrificed through your salary or from the employer superannuation guarantee (up to certain limits) contributions are taxed at just 15%¹ not your marginal tax rate.
- Money you earn on your investments is taxed at just 15%, or effectively 10% for capital gains on assets held more than 12 months.
- If you are over 60, for most people, money taken out of super is tax-free.
- In a retirement phase pension, investment earnings are tax-free. The amount of super that can be used to commence a retirement phase pension is limited by your individual transfer balance cap.

Australian shares

Australian shares potentially offer the lowest effective tax rate of all the investment asset classes. This is due to franking credits associated with share dividends.

1. An additional 15% tax (known as Division 293 tax) applies for higher income earners, where their combined Division 293 income and taxable super contributions, exceeds \$250,000.

Investment spotlight

Dividends and franking

As owning shares represents ownership of part of a company, it also entitles you to a share in profits. Companies can reinvest some or all of the profits back into growing the company (known as retained earnings) or alternatively distribute profits through payments to shareholders. These payments to shareholders are known as dividends.

Dividends can be taken as cash or, in some circumstances, automatically reinvested to buy more shares in the company.

In Australia, if you receive a dividend from a company, this is considered a form of income and you may be required to pay tax. However because the company also pays tax, this is a form of double taxation.

For this reason when you receive a dividend, they often come with franking credits. Also known as dividend imputation, this means you only pay the difference between the company tax rate (usually 30%) and your marginal tax rate.

Further information

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