

What is *negative gearing*?

Negative gearing is when you borrow to invest and the income you earn from your investments is less than the interest you pay on the loan, thus giving you a cashflow shortfall.

How does negative gearing work?

Here's an example with a person borrowing \$100,000 to invest:

Interest cost at 7% p.a.:	\$7,000
Investment income at 4% p.a.:	\$4,000
Cashflow shortfall:	\$3,000
Tax deduction on shortfall (tax rate 38.5%):	\$1,155
After tax shortfall:	\$1,845

Gearing magnifies losses and gains

When you borrow to invest, your gains are magnified because someone else's money was used to get the gain. So, using our negative gearing example from above, if you borrow \$100,000 and your investment appreciates by 10% in the first year, you would be ahead \$10,000 – less the \$1,845 cashflow shortfall. It's a \$8,155 gain, as shown in Chart 1 opposite.

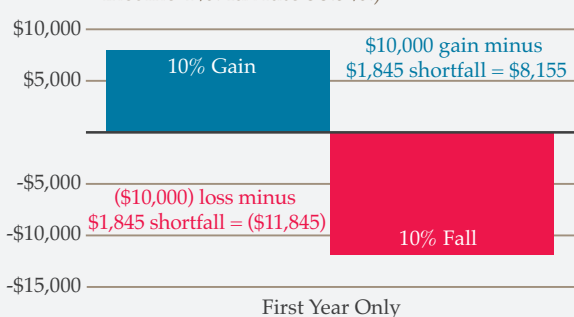
It works the same in reverse – with a 10% fall in the first year resulting in a loss of \$11,845, as shown in Chart 1.

The message here is you need to understand the full range of possibilities with a gearing strategy.

And you should only invest in quality growth assets with potential for solid capital growth over the long term.

Because it is capital growth which drives a gearing strategy. For a negative gearing strategy to be

Chart 1: Winning and losing with other people's money (\$100,000 borrowed. Interest 7%. Investment income 4%. Tax rate 38.5%.)



successful, your investments need to generate – over the long term – sufficient capital growth to more than cover the total cashflow shortfall (after tax) as well as tax on the capital gain.

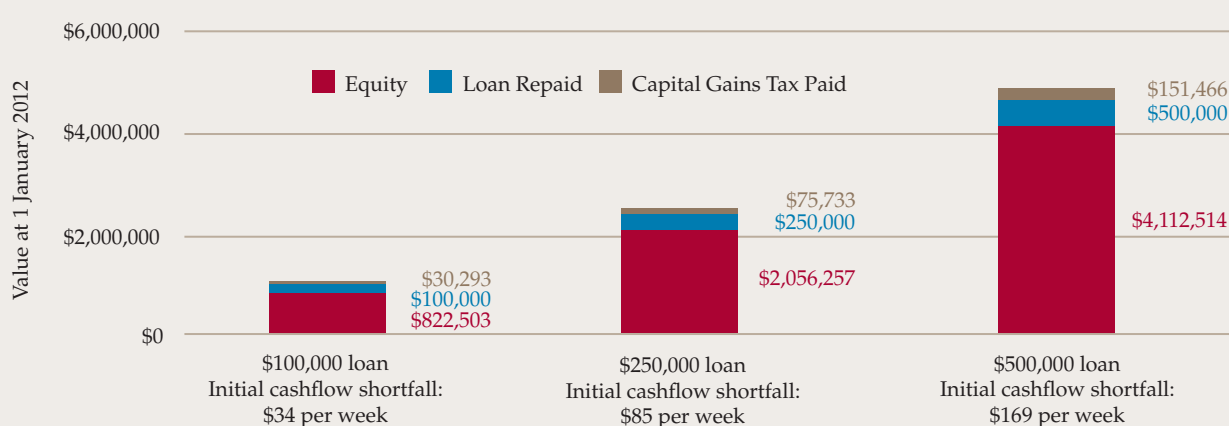
Case study: Create wealth of \$4,112,514 for \$169 per week

Let's look at an historical example of a successful gearing plan.

In Chart 2 we have someone who borrowed \$100,000 on 1 January 1983 and invested it in Australian shares. By 1 January 2012 they would have created wealth of \$822,503, after repaying the \$100,000 and paying tax on that

Chart 2: Gearing Australian shares to create wealth*

Invested in All Industrials Accumulation Index (1 January 1983 to 1 January 2012)



withdrawal, with an initial cashflow shortfall of just \$34 a week – after taking into account investment income and their tax deduction. (Note: we've used historical interest rates, with the rate in Year 1 of 12.42% and a high of 16.35% in 1990).

If this person had borrowed \$250,000 they would now have \$2,056,257, for an initial cashflow shortfall of \$85 per week.

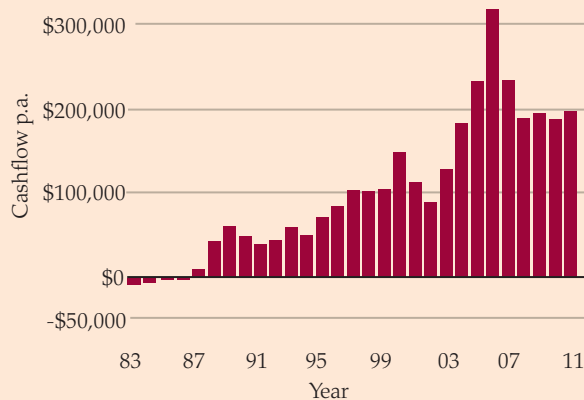
And borrowing the sum of \$500,000 would have enabled this person to create wealth to the tune of \$4,112,514 after repaying the loan and paying tax on that withdrawal.

Their initial cashflow shortfall would have been just \$169 a week, as shown below:

Borrow \$500,000: (interest 12.42%)	\$62,083
Less investment income:	\$40,071
Cashflow shortfall:	\$22,012
After tax shortfall: (after franking credits)	\$8,805
or:	\$169 per week

Importantly, that shortfall lasted for only 4 years – because, as the income from the share portfolio grew, the cashflow situation turned positive, as shown in Chart 3.

Chart 3: Negative gearing can turn into positive gearing*
Cashflow shortfall/surplus on \$500,000 gearing strategy. (All Industrials Index 1983 to 2012)



*Assumptions: All Industrials Price and Accumulation Indices to 31/12/01 and the S&P/ASX XNJ and XNJA1 Price and Accumulation Indices thereafter. Dividends 80% franked from the inception of franking. The top marginal tax rate at each year has been used. Interest calculated using RBA's Banks Variable Housing Loan Rates. Initial interest rate: 12.42% p.a. Past performance is not an indicator of future performance. Graphs in this document are for illustrative purposes only.

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- Superannuation
- Wealth creation
- Investments
- Home loans

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