



NORTHSTAR
WEALTH

Borrowing to Invest

A Financial Advice Technical Guide

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This booklet is about borrowing to invest (also known as gearing) to build wealth. It outlines the different ways you can use borrowed money to increase the amount you invest in property, shares and managed funds to help boost your long term returns.

The following information is current as at 1 July 2021

Gearing

What is gearing?

Gearing is using borrowed money to invest. The aim of the strategy is to achieve an after-tax return on investment that is greater than the cost of the loan. If you succeed in this, then your total return on investment will be greater than if you had simply invested your own money.

Investing in growth assets such as shares or property using borrowed funds can be one of the most effective ways to accumulate wealth over the long term.

What are the benefits of gearing?

- **Build your wealth faster** – accelerate wealth creation by investing a larger amount than you could have otherwise invested using your own money.
- **Reduce investment risk through diversification** – by having more funds available to invest, you can diversify your portfolio across a number of different asset classes.
- **Potentially pay less income tax** – interest and other costs of gearing may be tax deductible, and could potentially reduce your taxable income.
- **Utilise existing equity** – borrowing against your existing portfolio can unlock equity and enable you to hold a larger more diversified investment portfolio.
- **Bring forward tax deductions** – it may be possible to bring forward a tax deduction by prepaying interest (for up to 12 months).

Example

If you had \$100,000 to invest, and you invested it for a year in assets that produced a return on investment of 10% pa, your total return on investment would be \$10,000. Now, if you had also used a gearing strategy and borrowed \$50,000 (at a cost of 7% pa) and invested this in the same assets producing the same 10% p.a. return, your return on investment would be 10%, less the cost of finance (7%) – that is, a net additional return of \$1,500 – using someone else's money.

But what if the cost of finance is tax deductible? Then the net return can be greater.

Note: This example is provided for illustrative purposes only. It is not representative of any particular investment product, investment strategy or the returns on any investment. No allowance has been made for inflation, taxation, fees or expenses.

What are the risks of gearing?

- **Gearing magnifies gains but it also magnifies losses** – if investment returns are less than your gearing costs, you may be unable to service your loan. If so, you might have to sell some assets or default on your loan.
- **Loan cost and interest rate risk** – changes to interest rates and fees can vary the cost of your loan. Further, if you decide to terminate your loan, there may be additional charges.
- **Capital risk** – the assets you invest in may not perform as expected.
- **Income risk** – as with any loan, you need to be sure you can afford to service it. If you are relying on investment income to service your loan, this source may not always be sufficient. Even if you are relying on regular income from a job or a business, it is important to make sure your cashflow is sufficient to meet both your loan repayments and living expenses – and to build up some reserve capital for unexpected events. You should also consider what would happen if your income is affected by illness or accident – and the value of having insurance cover for this.
- **Legislative risk** – changes in tax legislation and the regulatory framework may reduce the tax benefits of gearing.

Tips to help manage the risks of gearing

- **Borrow less than you can afford** – to help ensure you can easily meet your regular interest payments even if things do not go according to plan.
- **Invest in high quality investments** – this may reduce the risk of negative returns.
- **Invest for the long term** – this may give you time to ride out any downturns in the market and take advantage of the upturns.
- **Diversify your investments** – spread risk over a range of asset classes and/or securities so that the poor performance of one asset class has a limited effect on total returns.
- **Repay your loan interest regularly** – to help prevent your level of gearing increasing (and to avoid a margin call, in respect of a margin loan).
- **Reinvest the income you earn from investments** – this will reduce your Loan to Valuation Ratio (explained on the following page).

Loan security – what is it?

The security for a loan is the asset(s) that the lender can either claim or force you to sell in order to repay the loan in the event that you fail to make your payments. Assets typically offered as loan security for gearing purposes are property, shares or interests in managed funds.

What is the gearing level?

The gearing level is the amount of money you have borrowed compared to the value of your investment portfolio – expressed as a percentage. For example, if your loan is \$20,000 and your portfolio is worth \$100,000 then your gearing level is 20%. Your gearing level will change as the value of your portfolio changes; if your loan stays at \$20,000 but your portfolio grows in value to \$200,000 your gearing level decreases to 10%.

What is the Loan to Valuation Ratio (LVR)?

The Loan to Valuation Ratio (LVR) is the amount of your loan compared to the value of the investment portfolio you buy with it, expressed as a percentage. When you borrow to invest, the lender will impose a maximum LVR.

For example if you want to buy a portfolio of Australian shares valued at \$100,000 and the LVR is set at 70%, the lender will only lend you a maximum of \$70,000. This is subject to your credit assessment. That way, even if the portfolio decreases in value by 30%, the lender will still have adequate security to cover the loan amount.

Home gearing

What is home gearing?

Home gearing is where you use equity in your home (or other property) as security for an investment loan. The equity in your property is the difference between its value and what you owe on it. Home gearing is a great way to put that equity to work. If you have been busy paying off your home loan and have also enjoyed substantial increases in the value of your property, this may be a strategy to consider.

What are the benefits of a home gearing strategy?

- Lower cost of finance – because the loan is secured by property, interest rates are often lower than when using shares or managed funds as security.
- Borrow more and invest more – because the loan is secured by property, a higher LVR may be possible.
- No restrictions on what you invest in – lenders generally are not concerned about what you invest in as the loan is secured by your property, not what you invest in.
- There may be no need for any additional security.
- Diversify into non-property assets – if your home is your only major asset then you have all your money tied up in one asset class. Using your home equity to diversify into other asset classes may be a beneficial strategy.
- Potentially pay less tax – interest and any other loan costs will generally be tax-deductible if you invest in income producing assets. Additional tax benefits, such as franking credits, may be available if you invest in Australian shares.
- Unlike margin lending, you will not be exposed to margin calls if the value of your portfolio falls in value (see Margin Loans).
- You may be able to pay off your home and create wealth at the same time.

What are the risks of a home gearing strategy?

The risks are the same as those listed under gearing on the previous page. In addition to these, the biggest risk of home gearing is that you may have to sell your home if your investments do not perform well enough in order to service the loan.

Margin loans

What are margin loans?

Margin loans are loans specifically designed to make it easy for you to borrow to invest in shares or managed funds. You can use existing cash, shares or managed funds as security.

When you take out a margin loan, the lender will allow you to borrow up to your borrowing limit. To determine your borrowing limit, a credit assessment needs to be made and you will be asked for information on your financial position.

Example

John has a managed Australian share fund valued at \$30,000. He would like to increase his investment portfolio and also diversify into international shares. A margin loan may allow John to borrow up to 70% of the value of his investment (existing plus recommended portfolio worth \$100,000), which equates to \$70,000 that he can invest into a managed international share fund. John's situation is now as follows:

- Total investments \$100,000
- Total borrowings (margin loan) \$70,000
- Gearing level 70%

Note: This example is provided for illustrative purposes only. It is not representative of any particular investment product, investment strategy or the returns on any investment.

What is a margin call?

A margin call is a demand by the lender to bring your loan back within the maximum LVR. This occurs when the market value of your portfolio falls to such an extent that your LVR exceeds the maximum LVR set by the lender.

Example

Sharon has an existing share portfolio worth \$35,000 and takes out a margin loan of \$65,000 to buy additional Australian shares. Her total share portfolio value is now \$100,000. Her LVR is 65%. This is 5% less than the maximum LVR of 70% set by her lender. 6 months later her loan amount is still \$65,000 but the value of her portfolio has fallen to \$90,000. So now her LVR is 72% – exceeding the 70% maximum. She receives a margin call from her lender to bring her LVR back down below the maximum. In this situation, Sharon needs to do one or a combination of the following:

- Reduce the loan amount by repaying at least
- \$2,000 off the loan
- Deposit additional securities of at least \$2,858 to increase the portfolio value (and therefore reduce the LVR)
- Sell at least \$6,667 of the portfolio and use these proceeds to repay part of her loan.

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Note that some lenders offer a 'buffer' on their margin loans. For example some will not issue a margin call until the LVR exceeds the maximum LVR by a specified percentage. (e.g. 10%).

Different portfolios have different maximum LVRs. The table below shows how much the market value of your portfolio may fall before a margin call occurs.

Personal Borrowing Level (i.e. Your Gearing Level)					
Maximum Loan to Value Ratio (LVR)	70%	60%	50%	40%	30%
70%	13%	25%	38%	50%	63%
65%		20%	33%	47%	60%
60%		14%	29%	43%	57%
55%			23%	38%	54%
50%			17%	33%	50%

Note: This table assumes a buffer of 10%.

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What are the benefits of a margin loan?

In addition to the benefits of gearing described earlier in this booklet:

- You do not need to own a home to obtain a margin loan.
- You can eliminate the stress of timing the market using dollar cost averaging. Many margin loans offer a regular gearing option, enabling you to automatically invest regular instalments – thus helping to avoid the problems of timing the market and trying to choose the best time to invest (see the 'Financial Planning Technical Guide' on 'Investing' for more information).

What are the risks of a margin loan?

In addition to those listed under Gearing, there is an additional risk that if your investments underperform and margin loan repayments are not met, the default will mean the lender can enforce their right to their loan repayments selling not only the geared investment but also your other personal assets, if the investment used as security is insufficient to meet the outstanding loan.

This may result in the redemption of your investments at an unfavourable time and at an unfavourable price.

Regular Gearing

While gearing has many advantages, using your savings to gear on a regular basis can offer some additional benefits. Regular gearing involves combining your savings with borrowed funds to invest into selected managed funds and or shares on a monthly basis.

It can help grow your portfolio faster and it is a simple and automatic way to drip-feed money into investments, allowing you to take advantage of dollar cost averaging – buying more when the market is down and less when the market is up. This can help smooth out the highs and lows of investing.

Case study¹ – How regular gearing works

Sam has \$2,000 equity and wants to invest into an Australian share fund. He can afford to invest an additional \$500 per month and wants to maximise his return over a 10 year period. Sam considers the following options:

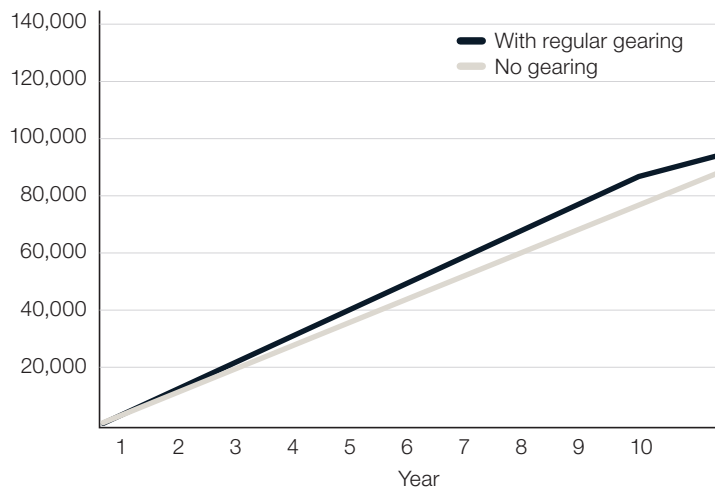
Option 1 – No gearing strategy

Invest the initial \$2,000 and \$500 per month into an Australian share fund. After 10 years the total net value of the investment would be \$85,946 as shown in the table below.

Option 2 – Regular gearing strategy

Combine the initial \$2,000 with a loan of \$5,000 to make an initial investment of \$7,000. Sam invests \$500 per month, as well as using regular gearing to invest an additional \$500 per month from the loan, i.e. he borrows \$500 to create a total investment of \$1,000 per month. After 10 years the total net value of the investment would be \$93,717 (net of a loan balance of \$65,000).

After 10 Years	Option 1	Option 2
Sam's equity contribution	\$62,000	\$62,000
Investment value after interest and tax	\$85,946	\$158,717
Less loan balance	\$0	\$65,000
Investment value after interest, tax and loan	\$85,946	\$93,717



This graph is for illustrative purposes only.

1. Assumptions: Interest rate 8% pa; Distributions re-invested; Capital growth 4% pa; Income yield 4% pa (70% franked); Marginal tax rate 47% (including Medicare levy). Capital gains are realised in the final year. Client has held investment for greater than 12 months using the CGT discounted method and no non-assessable adjustments have been made to the cost base. Any change in assumptions will change the results. This example is provided for illustrative purposes only. It is not representative of any particular investment product, investment strategy or the returns on any investment. No allowance has been made for inflation, fees or expenses.

As shown in the table and graph, regular gearing can give you the advantages of a regular investment plan combined with the advantages of gearing.

What are the benefits of regular gearing?

The investment strategy should be reviewed on a regular basis for several important reasons. These include:

- Provides an automatic and disciplined approach to saving and investing every month
- Benefit from dollar cost averaging – smooth out the highs and lows of investing
- Allows you to invest additional money as and when it becomes available
- Potential to purchase more as your investment portfolio increases in size.

What are the risks of regular gearing?

Similar to gearing generally but may benefit less in a rising market.

Self-Funding Instalments (SFIs)

What is a Self-funding instalment?

Self-funding instalments allow you to gain exposure to shares and other securities by making a part payment upfront and delaying a final payment (which is optional) until a later date.

How do they work?

- The initial payment is generally approximately 50% of the underlying share price and includes an interest cost, put option fee and borrowing fees.
- The put option gives you the option to sell the underlying asset at an agreed price upon maturity back to the provider, so there is no obligation to make the final payment.
- Further payments are generally not required during the investment term.
- Due to the convenient 'self-funding' feature, investment cashflows are automatically managed. In other words, interest is automatically added to the loan on June 30 each year while dividends and any reimbursements of pre-paid interest go to reduce the loan.
- The final payment represents the loan amount payable to the issuer. There are various options available upon maturity, which are outlined in the product information.
- Completion date is the date the outstanding loan is repaid and the underlying shares becomes yours.

What are the benefits?

- **Leverage** – by purchasing a self-funding instalment you pay a fraction of the price of the underlying asset and receive the full benefits of the underlying asset as if you had paid in full.
- **Diversification** – as you require less capital to buy a self-funding instalment, you can obtain greater exposure to the underlying asset. Cash can also be extracted from an existing security through a self-funding instalment to invest in other assets.
- **Automatic cashflows** – the franking credits and dividends paid are used to reduce the loan amount automatically.
- **Cash extraction** – you can unlock cash from existing holdings and you can convert existing securities to self-funding instalments without triggering capital gains.
- **Liquidity** – self-funding instalments are ASX listed – allowing you to sell or purchase at any time during normal market hours.
- **Eligibility** – self-managed super funds can invest in self-funding instalments if these meet certain requirements.
- **Potential tax benefits** – prepaid interest may be deductible.

What are the risks?

- Self-funding instalments increase your exposure to a given security and therefore while returns may be heightened, it is important to note that losses may also be magnified.
- Financial performance of listed entities – the amount of any dividends paid by the underlying securities and applied towards the reduction of the loan is dependent on the listed entities' financial performance and may decline from current levels. As a result, the loan might not be paid down to the extent anticipated.
- Variable interest rates – any increase in the annual interest rate will result in an increase in the cost of funding the self-funding instalments.
- Extraordinary events and corporate actions – the occurrence of an extraordinary event may result in the completion date being brought forward.

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