North Shore Mortgages
Suite 303, 107 Walker Street
North Sydney NSW 2060
☏02 8060 0618
admin@northshoremortgages.com.au
www.northshoremortgages.com.au

BORROWING MONEY AND NEGATIVE GEARING

THE FACTS FROM ASIC

Should you borrow money to invest? That depends on your own personal needs and circumstances.

GET ADVICE

Should you borrow money to invest? That depends on your own personal needs and circumstances. Get advice from a licensed adviser if you are not sure. A licensed adviser is obliged under the law to look at your own personal situation. Real estate agents and salespeople just look after their clients, not you.

Speaking generally, plenty of people and businesses borrow to invest every day. So long as the investment itself is sound, borrowing can be sound.

Borrowing for bad investments will destroy your hopes and plans. If the investment loses value or even ends up worthless, you not only lose all your own capital but you also owe a debt as well.

WHY DO PEOPLE GET INTO NEGATIVE GEARING?

First, negative gearing can offer tax benefits. With negative gearing, your borrowing costs exceed your investment income. The law allows you to deduct your borrowing costs from your total income provided that your investments are genuine.

However, you only get a tax benefit if you earn other taxable income in the first place.

For example, let's suppose Bruce buys an investment (it could be shares, managed funds, a rental property, etc) for $100,000 and pays $6,000 in interest and receives $3,000 income from the investments. He has a loss before tax of $3,000.

Suppose Bruce has a well-paid job (more than $150,000 per year) and pays tax on his salary at the top rate of 47.5%. He can now deduct this loss from his taxable income, and reduce his tax bill by $1425 (47.5% of $3000). The tax saving reduces Bruce's cost of borrowing.

If Bruce earned nothing else apart from his investment, he's just left with a $3,000 loss.

CAN YOU AFFORD NEGATIVE GEARING?

You can afford it only if you have money left over from your other expenses, and only if you can go on expecting reliable income from your job or other sources.

For example, Bruce won't be happy forking out money from his other income forever, just to feed a loss-making investment. He either expects to:

- turn around his yearly loss into a profit some time in the future, or
- sell his investment for a capital gain that's big enough to cover his past losses.

In either case, the tax office will start collecting income tax or capital gains tax.

JUDGE THE INVESTMENT FIRST, NOT THE TAX BENEFIT

A good investment must sooner or later show a profit, not a loss. A good investment should also give you a reliable and rising income. This will reduce your losses over time, and eventually you will expect to pay some tax. To choose a good investment takes time, knowledge and experience. Get independent, licensed advice if you do not want to research and manage investments yourself.
People selling you investments always look on the bright side. But let's check the dark side. Even experienced investors make mistakes and lose money sometimes, and the best, most honest advisers will sometimes give you a poor recommendation. Your experience and their skill and honesty do improve the odds of success. Inexperience and fast talking salespeople shift the odds towards failure.

WHAT'S THE BOTTOM LINE?

The longer you wait for your dollar, the more profit you need to earn to make up for lost time. A dollar today is worth more than a dollar tomorrow. If you earn a dollar today, you can invest it straightaway and earn income. Also, inflation makes tomorrow's dollar worth less than today's.

Remember that Bruce, using negative gearing, pays out today's dollars in interest in the hope of making a profit some time in the future. How long must Bruce wait to make a profit? Will his future profit compensate him for the past losses and the time he waited? Nobody knows for sure.

FIDO suggests you set a:

- realistic target by looking at rates of return from similar types of investments
- realistic time by when you aim to achieve your target. That way, you can check your progress.

WHAT IF INTEREST RATES GO UP?

You will obviously pay different amounts of money over time in interest - it might be less, but it could easily be more.

Check what you will pay if rates go up, for example, to 8% or even 10% per year. Make sure you can afford to meet the payments, or else you could be forced to sell in a hurry at too low a price.

There's also a hidden sting in higher interest rates that affects all investors. Higher interest rates generally reduce the capital value of your investments.

Remember how Bruce earned $3,000 from his $100,000 investment? That investment yields 3% per year. At an interest rate of around 6% per year, investors like Bruce might be happy to earn 3% per year. That's why he is prepared to pay $100,000 for an investment that yields $3,000 in income.

If rates go up, investors will have to pay more to their lender so they most likely will expect a better return than 3%. For example, if investors expect 5% per year, then they will be prepared to pay only $60,000 for an investment yielding $3,000 per year. (As you can see, 5% of $60,000 equals $3,000.)

If Bruce can sell for only $60,000 what he originally bought for $100,000, then he'll face a big loss.

TAKE AN HONEST LOOK AT NEGATIVE GEARING

Salespeople who sell negative gearing schemes often hide the truth. Investments can lose value because of economic forces beyond your control. Faced with this fact, every investor takes the risk that they may lose money. However, in time, if they choose good quality investments, they will win out and should make a decent return.

FIDO suggests you need to do at least 3 things to succeed with negative gearing
1 Buy good quality investments, preferably with a reliable and rising income stream.
2 Borrow conservatively so you can survive interest rate rises and possible loss of income.
3 Maintain reliable income from your job or other sources to cover your borrowing costs, especially in the early years.

If you borrow up to your eyeballs, especially if you're investing for the first time, you're risking financial ruin.

To find out more and discuss if negative gearing is right for you, contact us on 02 8060 0618 or email admin@northshoremortgages.com.au. We look forward to assisting you.