

q&a

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Q 1: I have friends who have been using loans to invest in shares for years but with the sharemarket falling over the last 18 months, their investment is now worth less than their investment loan. Is borrowing money to invest in the sharemarket still a useful strategy for creating wealth?

M.H., Queanbeyan

A 1: In short, borrowing to invest can still be a very useful strategy for creating wealth. To explain:

- 1) Borrowing money to invest (whether via a margin loan or accessing equity from a home mortgage) allows the investor "leverage" to get greater exposure to an investment than they have currently accumulated in assets
- 2) Income derived from the investment will be tax assessable, while the cost of borrowing funds (interest rate) will be an allowable tax deduction
- 3) In a normal average year, the costs of the borrowed funds would usually be greater than the assessable income derived from the investment (a negative gearing position) even after allowing for the follow on benefit of the tax deduction from negative gearing and input tax credits (franking credits) attached to investing in Australian shares
- 4) As such, from a cashflow point of view, the end result is that negative gearing actually makes you worse off!
- 5) So why do people use this strategy? Because they need to be investing in assets that have a large enough capital growth to outweigh the cashflow deficit created above.

This is the theory, however there are 2 key components that need to exist aswell to have a successful experience when using borrowed funds for investment, and they are:

1. The underlying investment needs to be a quality asset (ie well diversified to reduce risk of capital loss and capable of producing returns over the long term), and
2. The investor having a long term investment timeframe in mind (Preferably 10 years or more)

Here are some numbers produced by margin loan provider Colonial Geared Investments, which help illustrate the point comparing investing \$100,000 in savings to earn assessable income of 4% pa (among other reasonable assumptions), and borrowing \$100,000 at an interest rate of 8% pa:

1. For an investor on a marginal tax rate of 31.5%, the investment would need to have an average capital growth of 5.48% pa or more to make borrowing for investment worthwhile (after allowing for all taxes upon sale aswell). This would mean a total annual return from the investment of 9.48% pa
2. For an investor on a marginal tax rate of 39.5%, capital growth of 4.84% pa is required (total investment return of 8.84% pa)
3. For an investor on a marginal tax rate of 46.5%, capital growth of 4.28% pa is required (total return 8.28% pa)

With average annual returns from the Australian sharemarket for the last 109 years being 11.8% pa, borrowing to invest can still produce a greater overall benefit by a few percentage points per year – so long as you have the time and patience to remain invested. The lower valuation of sharemarkets now represent very cheap buying from a historical perspective.

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