



# TOP 10 MISTAKES TO AVOID

with

# NEGATIVE GEARING

## Letter from the Wealth Adviser Library

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Dear **Reader**

WELCOME TO THE WEALTH ADVISER LIBRARY.

This library was built specifically to facilitate the provision of sound financial information to everyday Australians.

Our mission is to build an accessible, comprehensively supported team of members who share our vision and commitment to providing tailored financial advice and a new foundation of financial understanding and security for everyone.

With a national network of likeminded experts, we have the potential to provide the financial building blocks for future generations.

**KNOWLEDGE GIVES YOU A HUGE ADVANTAGE**

We believe that knowledge gives you a huge advantage in creating and effectively managing wealth; in planning to reach your goals; and in being prepared for whatever unexpected twists and turns life may present.

That's why our team of experts has created this series of eBooks that seek to inform you of not only the benefits but also the potential risks and pitfalls of various strategies and investments.

We trust you enjoy this publication and find it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

**TAKE THE NEXT STEP**

We invite you to meet with one of our advisers to discuss what it was you were hoping to achieve when you obtained this document, and to establish if they can help you achieve your goals and objectives.

At the rear of this handbook you will find the details on how to book an appointment with one of our experts.

We look forward to meeting you soon.

**Wealth Adviser Library**

## Contents

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Before you get started .....	1
Letter from the Wealth Adviser Library .....	2
Introduction .....	4
Gearing Mistake #1 – Not Understanding the Basics.....	5
Gearing Mistake #2 – Making geared investments too close to retirement .....	6
Gearing Mistake #3 – Making geared investments with insufficient cash reserves .....	6
Gearing Mistake #4 – Not giving due consideration to how the debt will be paid off .....	7
Gearing Mistake #5 – Not giving due consideration to your personality and risk profile.....	7
Gearing Mistake #6 – Not having good buffers and contingency plans in place .....	8
Gearing Mistake #7 – Borrowing too much money .....	8
Gearing Mistake #8 – Believing that gearing is only about tax benefits.....	9
Gearing Mistake #9 – Not buying wisely .....	9
Gearing Mistake #10 – Not understanding the difference between strategic and tactical gearing ..	10
Conclusion .....	10
Readers Notes.....	11
Take the next step .....	13
Appointment Booking Request form .....	14

## Introduction

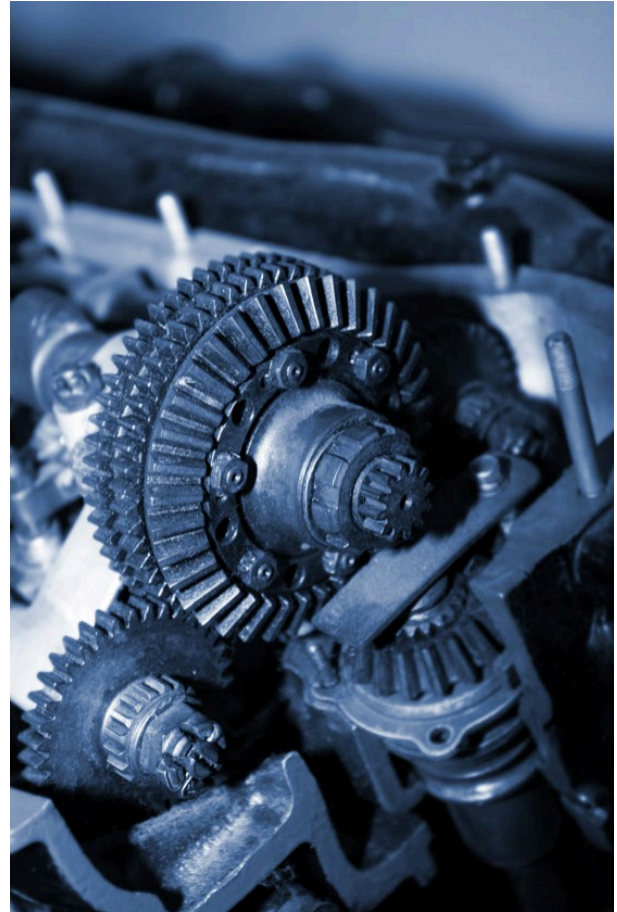
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It is fair to say that anyone who is serious about long term wealth creation would consider gearing as an integral part of their strategy. The term may seem slightly intimidating but gearing simply refers to the use of borrowed funds to gain control of an appreciating asset. This is obviously a rather basic definition (it will be fleshed out as we go along) but it does cut to the essence of why this could be a powerful way to boost your personal bottom line. By engaging in responsible borrowing (and the word 'responsible' should certainly be stressed) you can gain the leverage to acquire assets that would have been very difficult to acquire if you simply had your personal funds to rely on.

One of the main things that cause people to shy away from gearing at the moment is the constant debate in the media about the impact of 'negative' gearing on the economy. Negative gearing is where the cost of owning the geared asset (repayments, interest, management costs etc.) will be more than the income produced by the asset, at least in the short term. It is important to realise that not all gearing need to be 'negative'. Negative gearing is only one form of gearing. For this reason we will simply be referring to gearing throughout whilst making clear when the focus is specifically on negative gearing.

The contents of this eBook will be framed in the form of mistakes that investors often make when it comes to the area of gearing. By taking note of these mistakes and doing your best to avoid them you will position yourself to make better use of a wealth building strategy that has been a critical factor in the success of many investors in the past. We would like to strongly encourage you to get the best possible advice as you put this strategy in place and stand ready to serve you in this regard.

It should be noted that for the purposes of this guide the focus will be on the purchasing of geared property. There are obviously other forms of gearing (e.g. borrowing to buy shares) but it is probably fair to say that most investors who engage in strategic gearing will be investing in property so this will be the focus of this eBook unless otherwise specified.



## Gearing Mistake #1 – Not Understanding the Basics

The case is unfortunately, that many people rush into gearing without understanding the basics and the possible challenges associated with it. It is important that you do your homework and that you fully understand not only the concept of gearing but also the gearing strategies that are likely to provide the best returns.

It would probably be good to start with a formal definition of gearing before going on to discuss some of the basic factors that should be taken into account when entering into this type of investment. A good working definition is the following: Gearing is where money is borrowed to finance the acquisition of an asset in the expectation that the asset grows in value and that the income and gains exceed the holding and financing costs over time. If properly employed gearing can be a very effective wealth building tool as it could in the long term lead to full and unencumbered control of an income producing asset once the loan had been paid off.

As mentioned above 'negative gearing' is where the income derived from the asset is less than the cost of acquisition in the short term. In some cases tax relief can be associated with negatively geared properties.

The following points are useful in understanding some aspects of gearing as an investment strategy:

- It is important to note that for gearing to work the borrowed funds should be utilised to acquire an 'appreciating asset'. This means that there should be the expectation that the asset you are purchasing (most commonly property) will, in fact, increase in value over time. Without this growth there would really be very few reasons to engage in gearing.
- Those who engage in gearing should always be ready to take 'the long view' as you will essentially be choosing to convert income today into growth for tomorrow. You give up on the income from the investment (e.g. rent collected from a tenant) in the short term by handing it to the bank to service the loan. Once again future growth is what should really be in view

here as this 'sacrifice' could lead you to eventually have

- full control (i.e. without outstanding loan repayments) of an income producing asset.
- The fact that the bank 'chips in' by supplying borrowed funds means that you can acquire assets way beyond what would be possible with your own funds. This is a very attractive feature of gearing but it is important not to go overboard and overcommit yourself. Getting financial advice on the size of your investment is therefore highly recommended.
- Gearing does not come without risk as you will be taking on significant levels of debt. You can either be richly rewarded for these risks or be punished for them (especially if you took on ill-advised levels of debt) so it is, once again, critical that you make sure that your decisions in this regard are as informed and responsible as possible.
- Many spruikers 'sell' gearing on the basis of the tax deductions that you can currently claim on losses associated with geared properties. If this is the only reason that you are getting into gearing you should reconsider. Gearing is a wealth strategy first and foremost. If you are gearing for the tax deductions, then you are gearing for the wrong reasons.
- All of the above should make it clear that gearing can indeed be an attractive investment strategy but that it does not come risk free. It may, therefore, not be for everyone and your personality, life-stage and risk profile will certainly have to be taken into account before you decide to take the plunge. We trust that the rest of this guide will help you to make the call on whether gearing could possibly be for you.

## Gearing Mistake #2 – Making geared investments too close to retirement

The 'magic' of gearing really comes into its own if you have time available to allow the asset to grow and also make a significant dent in repaying the debt on the geared asset. As a general rule we would say that gearing in the 5-7 year window before retirement is probably not to be recommended. This is because ideally debt must be cleared by retirement as you would not want to still be making debt servicing payments from your retirement income. Taking on significant new debt and hoping to pay it off over a short time-period (i.e. fewer than 5 years) will, in most cases, be a bit of a tall order.

If you plan to make geared investments you should, in light of the above, do some clear headed planning on possible timelines that will allow for debt repayment as well as asset growth. Time is your friend as far as gearing is concerned and we would recommend, as mentioned above, that you have at least 7 years (with 10 or more being ideal). This kind of timeframe means that you increase the possibility of benefitting from at least one good market cycle. This reduces your reliance on blind luck (e.g. hoping for a sudden property spike over the next two years). Some people are comfortable with 'taking the plunge' and betting on the market but in the long run buying and holding for a substantial period is the best way to succeed at gearing for most people.

## Gearing Mistake #3 – Making geared investments with insufficient cash reserves

Getting into gearing against the background of a poor personal cash flow scenario is not a good idea at all. If your budget is already very tight and you do not have access to much extra cash you really should not be thinking about taking on significant levels of extra debt. If this is your situation we would suggest that your #1 priority should be to fix your cash flow first. Work hard on improving your budget bottom line, either by raising your income, reducing expenditure or both. When this has resulted in a strong annual surplus you can consider gearing.

The main reason behind this word of caution is that you may need to call on significant cash reserves while engaged in geared investments. This can come in the form of several weeks without tenants, sudden repairs or any number of unexpected situations. If you do not have 'fat' in your budget these kind of scenarios could prove very stressful.

Responsible investors know that there is no way to only use someone else's money to get rich! To get ahead you will have to save and contribute some of your own funds. We recommend aiming to have at least 10% of your annual income available as a surplus. For many people this will entail a significant effort in cutting back on their spending but the result could be the ability to engage in potentially lucrative investment strategies like gearing.



## Gearing Mistake #4 – Not giving due consideration to how the debt will be paid off

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One of the most basic aspects of gearing is that it involves taking on board a significant level of debt. An integral part of the gearing conversation should, therefore, focus on how this debt will eventually be paid off.

Some investors opt for an interest only strategy. This is where they would take out interest only mortgages in the hope that the asset will appreciate in value to such an extent that the principal part of the debt can be paid off from the proceeds of asset growth and an eventual sale. This is a risky strategy in the sense that you will be entirely dependent on appreciation in the value of the asset. It could, therefore, be seen as a form of 'playing the market' as you cannot be sure that the asset will, in fact, appreciate at the rate that you are hoping for.

In our opinion it is far better to opt to gradually pay off the debt (i.e. by taking out a repayment based loan or strategy). In this way you will be creating equity in two ways. Not only will you be paying off the debt thus increasing your stake in the asset, you may also still benefit from growth. A repayment strategy also means that you will in time have full, unencumbered, use of the asset including its income generating capacity in the sense that you will eventually be able to enjoy the income without having to service a loan.

We would, in light of the above, recommend that you plan to hold on to assets for as long as possible. Property transactions have significant costs associated with them and could also attract significant levels of taxation (e.g. Capital Gains Tax). It would be far better to plan to 'buy and hold' in order to eventually benefit from the income being generated by the asset. This would be very difficult to achieve if you do not begin to pay off the principal of the debt from the start.

## Gearing Mistake #5 – Not giving due consideration to your personality and risk profile

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All of us are different and we therefore also have different attitudes towards investments and what we feel comfortable with. Some people are extremely comfortable with risk and seem to thrive on it. Others will respond to the same level of risk with such high levels of anxiety that it is simply not worth it.

Temperament also comes into play. Some people are very phlegmatic and patient and will have no issues with holding on to a geared investment for a long time. Others may be so excitable and impulsive by nature that they would not be able to resist the temptation to go for the 'quick sale'.

A third factor has to do with risk profile. Simply put, how much risk can you put up with at this stage of your life? For younger people with no dependants the answer is probably 'quite a bit'. For others (i.e. those nearing retirement or with dependants still living at home) the answer may be exactly the opposite.

All of the factors mentioned above will have to be weighed up when it comes to the decision on whether to take on a geared investment or not. Not doing so could have significant negative consequences. It could lead to investors getting out too soon (due to being unable to cope with the possible risks) or unwisely selling assets to pursue short term gains.

We would, in light of this, highly recommend that you do some work on your own investor profile. Getting a financial advisor on board could prove invaluable as far as this is concerned.

## Gearing Mistake #6 – Not having good buffers and contingency plans in place

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We may not all subscribe to Murphy's Law but in the area of investment it would be wise to constantly keep in mind that things can and will often go wrong. If you, therefore, go into a gearing situation without any financial buffers or well thought-out plans for how you are going to deal with a variety of contingencies you may end up finding yourself in a very undesirable position.

We would, therefore, highly recommend that you draw up an inventory of your available reserves and also that you sit down to design some contingency plans even before you make the investment. This will enable you to quickly and appropriately respond should anything untoward happen. Some questions that you may want to ask include the following:

- Do I have access to enough of a household surplus to easily absorb and interest rate rise?
- Would I be able to access a sufficiently large cash buffer in case the geared property is without a tenant for a few months?
- Have all the relevant types of insurance been arranged? This should, at the very least, include life insurance, total & permanent disability, income protection and trauma insurance. On the property management side you should also ensure that you are covered by appropriate levels of property and landlord insurance.

Some people are temperamentally inclined to 'always look at the bright side of life'. They especially should make sure that they do the hard work to consider what might go wrong and preparing accordingly.

## Gearing Mistake #7 – Borrowing too much money

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Banks will often be willing to lend you significant amounts of money, especially if you have managed to maintain a good credit score. However, just because they are willing to hand that much money over does not mean that you should automatically take it. It is possible to overdo it! In the end you need to march to your own drum and follow your own strategy. This is obviously not necessarily the same thing as taking on as much debt as you can possibly get.

You should, in light of the above, take a long hard look at the gearing ratio that you're comfortable with. This simply refers to how much of the value of the property is owed to the bank in the form of your loan (e.g. 50% of the value of the property is relatively low while 90% can be considered high). The higher the gearing ratio the messier it can be if things go wrong as being too heavily in debt can expose you to significant risks in case of an economic downturn or other crisis.

Gearing ratios should not only be worked out in terms of the specific property but rather in terms of your household's bigger financial position. For example, you might end up borrowing 100% to buy a \$600,000 investment property but if your total assets after the purchase are \$3,600,000 and your total debts are \$1,200,000 your overall ratio is 33% which if you have good household cash flow and an adequate timeline is very reasonable. Conversely it may also be the case that a low geared property could add to an already unsustainable level of household debt. A situation best avoided. A financial advisor will be able to help you crunch the numbers to get this kind of bigger picture upon which to base your decisions.



## **Gearing Mistake #8 – Believing that gearing is only about tax benefits**

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Many investors are so excited by the possible tax benefits associated with gearing that they lose sight of the bigger picture. Tax benefits should not be seen as the alpha and omega of gearing. Simply put, borrowing money in order to save on your tax bill is not a good idea at all.

You should borrow money to use for the purpose of gearing because you have come to a considered conclusion that this can be an integral part of your wealth creation plan not because you want to jump on some negative gearing bandwagon where tax reductions are seen as front and centre. Yes tax deductions are welcome and will certainly improve your bottom line but do not see them as the ultimate goal.

## **Gearing Mistake #9 – Not buying wisely**

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Gearing is not a magic wand that will automatically turn your fortunes around. You will still have to buy the right property, at the right price, at the right place and at the right time. It is all too easy to believe that we are property experts or that the 'hot tip' passed around is based on a sound understanding of the property market. Sadly far too many people get their fingers burned in this way.

For a gearing strategy to work you will have to buy an asset that has good growth prospects over time. This means that a lot of homework will have to be done to find the best 'fit' possible and that to rush into transactions on flimsy recommendations or because you 'fell in love' with a place should be avoided at all costs. Make sure, in light of this, that you get the best possible professional advice before committing to what could be one of the most significant transactions of your life.



## Gearing Mistake #10 – Not understanding the difference between strategic and tactical gearing

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There are essentially two types of gearing. The first can be defined as 'tactical' and essentially comes down to 'playing the market'. A helpful way to understand this is to ask whether a failed gearing investment will have a material effect on the life of the investor. If not, we're probably dealing with tactical gearing. For example, if someone worth \$3m borrows \$30,000 to buy shares and then loses the lot he is engaged in tactical gearing. The entire loss although momentarily painful will not have a material effect on his life.

Strategic gearing is something altogether different. Think, for example, of someone worth \$1,200,000 who bought \$500,000 property in a mining town that is now valued at \$300,000 (and cannot sell it at that). This person is engaged in strategic gearing and the \$200,000 loss will have a material effect on his/her life.

Investors will have to have a full picture of where they stand financially to determine what type of gearing they are likely to engage in. Those who fall into the 'strategic' category will need to be very realistic about what they are engaging in and the risks associated with it. They should treat this investment with the respect and due diligence it deserves because if things go wrong it could have a significant negative impact on their lives. We would in light of this suggest that those who engage in strategic gearing should make it a priority to get professional help and advice as they plan their wealth building strategies.

## Conclusion

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The material presented above should make it clear that strategic gearing can be a very sharp sword. If handled well it has the power to cut through the barriers between you and your financial independence. But if handled poorly or in an amateurish way it has the ability to cut and disable that same progression.

We would, therefore, encourage you to get competent financial advice as you consider the role of gearing in your wealth creation plan. A good next step will be reading our eBook 'Your Guide to Negative Gearing'. This can be downloaded from [www.wealthadviser.com.au](http://www.wealthadviser.com.au)

We trust that this guide was useful in helping you to think through some of the issues associated with gearing and that it also set you thinking about some wider financial planning issues.

It would be impossible, however, to present a complete guide to all your financial planning needs in a document as brief as this. We urge you to continue your explorations by making use of some of the other resources and eBooks from the Wealth Adviser stable.





## Take the next step

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We trust you enjoyed this publication and found it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

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# Appointment Booking Request form

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Please nominate your preferred day, date and time to meet with us. One of our client services representatives will call you to confirm your appointment.

Preferred appointment day and time

Day

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Date

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Time

am/pm

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If you would like us to contact you via email to confirm your appointment or to answer any questions you have, please provide a valid email address for our records.

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Title

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