Fact Sheet.

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 39%):	$1,170
After tax shortfall:	$1,830

Gearing magnifies losses and gains

When you borrow to invest, your gains are magnified because someone else's money was used to create 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 $1,830 cashflow shortfall. It's an $8,170 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 $11,830, as shown in Chart 1.

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

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 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.

CHART 1: Winning and losing with other people's money

Case study: Create wealth of $5,013,341 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 2014 they would have created wealth of $1,002,668, after repaying the $100,000 and paying tax on that withdrawal, with an initial cashflow shortfall of just $34 a week – after taking into account investment income

CHART 2: Gearing Australian shares to create wealth*