

GEARED VERSUS NON-GEARED BREAK-EVEN ANALYSIS

It is generally known that borrowing to invest (often referred to as gearing) offers the potential to grow wealth at a faster rate when compared to not gearing. However, many investors who are familiar with the benefits of gearing believe that borrowing to invest is only appropriate in a strong rising market. Interestingly, the required rate of return that will result in an investor being better off using gearing, over not gearing is lower than many think.

While an investor would only undertake a geared investment strategy if they believed it would outperform a non-geared strategy, it is often difficult to determine at what point one strategy outperforms the other. Establishing the point where the profit from gearing and non-gearing is the same will depend on a combination of variables including the interest rate on the borrowed money, the expected capital growth rate and income yield from the portfolio and the investor's marginal tax rate.

EXAMPLE

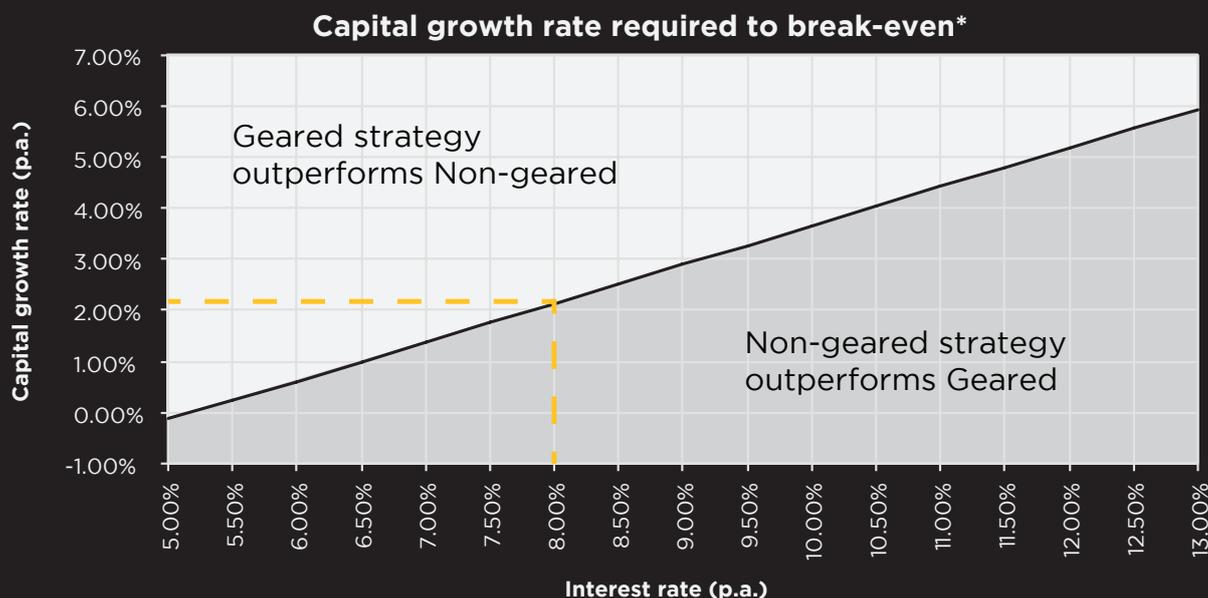
Let's assume an investor can achieve an income yield of 4.00% p.a. with an average franking level of 70%. It is assumed the investment is held for 12 months so a 50% discount is applied to the capital gains[^].

Based on these assumptions the graph shows the combinations of annual capital growth and interest rates required for a geared and non-geared portfolio to produce an identical after-tax investment return. The space above the black line shows the conditions that will result in the geared portfolio outperforming the non-geared portfolio. The space below the black line shows the conditions that will result in the non-geared portfolio outperforming the geared portfolio.

Our analysis shows that if the current investment loan interest rate is 8.00% p.a., only a modest capital growth rate of 2.12% p.a. will be required for a geared and non-geared portfolio to produce an identical after-tax return over the next 12 months. An investor who expects to achieve a capital growth rate higher than 2.12% p.a. may be better off considering a geared investment strategy to improve their potential returns. An investor who expects to achieve a capital growth rate lower than 2.12% p.a. may be better off considering a non-geared investment strategy.

This shows that even in times of modest capital growth, gearing may still provide greater returns than a non-geared portfolio.

Assumptions	
Investor's Contribution	\$50,000
Gearing level	50%
Interest rate (p.a.)	8.00%
Income yield (p.a.)	4.00%
Capital growth (p.a.)	2.12%
Franking Level	70%
Marginal tax rate	37.0%
Medicare levy	2.00%



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	Geared Portfolio	Non-Geared Portfolio
Start of year		
Investor's contribution	\$50,000	\$50,000
Loan balance	\$50,000	\$0
Value of portfolio	\$100,000	\$50,000
End of year		
Value of portfolio	\$102,122	\$51,061
Interest paid	-\$4,000	\$0
Investment income	\$4,000	\$2,000
Franking credits	\$1,200	\$600
Tax on income	-\$468	-\$1,014
Net cash flow	\$732	\$1,586
CGT liability	\$414	\$207
Net wealth	\$52,440	\$52,440
1 year after-tax-return*	4.88%	4.88%

GEARED VS NON-GEARED BREAK-EVEN SIMULATOR*

Take the guess work out and use our Geared vs Non-Geared Break-even Simulator for your own investment scenarios. This simulator will calculate the required capital growth rate, interest rate or income yield required to achieve an identical after-tax return from geared and non-geared strategies.

Simply **download the simulator** or visit **CommSec Adviser Services** (Forms & Resources > Resources > Investment Loan) to see our full range of calculators.

Example of a Geared vs Non-geared Break-even Simulation

Step 1	Result	Step 2	Step 3
Enter your assumptions Assumptions Client Equity <input type="text" value="\$50,000.00"/> Gearing Ratio (Geared strategy) <input type="text" value="50.00%"/> Interest Rate (p.a.) (Geared strategy) <input type="text" value="8.00%"/> Capital Growth (p.a.) <input type="text" value="2.12%"/> Income Yield (p.a.) <input type="text" value="4.00%"/> Franking Level <input type="text" value="70.00%"/> Marginal Tax Rate <input type="text" value="37%"/> Medicare Levy <input type="text" value="2.00%"/> Company Tax Rate <input type="text" value="30%"/> <input type="button" value="Clear Assumptions"/>	Investment cash flow - Year 1 Investment Strategy: Geared Non-Geared Start of Year Client Equity <input type="text" value="\$50,000.00"/> <input type="text" value="\$50,000.00"/> Amount borrowed <input type="text" value="\$50,000.00"/> <input type="text" value="\$0.00"/> Portfolio value <input type="text" value="\$100,000.00"/> <input type="text" value="\$50,000.00"/> End of Year Portfolio value <input type="text" value="\$102,121.74"/> <input type="text" value="\$51,060.87"/> Capital Gains Capital Gain/Loss <input type="text" value="\$2,121.74"/> <input type="text" value="\$1,060.87"/> CGT liability (50% discount applied) <input type="text" value="\$413.74"/> <input type="text" value="\$206.87"/> Capital Gain/Loss After Tax <input type="text" value="\$1,708.00"/> <input type="text" value="\$854.00"/> Cash flow Distributions <input type="text" value="\$4,000.00"/> <input type="text" value="\$2,000.00"/> Loan interest <input type="text" value="-\$4,000.00"/> <input type="text" value="\$0.00"/> Tax Payable/Refund <input type="text" value="-\$468.00"/> <input type="text" value="-\$1,014.00"/> Franking Credits <input type="text" value="\$1,200.00"/> <input type="text" value="\$600.00"/> Cash flow after tax <input type="text" value="\$732.00"/> <input type="text" value="\$1,586.00"/> Net Profit/Loss After Tax <input type="text" value="\$2,440.00"/> <input type="text" value="\$2,440.00"/> 1 Year Return After Tax <input type="text" value="4.88%"/> <input type="text" value="4.88%"/> BREAKEVEN	Calculate break-even point <input type="button" value="Calculate Breakeven"/> Required Interest Rate (pa) <input type="text" value="11.80%"/> OR Required Capital Growth (pa) <input type="text" value="2.12%"/> OR Required Income Yield (pa) <input type="text" value="1.08%"/>	Change an assumption <input type="button" value="Change Interest Rate"/> <input type="button" value="Change Capital Growth"/> <input type="button" value="Change Income Yield"/> <input type="button" value="Back"/> <input type="button" value="Print page"/> <input type="button" value="View disclaimer"/>



RISKS AND MANAGEMENT

Borrowing to invest involves risks. Just as it can accelerate your profits when your investments are successful, it can also multiply your losses if they fall and this may result in your security being insufficient to repay your loan.

There are various ways you can reduce these risks. They include:

- Borrowing less than the maximum allowed
- Diversifying investments to help reduce volatility
- Using investment income to reduce the loan balance
- Regularly reviewing the loan status

Please speak to your financial adviser for more information about how gearing can accelerate your potential wealth.

*Information on taxation is based on the continuation of current laws, as at the date of communication, and their interpretation which may be subject to change.

*See Important Information below before considering this information.

Important Information:

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