

# Leveraging or Gearing

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Leveraging or Gearing is a term often used in the Financial world but what does it mean and how do you, or can you benefit from it?

People often fear borrowing money as it creates a commitment that they feel uncomfortable with. This often stems from our parents philosophy i.e. "If you can't afford to pay cash for it you can't have it".

Unfortunately this "philosophy" can be flawed. Their outlook on debt is still true today if you take on bad debt but can be very counter productive when it comes to "good debt".

Firstly the difference between good and bad debt;

Bad debt - is money borrowed for consumables that tend to depreciate such as cars, white goods, televisions etc.

Good debt - is money borrowed for appreciating, income earning assets such as property, shares etc.

As an example let's look at Joe and Bill who come into \$50,000 and both decide to invest it for 10 years for their future. However, they have very different Philosophies about risk and borrowing money. (We will assume for the exercise that interest rates remain the same for 10 years and the inflation rate remains steady at 3%. We will also ignore the compounding effect).

Joe decides safety first and places his money in a term deposit in the Bank at 6% interest for 10 years. After the full term Joe has earned \$30,000 in interest less tax of \$9,000 (based on 30% tax rate), leaving a profit \$21,000. However we need to take into consideration the effects of inflation which mean that his initial \$50,000 has reduced in value by \$15,000. Total profit on his initial investment over 10 years is \$6,000.

Bill decides to leverage his investment and purchases an investment property for \$500,000 using his \$50,000 as the deposit and borrowing \$450,000 interest only. After rent and tax benefits the cost to him is \$125 per week. Over 10 years his out of pocket expenses are \$65,000 but the property, based on inflation has increased to \$650,000. He sells it, recoups his initial \$50,000, pays tax of \$22,500 on the capital gain deducts his input (\$65,000) and records a profit of \$62,500. Ten times Joe's profit.

This simple example is designed to show how "good debt" can multiply your returns and how debt should play an important part of any investment strategy.