ISSUE 1

Leverage

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Your guide to building personal wealth through effective financing from Statewide Assets

Gearing is not a dirty word!

Gearing ... one of the world's great wealth creation tools.

Gearing — it's a term that often strikes fear into the hearts of inexperienced investors. Especially those who recall the excesses (and eventual downfalls) of certain entrepreneurs of the 1980s whose fragile empires were built on excessive debt.

What these entrepreneurs learnt is that gearing can be a double-edged sword. But used wisely, gearing can be a relatively low-risk way to wealth, and the only way many of us will achieve financial independence in our lifetimes.

In this article, we take a look at the basics of gearing and examine who can benefit from one of the financial world's great wealth creation tools.

Gearing explained

Gearing, for the uninitiated, is quite simply financial jargon for borrowing money to increase the amount of capital you have available to invest. There are three types of gearing, and although the terms may sound daunting, they are basically quite simple.

The most talked about form is negative gearing. A negatively geared investment is simply one where the interest on the borrowed amount exceeds the net income received from the investment. The investor can then claim a tax deduction on the difference between the interest cost and the net income.

Positive gearing is the opposite. A positively geared investment is one where the net income from an investment exceeds the interest costs, while neutral gearing is where both the net income and the interest costs are the same.

Productive debt vs. unproductive debt

Many people have been brought up believing that all debt is bad. This is certainly not true, but it's important to draw a distinction between productive debt and unproductive debt.

Productive debt is borrowing that is used to purchase assets that produce income and grow in value. The added advantage of productive debt is that the interest on the borrowing can be offset against income, and any shortfall is tax deductible.

Unproductive debt, on the other hand, is borrowing that is used to purchase liabilities, typically things such as cars and furniture not used for business, and holidays, etc. Essentially, anything that doesn't produce income and/or growth, or depreciates in value.

Ultimately, leveraging our assets (i.e. gearing) is often essential to building wealth, and provided we invest in quality growth assets, it's the only way that many of us will achieve financial independence.

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the finance scene according to

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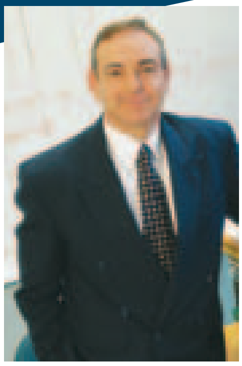

You pay for good advice once, but bad advice for a lifetime

By Graham Jay

The cover story of this issue of our newsletter makes an important point. And it's one that's true of any investment decision, but crucial when gearing an investment ... *the quality of the investment is everything!*

I'd like to take this one step further. The quality of your investment advice is paramount, because, let's face it, we can't all be experts in every investment category and every market.

As one person discovered, creative valuations or hidden commissions can prove to be a costly learning experience for the property investor. His story serves as a lesson in *caveat emptor* — let the buyer beware — and proves the value of doing your homework when choosing an adviser or selling agent.

A hard lesson learnt

When this person (I'll call him Adam for convenience) came to see us he was in a seemingly strong financial position, and ready to expand his investment portfolio with a second property.

He had paid $240,000 for his first investment property in Queensland four years previously — borrowing 100 per cent of the property's price plus borrowing and purchase costs which brought the total loan to about $264,000.

To finance the second property, we assumed the property in Queensland would value at the price he paid for it. Enquiries to the lender found that the value at the time of purchase to be only $200,000, and only $185,000, after a revaluation was requested!

Adam had planned to borrow 100% of the total price and costs of the second property, but a valuation of the Queensland property at $55,000 less than anticipated reduced the amount he was able to borrow by $44,000.

This left only two choices, either reduce the amount to be borrowed (perhaps choosing a less expensive property) or reduce his personal line of credit, which he was planning to use to build a share portfolio.

It was bad enough that Adam was left with negative equity of $79,000 ($264,000 – $185,000). But there were also four years of holding costs to add, ranging between $5,000 and $10,000 per year. This meant a total loss of between $99,000 and $119,000.

Then, most disheartening of all, there is the opportunity cost — if he had invested the same $240,000 in a quality, well-located residential property in Melbourne, for example, it could now be worth in excess of $340,000.

Ultimately, for Adam, bad advice resulted in an overall loss of approximately $200,000 over 4 years — about $100,000 in lost capital gain and about $100,000 in lost equity.

Who is your adviser serving?

Adam's story highlights the importance of doing your homework and being sure that your adviser is acting in your best interest.

This is best done by seeking advice from someone you know and trust, or being recommended an adviser by someone who you are sure has your interests at heart. Spending time now seeking quality advice is your best investment in your financial future.

Ultimately, choosing the right asset is still absolutely critical, getting it for the right price is next in importance, and both are the reward of good advice.

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Fix for less

A strange thing is happening in the world of interest rates. At the time of printing, most of the major financial institutions were offering fixed-rate loans at an interest rate of less than 8%. What's unusual about this is that many of the same institutions are offering a standard variable rate of 8.07%. Typically, you would expect to pay a premium to lock in a fixed rate.

In effect, you may be able to lock in a fixed rate cheaper than the current variable rate. Which is something that may be worth considering if you have substantial borrowing.

If you would like to discuss the possible advantages of fixing your loan, please phone us on (03) 9576 1355.

Statewide Assets workshop and seminar program

In another new initiative, we're currently developing a program of educational workshops and seminars to elaborate on the kinds of topics we'll be covering in this and future issues of *Leverage*. We'll cover the basics of using gearing to build wealth and look at more advanced strategies for maximising your equity use and special topics like debt reduction.

We'll keep you informed of upcoming workshops and seminars by mail, and in future issues of *Leverage*. If, in the mean time, you have any suggestions for future topics or there is something you'd particularly like to see, please let us know.

First Home Owner's Grant

If you or your partner haven't owned a home before, you may qualify for the Federal Government's First Home Owner's Grant – a $7,000 payment to assist you in buying or building your first home. A new government incentive to compensate for the GST. The good news is that it's not means tested or limited to a particular price range.

A number of financial institutions will be appointed as agencies to administer the grants. And if your loan is through one of these institutions, you'll be able to receive your grant at settlement. With other financial institutions, you'll have to wait until after settlement, so it's important to check with your institution before you bank on having these funds to settle.

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Is it for everyone?

For most people, the use of gearing is the most likely path to financial independence, but there is a couple of exceptions.

If you are in retirement or less than five years away from retirement, gearing is probably not the strategy for you. Negative gearing particularly relies on growth in the asset and, as markets naturally fluctuate, a four- or five-year timeframe is necessary to ride out market cycles, and for you to see any substantial return after set-up costs.

Gearing is also not recommended if you're uncertain of your personal income. Particularly with negative gearing, a certain personal income is needed to cover any shortfall between the income from the investment and interest payments.

It's equally important to be realistic about your investment income, particularly when you're servicing interest on a loan. With property, for example, unrealistic expectations of vacancy rates, or maintenance costs, can bring a geared investor down to earth with a thud.

If you have at least five years to invest and are confident of your income, then gearing is probably an essential step on the road to building wealth, and it offers a number of advantages.

The gearing advantage

The first and foremost attraction of gearing is the ability to multiply your returns exponentially.

Naturally, if you are able to borrow 10 times your own capital, you will receive 10 times the return. If you've chosen an appreciating asset and held it long enough, you should be able to repay the debt and reap the rewards.

Another advantage is that gearing leverages your capital base, opening up a greater selection and diversification of investment options.

For example, if your capital totalled $100,000, with gearing you could spread your risk by buying two properties rather than one, diversify with a mix of shares and property, or buy a better quality property offering better returns.

Certainty is in the planning

Don't over-commit. The importance of planning can't be overemphasised. Gearing is a long-term strategy, and at the heart of it is cashflow. Failing to meet interest payments could be disastrous. From the start, it's important to make allowance for rising interest rates, and ensure you have adequate insurance coverage against loss of income.

> **"Used wisely, gearing can be a relatively low-risk way to wealth, and the only way many of us will achieve financial independence in our lifetimes."**

While using a fixed interest-only loan may protect against rate rises and maximise cashflow and tax benefits, it may not be appropriate in your circumstances. The type of loan you take out needs to be considered in light of your position, and this is where seeking good advice becomes essential.

Don't be blinded by tax benefits. No matter how strong the tax benefits, negative gearing is still a loss compensated for by growth in the value of the asset.

An investor's primary motive should be building equity with the tax deductions as an added bonus. There is no point in negatively gearing an investment unless there is capital growth. For this reason, the quality of the asset you choose is crucial.

Consider your level of gearing. This needs to be assessed in light of the volatility and liquidity of the asset you choose, and your income security and consistency.

It's wise to be more conservative when gearing a share portfolio simply because of the volatility of equities and the possibility of negative growth.

With a margin loan, you may be asked to top up the difference between the value of the loan and the value of your shares — what's known as a margin call. This is why it's important not to gear too highly, leaving a safety buffer to ride out the dips in the market.

Although property is less liquid, it's a more stable asset, and one that's not prone to margin calls. So, provided you plan correctly, you can gear your asset base to a higher level and increase returns without increased risk.

Keep cash in reserve. Poor cashflow can be the undoing of any good gearing strategy, so it's important to keep cash in reserve. The more aggressively you gear, the larger the potential shortfall that has to be supported from your own funds. And with more property assets, there is a greater chance of loss of income from vacancy or unexpected maintenance.

Secrets of successful gearing

At the end of the day, provided you've planned well, gearing is not only often appropriate, it's often essential for building wealth. Unfortunately, through fear, many never take advantage of this remarkable wealth building tool.

If you find yourself feeling this way, keep in mind that you not only have a debt, you have an asset. Provided the asset is of good quality and it has been given time to grow, even if something does go wrong, it's simply a matter of selling the asset and repaying the debt. And therein lies the secret of good gearing.

How a Melbourne couple used gearing to build their dream home and a substantial investment portfolio within three years

Frank and Maria Briganti of Sanctuary Lakes in Melbourne have a dream — financial independence.

And for several years, their goal has been to build an investment portfolio that would give them this freedom plus a few luxuries — such as a new home — along the way.

With the help of the team at Statewide, it's a dream they are making happen, unexpectedly quickly.

As Frank, a Manager in Alcoa's Geelong plant, says, "We were referred to Statewide when preparing to purchase our first investment property and were immediately surprised by their approach.

"Rather than simply presenting us with a range of financial products, they took a wholistic approach to our finances and achieving our goals.

"They took the goals that we had in place and helped us refine them. Then they put in place processes to achieve them," he says. The first step was refinancing a $175,000 line of credit used to finance a share portfolio at a significantly lower rate.

From here, Statewide helped them purchase their first investment property, completely financed using the equity in the property itself and in their own home.

This involved establishing a new line of credit to cover the deposit, then arranging the finance for 100 per cent of the property's purchase price, plus costs. Once completed, the deposit was cleared from the line of credit. This then became their financial safety net.

What Frank and Maria ended up with was a substantial investment portfolio that was in effect paying itself off, thanks to tax deductions.

But in March 1999, the Brigantis decided to make a change. They wanted a change of lifestyle, choosing to move to Melbourne and build the home of their dreams. This created a dilemma.

To finance their new home they would have to sell the very security that was underlying their investment portfolio — their existing home. This meant they would lose the tax benefits and have to rebuild their investment portfolio from scratch.

But, as the they discovered, this wasn't the only option. The Statewide team developed a plan that would let them retain their investments and tax advantages — and build their new home.

Firstly, Statewide arranged for the proceeds of the sale of their home to be moved to a cash deposit and for this to secure their investment portfolio. This alone saved Frank and Maria about $10,000 p.a. in otherwise lost tax deductions.

The next step for Frank and Maria was building their dream home. A loan of $320,000 was needed and, as Frank says, "We had a number of issues with lenders. They couldn't see the big picture." Thankfully, Statewide had the experience to resolve these problems.

Frank and Maria enjoy their new home.

Statewide then reduced this large undeductible debt using the $220,000 proceeds from their first home, transferring the security of their investments to their new home. This way, their portfolio remained undisturbed and producing healthy returns.

Frank says he had no idea that this could be done, but was glad that it proved possible. "I was extremely impressed with Statewide's processes and even more impressed with their customer focus. They didn't tell us what to do. They simply asked us what we really wanted to do, and then helped us build the infrastructure to do it."

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