

RIVKIN

WEALTH ADVISORS

# A GUIDE TO GEARING



## The Australian dream is to purchase a home on a quarter-acre block.

Passed on from one generation to the next is the proviso of paying down the mortgage as quickly as possible. Our cultural norms of being debt free can in certain situations be at odds with the rational-cold world of finance and economics.

The reality is that debt and credit used wisely can leverage our ability to get to the next level of where we want to be, minimise our tax, fund an additional holiday or provide our children with better opportunities. Not to mention, structuring debt in a prudent manner can also allow us to pay off the mortgage faster and cut years off your mortgage.

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# What is Gearing?

Gearing refers to the use of borrowed money to invest in an asset, such as property or shares. It's a form of leverage, where an investor borrows funds to potentially amplify the returns from their investment. Gearing can be either positive or negative, depending on the income generated by the investment compared to the costs of borrowing.

- **Positive gearing** occurs when the income from the investment (e.g., rental income or dividends) is greater than the costs associated with the loan (such as interest payments), resulting in a net profit.
- **Negative gearing** occurs when the income from the investment is less than the loan costs, resulting in a net loss. Investors typically use this strategy to claim the loss as a tax deduction, while aiming for long-term capital gains when the asset increases in value.

Gearing allows investors to access more capital, but it also carries risks, as borrowing amplifies both potential gains and losses.

# What is a Debt Recycling Strategy?

Debt recycling is a financial strategy that allows homeowners to leverage the equity in their property to invest in income-generating assets, such as shares or managed funds. The goal is to convert non-deductible home loan debt into tax-deductible investment debt, while simultaneously building a portfolio of securities that can grow over time. While this strategy can accelerate wealth creation, it comes with certain risks and is not suitable for everyone.

The key benefit of debt recycling is the potential for interest deductibility. The interest payable on an investment loan can generally be claimed as a tax deduction, unlike the interest on a typical home loan, which is non-deductible. This tax benefit can reduce your taxable income and improve the overall return on your investment.

For example, let's say you redraw \$50,000 from your mortgage to invest in a diversified portfolio of stocks. The interest on the \$50,000 is now considered investment debt, and you can claim it as a tax deduction, as long as the loan is used solely for investment purposes. Meanwhile, your investment portfolio may grow in value and generate income, which you can then use to pay down your home loan or reinvest.

# How it Works

## Case Study

Gerald and Michelle are in their 30s and are based in Sydney's inner west. They own their home with a \$500,000 home loan and have had their home valued at \$1,000,000. Gerald is earning a salary of \$150,000 per annum while Michelle is earning \$70,000. They both have investment goals of having \$2m in investments alone by retirement with a paid off home.

As part of their debt recycling strategy \$360,000 of credit was available to draw from the equity of their home. They started with an initial investment of \$100,000 into a portfolio of listed securities while also drawing \$100,000 from their equity to invest while using \$30,000 to invest from their regular cash flow.

### YEAR 1

Home Value (Non Deductible)	\$1,000,000
Home Loan	\$500,000
Credit Available (Investments)	\$360,000
Initial Investment	\$100,000
Investing from Loan	\$100,000
Cashflow Investments	\$30,000

## Year 3 - Home Value - \$1,200,000



Home Loan  
(Non deductible)  
**\$408,000**

Investment Line of  
Credit (Tax deductible)  
**\$240,000**

Investments **\$430,000**

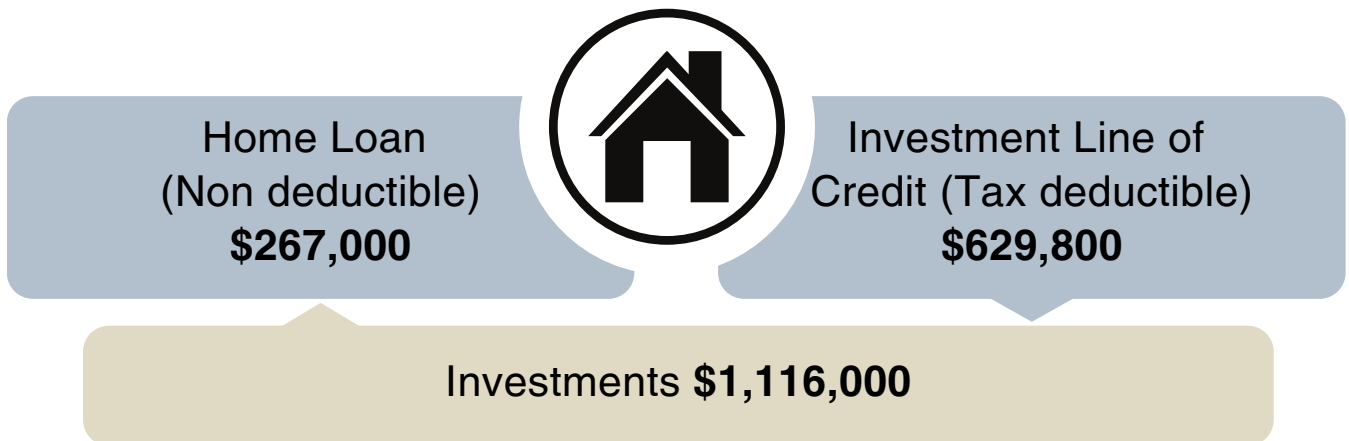
After 3 years, Gerald and Michelle have paid down their mortgage to a balance of \$408,000 (non-deductible); however by this stage under the current repayments and additional drawings from the home, they have deductible debt of \$240,800. Their home is now valued at \$1,200,000. For the first three years of the strategy they have continued to deposit \$30,000 into a share portfolio and draw \$100,000 from their home into the portfolio. Their investments are now worth \$430,000.

### YEAR 3

Home Value	\$1,200,000
Home Loan (Non-deductible)	\$408,000
Loan (Tax Deductible)	\$240,800
Investments	\$430,000
Income from Investments	\$9,486
Interest Claimed As Tax Deduction	\$14,455

## Year 7 - Home Value - \$1,300,000

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In just 7 years, Gerald and Michelle are more than a quarter towards their investment goals and more than halfway towards their financial goal of paying off their mortgage. They have paid down their mortgage to a balance of \$267,000 and their home is now valued at \$1,300,000. Their investments are now worth \$1,116,000.

### YEAR 7

Home Value	\$1,300,000
Non Deductible Debt	\$267,000
Deductible Debt	\$629,800
Investments	\$1,116,000
Income From Investments	\$33,447
Interest Claimed As Tax Deduction	\$38,626

As a result of the appreciating value of their home, the decreasing debt burden of their home loan and the success of their investments, Gerald and Michelle have increased their loan to \$896,800 - however the majority of this loan (70%) is used for investment purposes where the interest is claimed as a tax deduction. This means they can borrow more to put towards their investments. Using this strategy for the next 10 years or so will easily have them reaching their financial goals. Alternatively, they can also stop any additional investments should they wish and have sufficient cash flow to begin paying down the debt and letting the investment compound.

**Year 1 - Home Value - \$1,000,000**



Home Loan  
(Non deductible)  
**\$500,000**

Investment Line of  
Credit (Tax deductible)  
**\$360,000**

Initial Investment **\$200,000**

**Year 3 - Home Value - \$1,200,000**



Home Loan  
(Non deductible)  
**\$408,000**

Investment Line of  
Credit (Tax deductible)  
**\$240,000**

Investments **\$430,000**

**Year 7 - Home Value - \$1,300,000**



Home Loan  
(Non deductible)  
**\$267,000**

Investment Line of  
Credit (Tax deductible)  
**\$629,800**

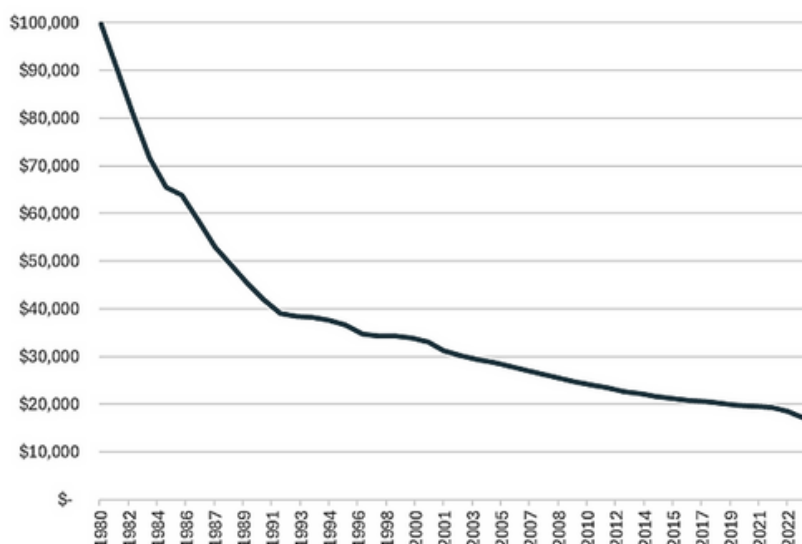
Investments **\$1,116,000**

# Why Not Keep Funds Sitting in an Offset?

## What about inflation?

The trade off from keeping funds in an offset is that it lowers the interest payable and repayments on the loan compared to claiming a deduction on the interest and creating passive income. In retaining funds in an offset, your capital is concentrated in the primary residence, and you miss out on the benefits of diversification from an investment portfolio. In the long term, the only guarantee with investing is that inflation and remaining in cash will reduce your purchasing power compared to being invested.

For example, if you had \$100 000 in an offset as savings in 1980; today, you would have less than \$20 000 in purchasing power (As shown in the graph below).



# How Do Interest Rates Affect My Cash Flow

It's prudent to be aware of how interest rates can affect your cash flow, particularly in a rising rate environment. The repayments made to the loan are a function of how highly leveraged you are and how far interest rates rise and impact the repayments\*. The success of this strategy ultimately depends on how disciplined you are with managing your budget and cash flow. It is also important to consider taking out a prudent amount of insurance, particularly income protection and critical illness coverage if you were in a position of not being able to work and make the repayments.

	Before Gearing	After Gearing <sup>^</sup>
Salary	\$150,000	\$150,000
Dividends	\$0	\$5,200
Franking Credits	\$0	\$2,229
Interest Deduction	\$0	(\$8,000)
Taxable Income	\$150,000	\$149,429
Tax Payable	-\$38,838	-\$36,627
Medicine Levy	-\$3,000	-\$2,989
<b>Total Tax</b>	<b>-\$39,838</b>	<b>-\$37,387</b>
<b>Net Earnings</b>	<b>\$110,162</b>	<b>\$109,813</b>
Living Expenses & Loan Repayments*	\$100,000	\$100,000
<b>Net Cash Flow</b>	<b>\$10,607</b>	<b>\$10,258</b>

<sup>^</sup>Assumed capital growth of portfolio = \$4,000

# What are the Risks?

## Understanding Volatility

The investment risk attached to the investment portfolio increases because the borrowed amount increases the client's exposure to the market. Gearing provides an opportunity to increase gains when markets are rising. However, when markets are falling, losses are magnified. Where markets are volatile and uncertain it is important to consider your 'sleep at night' factor.

Volatility is the price you pay for capital growth and provides investors with the opportunity for investment gains. It is usually recommended that you mitigate volatility by dollar cost averaging where the timing of investments are placed at regular intervals.

### **Explained: Dollar Cost Averaging**

Dollar-cost averaging (DCA) is an investment strategy where an investor regularly purchases a fixed dollar amount of a particular asset, regardless of its price at the time. This systematic approach means buying more units when prices are low and fewer units when prices are high, ultimately averaging out the cost per unit over time.



# What About Your Investment & Lifestyle Goals?

Money is a medium of exchange and a store of value. It is a commodity that enables us to achieve our desired lifestyle. While considering investing and using leverage, whether it be a portfolio of securities or an investment property, it's always important to take stock and ask why and what is the long-term objective of investing.

If your investment goals include long-term wealth accumulation and you're willing to accept short-term losses for future capital gains, using the debt in your mortgage might align well with your objectives. However, if your goal is immediate income generation or low-risk investments, the strategy might not suit your needs.

Your lifestyle goals also matter, as gearing can impact your disposable income, requiring you to sustain higher repayments on your mortgage over a number of years. If maintaining a specific lifestyle or saving for short-term personal goals is a priority, you'll need to assess whether you can afford the financial burden of gearing without compromising your other ambitions.

Your advisor is to understand your needs and motivations, all the while establishing a dialogue as to how your finances can enable you to achieve your financial goals.



If you'd like to get in touch with us, scan the QR code with your phone's camera to be taken to our website. You can also give us a call or email us at the following details:

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# Gearing Quiz

Are you confident in your investment plan?

1 = No

2 = Uncertain

3 = Yes

- 1** I am confident that I have the right investment goals for my lifestyle and income.

1

2

3

- 2** I am confident that I will reach my investment goals with my current investment plan by the time I retire.

1

2

3

- 3** I am confident in my understanding of gearing and the risks associated with this kind of financial strategy.

1

2

3

- 4** I am confident in my investment experience, discipline and knowledge.

1

2

3

Scored under 15? **Contact us today for expert advice.**

# Contact

## Ready to have a conversation?

Rivkin Wealth Advisors is committed to guiding you with the utmost professionalism and dedicated service as you navigate your financial journey. We look forward to partnering with you on this exciting path towards financial growth and stability.



### Jock Evans, Financial Advisor

Jock Evans is a key member of our Wealth Advisor team. With over seven years of experience in the financial services industry, Jock specialises in creating tailored wealth management strategies and investment plans. Holding a Bachelor of Commerce and having studied Financial Planning and Economics at the postgraduate level, he is dedicated to helping clients understand the intricacies of their investments, empowering them to make well informed financial decisions.



### Alex Galvin, Financial Advisor

Alex Gavin is a Senior Financial Advisor at Rivkin Wealth Advisors. He has over ten years of experience with focus on helping clients create and preserve their wealth. Alex adopts a client-first approach in crafting prudent financial strategies that ensure that his clients achieve their financial and lifestyle goals. He holds Certified Financial Planner status and an Investment Management Analyst Certificate, while also possesses a Bachelor of Commerce and a holds Master of Financial Planning.

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