NEGATIVE GEARING

WHAT IS 'GEARING?'

Gearing is the term used to describe borrowing money to buy an investment asset. The term is used because borrowing increases the return of the investment for a given amount of an investor's money – much like the gears in a car generate more output for a given number of revs.

Always remember that gearing makes both types of investment return bigger – losses and gains. If you borrow money to invest and the investment makes a loss, you lose more of your own money.

WHAT IS 'NEGATIVE GEARING?'

Negative gearing is a situation where the person holding the investment pays more in loan interest (and other expenses) than they receive as rent or dividends. Rent or dividends are forms of 'income return.' The other type of return is 'capital return.' Capital return is the difference between the price at which you buy and the price at which you sell.

If the cost of holding an investment exceeds the income return, then the immediate income return is negative… which leads to the term 'negative gearing.'

WHY WOULD PEOPLE USE NEGATIVE GEARING?

Negative gearing means that (i) you borrowed money to make an investment; and (ii) the costs of holding the asset exceed the income the asset creates. To compensate for the short-term losses, the investor will need to make a positive capital return on the investment – that is, the investment will need to rise in value over time. If that does not happen, then negative gearing is a bad way to make an investment!

History shows that, over time, assets such as property or property often rise in value. So many people who use negative gearing find that the eventual capital gain more than compensates for the short-term loss that they initially incurred.

In addition, negative gearing is often a temporary situation. Typically, rent and dividends rise over time. The rising income means that a negative gearing situation often becomes a 'positive gearing' situation over time - especially if interest rates fall and/or the investor repays some debt.

The Australian tax system usually allows an investor to offset investment losses against other taxable income. This means that the short-term loss created by negative gearing is typically tax deductible. This reduces the after-tax cost of holding the negatively-geared asset.

Despite that, investors should never invest simply to get a tax break. Negative gearing only makes sense for people with a long-term approach and who buy assets that are expected to increase in value. If used, negative gearing should be just one element of a comprehensive financial plan.

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