



NEGATIVE GEARING THE PITFALLS AND BENEFITS

Negative gearing has been around for many years and is either praised or derided depending upon the circumstances at the time. Negative gearing can be utilised in various ways but for most people it is utilised either for property or shares.

Negative gearing is neither good nor bad, it is neutral. What dictates whether it will be beneficial or detrimental are the circumstances and reasons for which it was undertaken.

WHAT IS IT

Gearing in simple terms means the acquisition of an asset using borrowed money.

Negative gearing means that the loan interest and other expenses in maintaining the asset exceeds the income that it generates. Thus the asset is running at a loss and as such is called 'Negative'.

Negative gearing contains a high element of risk because you are forecasting future income streams and capital growth. Remember, whilst we know the past that nobody can know the future. You can assume, propose or predict but you cannot **know**. Never, ever, assume that past performance is an indication of future performance.

WHY DO IT

Why does any sane person invest to lose money. Because, the losses are tax deductible the person can offset the losses against their taxable income thus generating a short term gain by reducing the amount lost by the tax credit on the loss. Note however, that over time (7-9 years) the asset will start to become neutral and then positive geared at which time tax will have to be paid on the profits. Also be aware that assets are subject to Capital Gains Tax on any capital gains made on sale, whilst capital losses cannot be offset against taxable income but only against capital gains.

For a person on a high rate of marginal tax negative gearing is highly attractive as the losses they sustain are only marginally higher than if they had paid the tax on that income.

You are therefore betting that over the time that you hold the asset that it will increase in value both in income streams and capital growth to counter the above and still make a profit.

WHO SHOULD /SHOULD NOT

The only people that should seriously consider a negative geared investment are persons that have a high tolerance to risk and are prepared to accept that risk and any subsequent losses.

If you are a conservative person with a low to medium risk tolerance, or a person that cannot sustain a potential loss, then you should either limit your exposure to negative gearing or find other more suitable investments.

Negative gearing is best for people that:

- * have paid off their own houses,
- * are on a high rate of marginal tax,
- * have a high risk tolerance,
- * have a high degree of job security,
- * have grown up children or expect no children, and
- * have sufficient disposable income that they can sustain three months of expenditures without receiving income.

Negative gearing should really not be considered at all by people that:

- * have a growing family and are paying off a mortgage,
- * have a low risk tolerance,
- * have little or no taxable income,
- * are unsure of their future job prospects, and
- * depend upon the income that the asset generates to continue to be able to afford the asset.

TIMING

There is no general good time or bad time to enter into negative gearing as there are so many factors involved for each person as an individual.

The best time to enter into negative gearing is:

- * the economy is in the depths of recession,
- * asset values are cheap or declining,
- * demand for capital is low,
- * inflation is still entrenched, and
- * the government is looking to lower interest rates to stimulate the economy.

The worst time to gear is:

- * when the economy is going well after several years of recovery,
- * asset valuations are high, and
- * the government is looking to raise interest rates to rein in growth and inflation.

The environment in which negative gearing works best is:

- * high nominal interest rates;
- * high but falling inflation;
- * low (or falling) real interest rates;
- * attractive asset valuations (generally in a recession); and
- * following a period of poor returns in markets.