The Pros & Cons of Negative Gearing.

A Snelleman Tom Whitepaper.

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Consulting Accountants and Financial Planners

Contents Page

Negative Gearing ... 3

Background ... 4

Tax Advantages ... 5

Political & Social Issues ... 6

Does negative gearing work and should I do it? ... 7

Conclusion ... 10

About Snelleman Tom ... 12

Negative Gearing

Throughout the last few decades, the negative gearing concept has had its fair share of promoters and naysayers which is often driven by various factors of the time including media spin, political vote winning tactics, economic conditions and property and equity market performance.

In this article, we want to look through the various 'noise' that often influences investors trying to build their wealth. We'll outline the pros and cons of negative gearing to determine whether it is a legitimate wealth creation strategy and use some hard evidence to demonstrate the effects of negative gearing.

Background

Firstly, a recap of what negative gearing is all about.

Gearing in its simplest form is borrowing to invest in an investable asset e.g. Property, Shares, Managed Funds.

The 'negative' part of gearing is when the costs of the borrowing (i.e. interest on the loan) exceed the investment income of the asset (i.e. net rental income, dividends, distributions). This is what is referred to as 'negative gearing'.

Gearing allows investors to use someone else's money (the bank) rather than their own money to invest in assets that they otherwise would not have been able to fund from their own cash. With the intention being that the returns from the asset (capital growth and income) will in time outweigh the borrowing levels and costs and thereby creating wealth.

Tax Advantages

In Australia, negative gearing has an extra bonus in that the 'negative' amount is allowed as a tax deduction to offset all other income earned by the investor. Most countries in the world do not allow this tax benefit with Australia being one of only a handful that allow it (NZ and Canada the other two).

The ability to claim a tax deduction on the excess costs is a benefit that investors can use to their advantage in order to build up their investment assets as the impact of the excess cost is reduced by the taxman assisting to continue to own the asset.

Of course at the end of the day, when the investment is sold for a profit and a capital gain is realised, the taxman is able to collect on this gain. The taxman (like the investor) is expecting that the gain on the property will outweigh the holding costs along the way. So it benefits both parties.

A quick example:

John borrows $100k and uses $50k of his own money to invest in $150k of shares. The interest on the $100k is $7k p.a. and the share portfolio returns dividends of $5k p.a. The $2k shortfall can be claimed as a tax deduction on John's tax to offset John's salary income.

One point that is often overlooked is that there is a general conception that a tax deduction is a good thing and people's motives are often driven by the tax benefits available and the quality of the investment comes second. You may receive a tax deduction for the excess expenses, however a loss is a loss which is cash flow out of your pocket. If the investment does not produce a gain that is in excess of your losses along the way then you have wasted your time and money on an investment that has simply cost you money and stress.

There is also a conception that you have to have a negatively geared investment for it to be worthwhile because a 'positively geared' investment means you have to pay tax each year on the rental / dividend profits. This may be the case, but a positively geared investment has you in a better overall position versus the same investment that is negatively geared. Of course, it all depends on the specifics of the situation.

Political & Social Issues

The ability to claim a deduction for negatively gearing has also caused much political debate over the years with the most recent debate coming from the Henry Tax Review recommending the removal of this system. The Government responded by rejecting these recommendations and for the negative gearing concessions to remain in place. Given Australia's high level of investment property ownership, it is in the Government's best interest to retain these concessions to avoid any backlash from a rule that benefits a significant number of Australians.

Australia has one of the highest priced property market in the world. Part of this is that there is an argument that the negative gearing rules contribute to these high values. This has the effect of pushing first home owners out of the market as the investors make use of the tax breaks of owning properties and therefore are willing to pay a bit more on purchase. Negative gearing has led to arguments of social issues in the Australian population with young people resenting investors and wealthy retirees as they are squeezed out of the market whilst the latter receive tax benefits for owning property.

When property or stock markets are booming, you will often see an increase in attention to borrowing to invest from the media (Today Tonight stories of 25 year olds buying 15 properties etc), politicians, and investment salespeople (including real estate agents). Negative gearing is a powerful tool in any rising equity or property market.

It can also be a very dangerous tool when not used correctly, which we have all seen in recent times with the Storm Financial clients experiencing the real and painful effects of being highly negatively geared in a downward equity market.

As the property market does not have a daily market like the stock market, it is often overlooked by property investors that their property investment may not be making as much as they expected when it comes time to sell or when rents are not increasing. Property rents and capital gains are not guaranteed to go up in a straight line, however the risk of being forced to sell a property due to a downturn in the property market is much less versus equity borrowing such as margin loans. This is another topic in itself which we wont get into here.

Will increasing interest rates affect my negative gearing strategy?

Rising interest rates create a couple of significant outcomes for a negatively geared investment strategy.

Firstly, the most obvious being that it increases your holding costs of the investment as the loan becomes more expensive to service.

Secondly, rising interest rates generally dampen the effects of capital growth on assets including property and equities. This means that you may not receive the price you were aiming for when it is time to sell.

A quick example:

A $300,000 investment is producing an income yield of 5% or $15,000 p.a. with the loan interest rate being 6% or $18,000 p.a. The investor is happy with a 1% differential in the current investment environment.

If interest rates rise to 8% p.a. then firstly the interest cost increases to $24,000 p.a. If you are planning to sell the investment at that time then other investors will also have higher lending costs and therefore are willing to pay less for holding an investment. With the change in economic and therefore investment conditions, investors require a 2% differential. So your investment may be only worth $250,000 to a buyer as they are after a 6% yield (up from 5%) with an 8% loan cost. i.e. $15,000 is 6% of $250,000.

Does negative gearing work and should I do it?

One of the most important factors in making an investment decision is what you are investing in and the quality of the investment, be it a property, shares, or managed funds. This includes making an analysis of the income from the investment (reliable and rising) plus the expected capital growth return. The tax benefits certainly form part of the decision making process as to whether to invest or not, but should not ever be the sole driver to making an investment decision.

Negative gearing is a legitimate strategy for wealth creation. Per the above, it's the quality of the investment that is the most important factor is building your wealth. Negative gearing allows you to access investments that you would otherwise be unable to afford with your own funds with the benefit of having the taxman assist you with your investment holding costs.

An investment that is negatively geared will eventually become positively geared over time as the income from the investments will increase (rent or dividends) by a greater proportion than the interest on the loan as the loan balance stays constant. The capital value of the investment will also increase. Thereby upon sale and repayment of loan, the investor will be significantly in front versus an investor who uses their own funds due to the borrowing effect. Borrowing magnifies gains in rising markets and magnifies losses in downwards markets whether this is in property or equity markets.

Anyone can negatively gear an investment (on the basis your cash flow can afford the shortfall) – however if the investment fails or does not meet return expectations then you can be left with a debt you can not pay back even after the sale of the investment in addition to having lost money during the years of holding. There's no point to a tax deduction if you lose money.

One way we thought would show the benefits of negatively gearing was to use some real life examples.

Firstly, a property example. We have used the data from a real scenario sourced from the tax returns of one of our clients. The property is a 30 – 40 year old house at Bardon, 3 bedrooms, 1 bathroom, carport, easy access to the City and close to shops and amenities. The data shows the following:

Red Hill						
	2009	2008	2007	2006	2005	2004
Rent	$26,218	$25,006	$23,400	$21,760	$20,351	$18,853
Expenses	$7,238	$6,715	$7,867	$7,052	$6,500	$6,633
Interest	$32,908	$38,518	$34,365	$31,704	$30,520	$30,240
Net Rent	-$13,928	-$20,227	-$18,832	-$16,996	-$16,669	-$18,020
Value of Property	$740,000	$710,000	$680,000	$650,000	$560,000	$500,000
Loan Balance	$475,000	$475,000	$475,000	$475,000	$475,000	$475,000
Net Value	$265,000	$235,000	$205,000	$175,000	$85,000	$25,000

To make a fair comparison, we have also used another client's data from their tax return from their property being a 2 bedroom unit at Yeerongpilly, brick, lock up garage, 20 years old, 8kms from the city, close to train, easy access to Universities. Data shows the following:

Yeerongpilly						
	2009	2008	2007	2006	2005	2004
Rent	$18,890	$17,940	$15,180	$17,244	$15,890	$15,412
Expenses	$5,688	$5,525	$5,670	$5,374	$4,950	$4,875
Interest	$16,225	$18,991	$16,890	$15,812	$15,404	$15,320
Net Rent	-$3,023	-$6,576	-$7,380	-$3,942	-$4,464	-$4,783
Value of Property	$420,000	$410,000	$390,000	$340,000	$300,000	$240,000
Loan Balance	$224,000	$224,000	$224,000	$224,000	$224,000	$224,000
Net Value	$196,000	$186,000	$166,000	$116,000	$76,000	$16,000

The data above shows a number of observations:

- Rent increases annually
- Expenses remain relatively stable
- Value of property increases
- Loan remains constant

Although the ongoing cost is a negative each year, the value of the property has increased and if the property were sold today the gains made on the property would outweigh the ongoing expenses. Plus in addition the client has received a tax benefit each on their tax return (eg 46.5% taxpayer would receive a $6,477 benefit on their tax for 2009 scenario 1).

Also, the return figures are interesting. The gross value of the properties have increased around 8.16% and 11.84% p.a., respectively. However, with the effect of gearing, the net result to the investor has been an average capital value return of 60.4% and 65.1% p.a., respectively.

The same concept works for shares and managed funds, however the main difference between shares and property being that shares typically produce relatively higher levels of income and lower growth versus property. Based on the real results from our clients data we have found that property versus share returns over the long term are around:

Return	Property	Shares
Income	2%	4.5%
Capital Growth	9%	7.5%
Total Return	**11%**	**12%**

To use an example for shares of negatively gearing we have taken a selection of shares based on the same time period's of the above properties to show how negative gearing works and to also show how investment returns reach their break even points at different times.

We have used a parcel of shares to reflect a spread of different sectors in the market as follows:

Resources – BHP
Groceries – Woolworths
Banks – CBA
Liquor – Fosters
Insurance – QBE
Energy – Origin
Oil & Gas – Santos
Healthcare – CSL
Retail – David Jones
Telecommunications – Telstra

Share Portfolio	2009	2008	2007	2006	2005	2004
Dividends	$14,181	$13,768	$13,367	$12,978	$12,600	$10,800
Interest	$11,200	$13,440	$20,160	$17,920	$15,680	$15,405
Net	-$2,981	-$328	-$6,793	-$4,942	-$3,080	-$4,605
Value of equities	$339,653	$436,012	$496,031	$380,684	$299,280	$240,000
Loan Balance	$224,000	$224,000	$224,000	$224,000	$224,000	$224,000
Net Value	$115,653	$212,012	$272,031	$156,684	$75,280	$16,000

From the comparison of property versus equities you can see that property remains negatively geared for a longer period than shares due to the differences in income returns from the investments over the holding period.

A number of observations from the data:

- Dividends increase annually;
- Main expense is interest and therefore very sensitive to interest rate movements;
- Value of portfolio increases over time (including taking into account worst period in history);
- Loan remains constant.

The return figures show that the gross return is 7.2% p.a. on the capital value and 48.5% p.a. taking the gearing into effect. This is an abnormally low return for shares as we have only looked at the growth of a specific set of 5 years with 2.5 of those years being the worst performing years in 80 years. Whereas, compared to property in the same period property also experienced a high rate of return in the early part of the range, however did not reflect such a dramatic downturn in the 2007 – 2009 period.

However, the level of dividends has increased in a greater proportion than rent and therefore the ongoing cash return has been much better over the period versus property which is typically the scenario with most property versus equity investments.

Conclusion

In summary, negative gearing is a legitimate strategy for wealth creation, however it is a strategy that needs to be considered as part of the overall investment decision and not the sole driver for investing.

The main points to take away are:

- Do your homework on the investment first and buy good quality investments being property or equities;
- Borrow within your means and serviceability (ie reliability of other income);
- A powerful strategy in rising markets and dangerous in falling markets;
- Interest rate movements can have a large impact on the strategy;
- Political debate, media hype, salespeople hype will continue to provide interest in this area with the pros or cons being used in the relevant arguments for and against the strategy.

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About Snelleman Tom

Snelleman Tom challenges the way you have been advised for years.

Using an integrated approach of combining accountants, business consultants, financial planners and insurance experts, you or your business will achieve the future you've always dreamed. Snelleman Tom, allows the creativity of wealth creation or the focus of building businesses to be as important as making sure you pay the least amount of tax possible.

If you'd like to know more, call us now on **07 3871 0081**.

About Our Directors

Martin Kerrigan

Martin Kerrigan is a Director and CEO of Snelleman Tom Consulting Accountants and Financial Services. Prior to joining the firm in 1994, Martin owned a diverse range of businesses including waste paper contracting, limousines and wholesale nurseries. He hold a Bachelor of Commerce from University of Queensland and is a qualified CPA and Financial Planner. Martin in the chairman of the Snelleman Tom investment committee and a regular contributor to industry forums and parliamentary submissions.

Grant Titman

Grant Titman also joined Snelleman Tom Consulting Accountants and Financial Services in 1994, and is now a Director, heading up the Accounting division. The business has since grown to be the largest Accounting and Financial Services business in the Western Suburbs of Brisbane. Grant and his team deliver wealth creation solutions to clients as consulting accountants, especially to small and medium size businesses. Grant is also a regular speaker at CPA Australia's Public Practice Certification courses.

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