Antipodean Advisory

Antipodean Private Pty Ltd
133 Alexander Street
Crows Nest NSW 2065
Phone: 1300 101 250
Mobile: 0438 893 571
Email: michael@antipodeanadvisory.com
Web: www.antipodeanadvisory.com

We're proud when we say that most of our clients have come to us by way of referral from our existing happy, satisfied clients.

The many risks of gearing

If you are you borrowing money to invest, or considering it, it's important to ensure you aware of the many risks involved.

Gearing, or borrowing money to invest, can be a great way to grow your wealth, but it isn't for everyone. The aim is to borrow money at a lower rate of interest than the return you will earn by investing that borrowed money – to make a profit.

We often hear about gearing when people talk about investing in property – that is, they've taken out a mortgage to help pay for the property or they hope to benefit by negatively gearing it for tax purposes. But many investors use gearing to fund other asset classes, such as direct shares and managed funds.

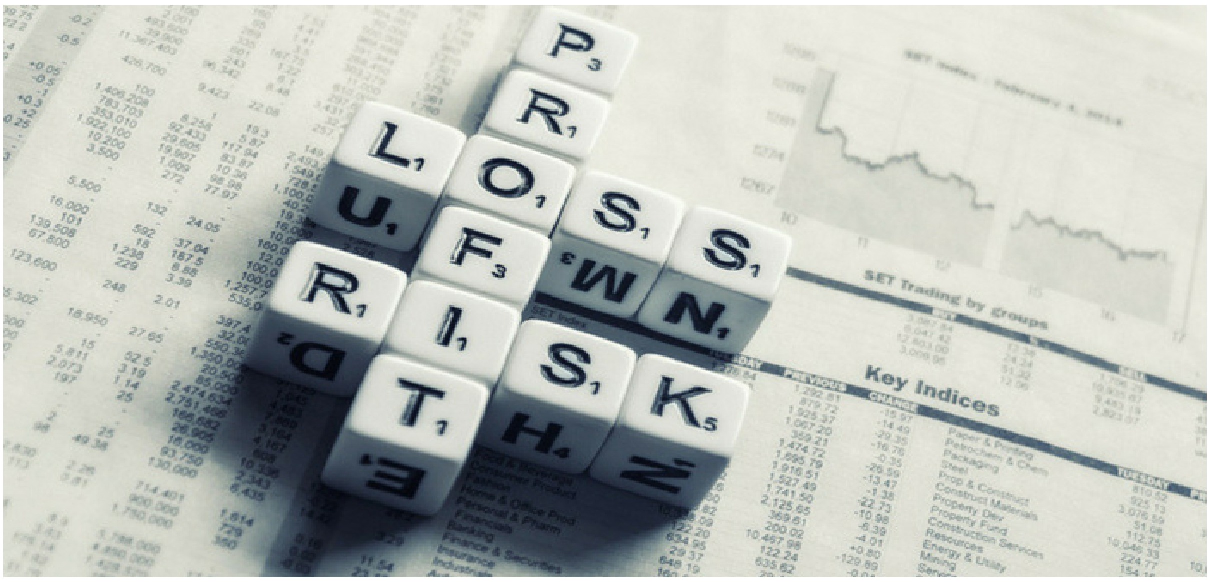
Gearing can magnify your gains, but it can also magnify your losses. Here are some factors to consider:

Market conditions

Gearing pays off when asset prices are poised to rise or are rising. But what happens if they fall? The dramatic plunge in share prices in the wake of the global financial crisis in 2007 and 2008 was a sharp reminder of the risks of gearing.

Thus, an important consideration is how you expect markets to perform. If you follow the markets, you'd know that share markets have been on a 10 year bull run and that the property market, especially in Sydney and Melbourne, has been booming in recent years.

After such good runs, it's no surprise that some experts believe both of these markets could be in for a correction in the near-term. World markets are also fairly volatile, given talk about trade wars and problems with countries like Russia and North Korea. Could there be some unpleasant surprises that affect investment markets?



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Interest rates

Interest rates have been low for the past decade, but they are starting to rise in some parts of the world and at some point, the Reserve Bank will also lift them again in Australia. In addition, it's possible that your bank could lift the rates it charges you because it faces rising regulatory costs. How will higher interest rates affect the returns on your investments? And will you have the capacity to pay these higher rates?

Margin calls

If you have taken out a margin loan, there is the risk that if the assets you have used as security for this loan drop in value, your bank will ask you to provide additional security or pay down part of the loan. If you don't have the money available, you may even have to sell the asset at a loss to meet the bank's demands.

There's also the risk that your lender will adjust the loan to value ratio or LVR on your loan. The LVR is the amount of your loan divided by the total value of your shares or property. Most lenders require you to keep the LVR below a maximum of 70 per cent.

If the lender lowers the LVR, you will have to find the extra cash to pay the lender. If you don't have it, you may have to sell part of your investments to raise the cash or you may have to provide additional security for the loan.

Timing

Another risk is that your income may lag behind your interest payments. On the investment side, the income you receive may be delayed because your property currently has no tenant in it or a company decides not to declare a dividend. In addition, your income could also be affected if you lose your job or fall ill.

Reducing the risks

The following are some of the ways in which you could reduce the risks of gearing:

- Have an emergency cash stash in an account that you can use to meet any margin calls. You will have to respond quickly if your bank makes the call, perhaps within 24 hours or less.
- Consider getting some income protection insurance in case you become sick or injured and unable to work.
- Borrow less than the maximum amount the lender offers you. This will reduce the chances of you experiencing a margin call.
- Diversify your investments. Spread your investments across different industries, regions and asset classes. If one type of investment falls, another may rise, smoothing out the volatility in your portfolio and making a margin call less likely.
- Make regular interest repayments on your loan to prevent your debt from growing.
- Be vigilant. Keep a regular eye on your investments, the market and your margin loan and be ready to adjust your strategy if circumstances change.

Source: Money & Life