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How gearing up affects risk and return

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Managing My Investments

How gearing up affects risk and return

In this step, we examine the impact of borrowing to fund investments impacts on the risk versus return

Let's see how this works.

Scenario A: You invest £100 of your money in the market portfolio and the market rises by 5%. You make £5 and your portfolio is now valued at £105.

Scenario B: You invest £200, but only £100 is yours and the other £100 borrowed. The market rises by 5%. You make £10. You repay the £100. So you're left with £110. A 10% return.

Scenario C: Same as scenario as B but the market falls by 10%.

You lose £20 and after repaying the money you are left with £80 – a 20% hit. Without borrowing and investing that extra £100 you would only have taken a hit of £10 (10%).

In Scenario D you borrow £1900 to add to your £100. The market falls by 10% (a hit of £200 on the total portfolio of £2000). So ahead of repaying the lender £1900 you are holding assets worth £1800. Not a good idea!

So gearing-up, by investing with borrowed money, increases the exposure you have to the risk on your portfolio.