How gearing up affects risk and return

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Managing My Investments

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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.