# Debt strategies

Use borrowed money to build wealth

By borrowing money to invest, you could potentially multiply your investment profits and achieve your wealth goals sooner.

## How does the strategy work?

This strategy, commonly known as gearing, involves borrowing money to make an investment.

Gearing can enable you to build your wealth faster than if you relied exclusively on your own capital.

The downside is that it can increase your losses if your investments fall in value.

To be successful in the long term, the investments you acquire with borrowed money must generate a total return (income and capital growth) that exceeds the after-tax costs of financing the investment (including interest on the loan).

## Which investments

It is generally recommended the borrowed money is invested in quality share or property investments (either directly or via a managed fund).

This is because shares and property have the potential to grow in value over the longer term and typically produce assessable income.

## Gearing options

There are a number of ways you can establish a gearing strategy:

1. You could use a **home equity loan**. This approach offers the benefit of a low interest rate and there are no restrictions on what you can invest in.
2. You could take out a **margin loan**. This type of loan may enable you to borrow generally up to 75% of the value of approved shares and managed funds.
3. You could invest in an **internally geared share fund**. These are funds where the manager borrows on behalf of investors to make a larger investment in Australian or global shares.

**Note:** Before borrowing to invest, you should ensure you have a suitable time frame (preferably five years or longer) and understand that if your investments fall in value, your financial situation could be significantly worse than if you hadn't borrowed to invest.

## Other considerations

- Gearing should be seen primarily as a wealth creation strategy rather than a way to save tax. If you invest in assets that fail to produce enough income or capital growth over the longer term, your losses could outweigh any reduction in your tax bill.
- If you take out a fixed rate investment loan, you can manage interest rate risk and bring forward your tax deduction by pre-paying up to 12 months interest in advance.
- You should ensure you have enough insurance to protect your income and cover your loan repayments in the event of your death or disability.

## Seek advice

A financial adviser can help you assess all the issues that need to be considered and determine whether borrowing to invest suits your needs and circumstances.

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## Case study

Jenny has $100,000 invested in an Australian share fund and earns a pre-tax salary of $90,000 pa. She wants to build her wealth faster over the next 10 years.

She has paid off most of her home loan and her financial adviser presents three different options. These include:

- maintaining her investment at its current level of $100,000
- doubling her investment by borrowing $100,000 (ie a 50% gearing ratio), and
- tripling her investment by borrowing $200,000 (ie a 67% gearing ratio).

Table 1 illustrates the potential outcomes after 10 years, assuming Jenny uses a home equity loan in options 2 and 3, with an interest rate of 7.5% pa.

Clearly, the higher the gearing ratio, the greater the potential gains. But it's important to remember that Jenny still has an outstanding loan in options 2 and 3 of $100,000 and $200,000 respectively.

If she withdraws a portion of her investment after 10 years to repay the outstanding debt and pay Capital Gains Tax (CGT) on the amount withdrawn, the value of her investment is shown in Table 2.

As you can see, Jenny's financial position could improve by using a gearing strategy if the value of her investments rises sufficiently.

**Table 1: Investment values after 10 years**

| | Option 1<br>No gearing | Option 2<br>50% gearing | Option 3<br>67% gearing |
|---|---|---|---|
| Value of investments (after 10 years) | $247,823 | $398,320 | $559,189 |
| Loan amount | Nil | $100,000 | $200,000 |

**Table 2: Investment values after repayment of loans**

| Option 1 – No gearing | Option 2 – 50% geared | Option 3 – 67% geared |
|---|---|---|
| **$247,823** | **$291,353**[1] | **$344,865**[1] |

[1] After CGT is deducted from the amount withdrawn. CGT is calculated at a marginal tax rate of 39%, including the Medicare levy.

**Assumptions:** Investment return is 9.4% pa (split 4.3% pa income, 5.1% pa growth and franking 77%). Interest on the loan is 7.5% pa. Salary is increased by 3% pa. These rates are assumed to remain constant over the investment period. Excess investment income and tax advantages are reinvested.



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