

Using debt effectively

Debt smart strategy guide



Appreciating the value of debt

In this booklet, we outline strategies that have the potential to be highly effective in helping people make the most of debt.

Individually, each strategy could significantly improve your financial position. By using a number of them in combination, you could optimise your finances and achieve financial independence sooner.

For example using debt you could buy a house you may not be able to afford outright. You just need enough to cover the deposit and costs and you can borrow the rest, assuming you can make the repayments.

Debt can also be used to buy investments with potential to grow in value, like shares and property.

This strategy, known as gearing, may help you to build an investment portfolio faster than you otherwise could have.

To help repay the loan, you'll have income generated by your investments. So, for many people, servicing an investment loan may be an achievable outcome.

There are two types of debt you could use

	Inefficient debt	Efficient debt
The key differences	<ul style="list-style-type: none"> This is used to buy goods, services and assets that don't generate income, will depreciate in value, or have no value once they are used. You can't claim the loan interest as a tax deduction. You don't receive any additional income from the asset to help you repay the debt. To service the debt you have to rely on your own resources. It's wise to reduce this kind of debt as quickly as possible. 	<ul style="list-style-type: none"> This is used to acquire assets that have the potential to grow in value and generate assessable income. You can generally claim the loan interest as a tax deduction. You can use the income generated by the asset to help repay the debt. It's more easily serviceable and it can be used to accelerate the creation of wealth.
Examples	<ul style="list-style-type: none"> A personal loan to buy a car is inefficient because the car depreciates in value, it doesn't generate any income and the interest is not tax deductible. Using a credit card to pay for living expenses is inefficient if it's not repaid within the interest-free period. This is because the interest on the debt isn't tax deductible and the things you buy generally have little or no resale value after use. Home loans are generally a less efficient form of debt because the home doesn't produce an income and therefore the loan interest is non-deductible. 	<ul style="list-style-type: none"> Using an investment loan to acquire an investment asset, like shares or property (either directly or via a managed fund), is efficient because the asset has potential to appreciate in value, it generates income and the interest on the loan is generally tax deductible. Another way to take advantage of efficient debt is to invest in an internally geared share fund. This is a managed fund that borrows to increase its investments in Australian or global shares. As the fund incurs the interest cost and generates the assessable income, the tax deduction for the interest should be claimed by the fund rather than by the investors directly. The share portfolio also has the potential to grow in value, over the longer term, at a greater rate than one that doesn't borrow money on behalf of investors.

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Strategies at a glance

Strategy	Potential key benefits
1 Consolidate your debts to save money	<ul style="list-style-type: none"> • Reduce the interest rate applying to your debts • Pay off your inefficient debts sooner
2 Use your emergency cash reserve more effectively	<ul style="list-style-type: none"> • Earn a higher after-tax return than a cash account • Pay off your inefficient debts sooner (while retaining full access to your money)
3 Harness your cashflow to reduce inefficient debt	<ul style="list-style-type: none"> • Save on interest • Create equity in the family home that could be used as security for an investment loan.
4 Use borrowed money to build wealth	<ul style="list-style-type: none"> • Multiply your investment profits • Achieve your wealth goals sooner
5 Transform your debt using a financial windfall	<ul style="list-style-type: none"> • Replace inefficient debt with efficient debt • Establish an investment portfolio to help build your long-term wealth
6 Build wealth via debt recycling	<ul style="list-style-type: none"> • Replace inefficient debt with efficient debt on a regular basis • Establish an investment portfolio to help build your long-term wealth
7 Offset your investment loan to retain cash-flow efficiency	<ul style="list-style-type: none"> • Earn a higher after-tax return than a cash account • Withdraw money for any purpose without affecting the tax deductibility of the loan
8 Make gearing more effective for a couple	<ul style="list-style-type: none"> • Reduce tax on investment earnings • Accumulate a larger amount of wealth
9 Leverage your investment via an internally geared share fund	<ul style="list-style-type: none"> • Access the power of gearing without having to arrange an investment loan yourself • Take advantage of potentially lower interest costs
10 Investing with borrowed money	<ul style="list-style-type: none"> • Use the equity in your home to borrow money to invest where you choose • Control over gearing levels

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Strategy 1 Consolidate your debts to save money

If you have a range of inefficient debts, you may want to consider consolidating them into your mortgage.

What are the benefits?

By using this strategy, you could potentially:

- save on interest, and
- pay off your debts sooner.

How does the strategy work?

With this strategy, you need to:

- increase the mortgage on your family home, and
- use the extra funds to pay off other inefficient (not tax deductible) debts, such as a personal loan or credit card debt.

By doing this you could potentially pay less interest, as the lower interest rate on your home loan will apply to all your debts.

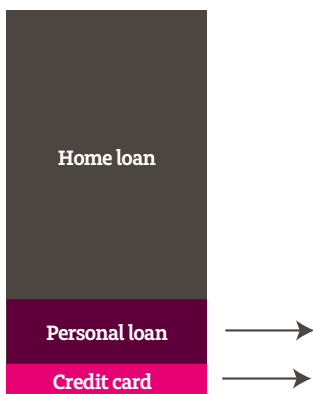
However, it's important you keep **making at least the same overall loan repayments. Otherwise:**

- it could take longer to pay off your combined debt, and
- you could end up paying more interest over the life of the loan, despite the lower interest rate.

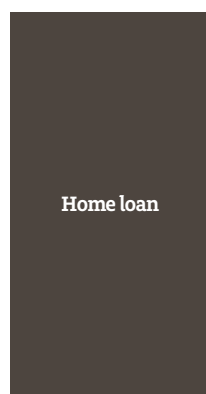
Before you consolidate your debts, you should find out if your existing home loan offers features that can enable you to pay off the combined debt quickly, such as a 100% offset account or a redraw facility.

If it doesn't, you may want to consolidate your debts into a more flexible loan facility.

Before consolidating



After consolidating



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Case Study 1 Consolidate your debts to save money

Carolyn and Ian are married with a young family. Their home is worth \$500,000 and they have the following debts.

Debts	Outstanding balance	Interest rate	Current repayments (pm)
Home loan (20 year term)	\$300,000	7.5%	\$2,417
Personal loan (5 year term)	\$10,000	13%	\$228
Credit cards	\$5,000	19%	\$72
Total	\$315,000		\$2,717

They want to pay off their debts as quickly as possible and save on interest. After assessing their goals and current debt position, their financial adviser and mortgage broker in consultation recommend that they consolidate their debts by:

- increasing their home loan from \$300,000 to \$315,000, and
- use the extra \$15,000 to pay off their personal loan and credit cards.

By doing this, the home loan interest rate of 7.5% pa will apply to all their debts and the total minimum repayment will drop from \$2,717 to \$2,538 a month.

They also calculate that if they continue to pay \$2,717 into the consolidated loan each month, they will pay off their debts sooner and save \$16,084 in interest (see table below).

Consolidated loan ¹		
Outstanding loan(s)	\$315,000 ¹ loans ¹	\$315,000
Monthly repayments	\$2,717	\$2,717
Remaining term	17 years 9 months	17 years 4 months
Total interest payments	\$263,508	\$247,424
Interest saving		\$16,084

Conversely, if they spend the interest savings and make the reduced repayment of \$2,538 per month, it will take them 20 years to repay their consolidated debt and the interest payments over this period will total \$294,258, which is \$30,750 more than if they hadn't consolidated their debts. This highlights why it's so important, when consolidating your debts, that you maintain the same total repayments rather than spend the interest savings.

Note: This case study illustrates the importance of speaking to a financial adviser and mortgage broker about consolidating your debts. They can also address a range of potential issues and identify other suitable strategies – see Tips and Traps.

Tips and traps

- Before consolidating your debts, you should consider whether you need to pay any refinancing costs, including loan application fees, stamp duty and early termination fees.
 - If you have any surplus cash, you should consider using it to reduce personal loans or credit card debt and avoid the need to consolidate your debts.
 - If you're concerned about having access to your emergency cash, you could consolidate your debts and place the cash in a 100% offset account or the loan itself provided it has a redraw facility.
 - If you have debt, you should ensure you have enough insurance to protect your income and enable the loan to be repaid in the event of your death or disability.
- 1** In both options, we've assumed repayments of \$2,717 are made for the life of the home loan. With the separate loans, payments are redirected to the home loan once the personal loan is repaid.

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Strategy 2 Use your emergency cash reserve more effectively

If you hold an emergency cash reserve in a cash account, you may want to consider using the money to reduce your mortgage.

What are the benefits?

By using this strategy, you could:

- earn a higher after-tax return than a cash account, and
- reduce the term of your loan (while still being able to access the money).

How does the strategy work?

Holding a cash reserve for emergency purposes is always wise. You might need the money for an unplanned trip, urgent repairs to your home or an unexpected illness.

Many people keep their emergency cash in a cash account because it gives them immediate access to their money. But the problems with cash accounts are that:

- the interest rate is usually much lower than what you pay on your home loan, and
- every dollar you earn should be taxable at your marginal rate, which could be up to 49%¹.

A potentially better option is to hold your emergency cash in an offset account² or your home loan (provided it has a redraw facility³).

By doing this, you will effectively reduce the balance on which your home loan interest is calculated. As a result, you will earn the rate of interest charged by your home loan and no tax is payable on these earnings.

If you then continue your repayments at the same level, you'll pay even more off your loan and eliminate your debt sooner. Plus, you can usually access your emergency cash via a redraw facility or 100% offset account within 24 hours.

¹ @ Dec2016 includes Medicare levy and Temporary Budget Repair levy.

² An offset account is a transaction account that is linked to a home (or investment) loan and the balance is directly offset against the loan balance before interest is calculated.

³ If your home loan has a redraw facility, you can make extra payments directly into your loan and withdraw the money if necessary.

	Earn higher interest rate	Tax-effective	Repay home loan sooner	Fast access to emergency funds
Cash account				•
Home loan / 100% offset account	•	•	•	•

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Case Study 2 Use your emergency cash reserve more effectively

Carolyn and Ian have a home loan of \$315,000 after consolidating their debts and the interest rate is 7.5% pa. Carolyn recently received an after-tax bonus of \$12,000 and the money is sitting in their joint cash account earning 4% pa.

Although they can access these funds at any time to meet unexpected bills or expenses, the after-tax return is only 2.62% pa, when you take into account they both pay tax at a marginal rate of 34.5%⁴.

To use their emergency cash more effectively, their financial adviser and mortgage broker in consultation recommend they transfer the money into a 100% offset account linked to their mortgage.

This will reduce the home loan balance on which interest is calculated to \$303,000. As a result, their emergency cash will effectively earn the home loan interest rate of 7.5% pa and which should not be subject to tax.

Their mortgage broker also explains that if they continue to make home loan repayments at the same rate of \$2,717 per month, they will save a total of \$29,494 in interest and cut over a year off the term of their loan. Furthermore, they will be able to withdraw their emergency cash from the offset account at any time.

Note: They could gain the same benefits by transferring the money directly into their home loan, as long as it has a redraw facility.

Tips and traps

- The interest savings will usually be the same regardless of whether you put your emergency cash in a 100% offset account or directly into your home loan. This is because both options will effectively reduce the size of your loan before interest is calculated. However, a 100% offset account may be a better option, given that fees and restrictions may apply to a redraw facility.
- Some lenders allow you to establish multiple offset accounts to help you better manage your cashflow.
- Be careful when selecting a fixed rate home loan, as an offset account can usually only be linked to a variable rate loan.
- If you have debt, you should ensure you have enough insurance to protect your income and enable the loan to be repaid in the event of your death or disability.
- Once you've paid off your home loan, if you have an investment loan, it could be more tax-effective if you put your emergency cash in an offset account linked to your investment loan rather than the loan itself.

	Before strategy	After strategy
Loan term	17 years 4 months	16 years
Total interest payments	\$247,424	\$217,930
Interest saving		\$29,494

⁴ Includes Medicare levy and assumes that Ian earns \$75,000 pa and Carolyn earns \$60,000 pa.

Note: This case study illustrates the importance of speaking to a financial adviser and mortgage broker about putting your emergency cash to a potentially better use. They can also address a range of potential issues and identify other suitable strategies – see Tips and Traps.

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Strategy 3 **Harness your cash flow to reduce inefficient debt**

If you are currently spending less than you earn, you may want to consider using your surplus cashflow to accelerate the repayment of your home loan.

What are the benefits?

By using this strategy, you could:

- save on interest, and
- create equity in your home that could be used as security for a loan for investment purposes.

How does the strategy work?

The interest on many home loans is calculated on the daily balance, even though it may be charged against the loan less frequently.

You can therefore reduce the average daily loan balance (and save a considerable amount of interest) by:

1. **Increasing the repayment frequency**

(eg from monthly to fortnightly).

This can reduce your average daily loan balance even though the annual repayments remain the same.

Note: These benefits are only available if your salary is paid more frequently than you are making loan repayments.

2. **Increasing the repayment amount.**

This involves using your surplus cashflow to pay off your loan sooner.

3. **Crediting your entire salary**

automatically into your home loan or a 100% offset account (if available).

By doing this:

- Your salary hits your loan account sooner, having the same effect as increasing the repayment frequency.
- Your salary is immediately used to reduce the size of the loan, having the same impact as increasing the repayment amount.
- You may achieve a higher after-tax return than if your salary is paid into a cash account.
- You can access your money (either from a 100% offset account or using the loan's redraw facility) to meet your living expenses during the month.





Case Study 3 Harness your cashflow to reduce inefficient debt

Carolyn and Ian have a home loan of \$303,000 after consolidating their debts and transferring their emergency cash of \$12,000 into a 100% offset account.

Ian receives a fortnightly salary of \$2,215 after tax and Carolyn receives \$1,841 after tax. They are making home loan repayments of \$2,717 per month and their combined living expenses are \$4,800 per month (excluding loan repayments).

Their financial adviser and mortgage broker in consultation recognise they are spending less than they earn and outlines some ways they could use their surplus cashflow to reduce the daily loan balance and save on interest. These include:

- **Increasing the repayment frequency** from monthly to fortnightly (by paying \$1,254 each fortnight rather than \$2,717 per month).
- **Increasing the repayment amount** by \$20 per fortnight to \$1,274.
- **Crediting their entire salary into a 100% offset account** and withdrawing money as required to meet their living expenses.

The incremental advantage of adopting each of these strategies is:

	Loan term	Total interest payments
Before strategy	16 years	\$217,930
Changing payment frequency	15 years 9 months	\$213,473
Increasing regular repayments	15 years 4 months	\$206,262
Salary crediting	8 years 7 months	\$107,413

By using these strategies, Carolyn and Ian could reduce their home loan term by over seven years and save up to \$110,517 in interest.

Also, by paying off their inefficient (non tax deductible) home loan debt as quickly as possible, they'll build a considerable amount of equity in the family home each year. Assuming they then wish to build their wealth further, they could use this equity as security for a more-effective investment loan .

Note: This case study illustrates the importance of speaking to a financial adviser and mortgage broker about using your surplus cashflow to pay off your inefficient debts faster. They can also address a range of potential issues and identify other suitable strategies – see Tips and Traps.

Tips and traps

- To accelerate the repayment of inefficient debt, it is essential that you maximise income, limit expenditure and claim all the tax deductions and offsets you are entitled to. To help you determine your tax deduction and offsets we recommend you speak to a registered tax agent.
- Many home loan simulations show a dramatic reduction in the loan term as a result of changing the payment frequency from monthly to fortnightly. However, these simulations often divide the monthly repayment by two (eg \$500 per month to \$250 per fortnight). This results in annual repayments of \$6,500 pa compared to \$6,000 pa with monthly payments.
- If you are considering salary crediting, check your payroll provider can pay your salary either directly into your home loan or a 100% offset account.
- Your lender may not allow you to make additional repayments into the fixed rate component of the loan.
- Some lenders allow you to automatically transfer money from your offset account to repay your credit card (in full) within the interest-free period.
- If you have debt, you should ensure you have enough insurance to protect your income and enable the loan to be repaid in the event of your death or disability.

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Strategy 4 Use borrowed money to build wealth

Once you have your inefficient debt under control, you may want to consider borrowing for investment purposes.

What are the benefits?

By using this strategy, you could potentially:

- multiply your investment profits, and
- achieve your wealth goals sooner.

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 enhance 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).

It is therefore 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. They also typically produce assessable income (which means you may be able to claim the interest on the investment loan as a tax deduction).

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

1. **You can borrow against the equity in your home.** This approach offers the benefit of a low interest rate and there are no restrictions on what you can invest in.
2. **You can take out a margin loan.** This type of loan may enable you to borrow up to 75% of the value of approved shares and managed funds. For example, if you have \$25,000 and you want to purchase an approved investment with the help of a margin loan, you may be able to borrow up to \$75,000 and make a total investment of \$100,000. It's also possible to use a margin loan to gear on a regular basis. This is known as instalment gearing.
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 you use a gearing strategy, you should ensure you have a suitable time frame (preferably five years or longer) and understand the risks.

For example, if your investments fall in value, your financial situation could be significantly worse than if you hadn't used a gearing strategy.

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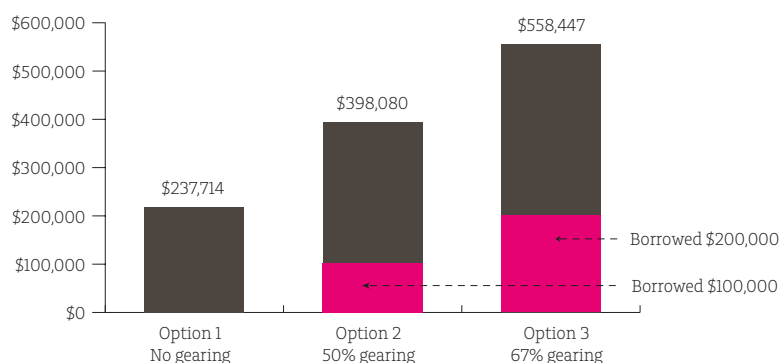
Case Study 4 Use borrowed money to build wealth

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 and mortgage broker in consultation present 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).

The graph below illustrates the potential outcomes after 10 years, assuming Jenny uses an interest-only home equity loan in options 2 and 3, with an interest rate of 7.5% pa.

Investment value after 10 years



Assumptions: Investment return is 9.5% pa (split 4.4% pa income 5.1% pa growth franking 77%). Interest on the loan is 7.5% pa. These rates are assumed to remain constant over the investment period. With options 2 and 3, where investment income and the benefit of the tax deduction are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax advantages are reinvested.

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 withdrew 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 the table below.

Investment value after repayment of loan

No gearing	50% gearing	67% gearing
\$237,714	\$291,111 ¹	\$344,116 ¹

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

Note: This case study illustrates the importance of speaking to a financial adviser and mortgage broker about using gearing to grow your long-term wealth. They can also address a range of potential issues and identify other suitable strategies – see Tips and Traps.

Tips and traps

- 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 margin loan, you may need to meet a margin call if your investments fall in value. To reduce the likelihood of a margin call, you should maintain a conservative loan-to-valuation ratio. You should also hold significant cash (or other liquid assets) to meet margin calls if required.
- If you have a partner, you may want to consider investing the existing funds in the name of the lower income earner and the borrowed funds in the name of the higher income earner.
- 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.
- If you have debt, you should ensure you have enough insurance to protect your income and enable the loan to be repaid in the event of your death or disability.

¹ After CGT on the amount withdrawn.

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Strategy 5 Transform your debt using a financial windfall

If you receive a financial windfall, you may want to consider using it to reduce your home loan and borrow an equivalent amount for investment purposes.

What are the benefits?

By using this strategy, you could:

- replace inefficient debt with efficient debt, and
- establish an investment portfolio to build your long-term wealth.

How does the strategy work?

While paying off your home loan, it's possible you will receive a financial windfall such as a work performance bonus, an ex gratia payment on changing employers or an inheritance.

If that's the case, you may want to:

- use the windfall to reduce your home loan, by either paying the money into your loan or a 100% offset account attached to your loan
- arrange to borrow through an investment loan, and
- invest the borrowed money in assets such as shares or property—either directly or via a managed fund.

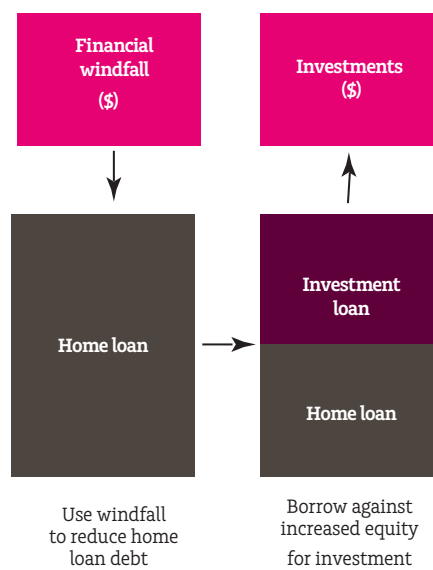
This strategy is known as debt transformation because it enables you to convert some of your inefficient home loan debt (where the interest isn't tax-deductible) into an efficient investment loan (where the interest may be tax deductible).

As a result, you could potentially reduce your after-tax interest cost considerably (see case study) and establish an investment portfolio to help build your long-term wealth.

The cash-flow efficiency generated from the borrowed investment could also enable you to reduce your remaining home loan faster.

Note: Before you use a gearing strategy, you should ensure you have a suitable time frame (preferably five years or longer) and understand the risks.

For example, if your investments fall in value, your financial situation could be significantly worse than if you hadn't used a gearing strategy.



Use windfall to reduce home loan debt

Borrow against increased equity for investment

- Non-tax deductible debt
- Tax deductible debt

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Case Study 5 | Transform your debt using a financial windfall

Daniel has a home loan of \$200,000, the interest rate is 7.5% pa and he pays tax at a marginal rate of 39%¹. He has just received an inheritance of \$100,000 and would like to invest this money to build his long-term wealth.

If he uses the inheritance to purchase the investments directly, his home loan will remain at \$200,000 and, because the interest payments are not tax deductible, the after-tax interest cost will be approximately \$15,000 pa (see option 1 below).

After assessing his goals and financial situation, Daniel's financial adviser and mortgage broker in consultation explain that a potentially better approach would be to:

- use the \$100,000 to reduce his home loan
- borrow an equivalent amount through an interest-only investment loan secured by his home, and
- purchase the investments with the borrowed money.

If Daniel follows this advice, he'll have a home and investment loan of \$100,000 each and the after-tax interest cost of the home loan will be \$7,500. However, because the investment loan interest (also \$7,500) may be tax deductible², the after-tax cost of this loan could potentially be \$4,575 pa (see option 2 in the table below).

In other words, if Daniel uses this debt transformation strategy, while his total debts will remain at \$200,000, his total after-tax interest bill could reduce from \$15,000 pa to \$12,075 pa and he'll still get to invest \$100,000.

	Option 1 Without debt transformation	Option 2 With debt transformation	
Loan type	Home loan only	Home loan	Investment loan
Loan amount	\$200,000	\$100,000	\$100,000
Interest payable at 7.5% pa	\$15,000	\$7,500	\$7,500
Less tax advantage at 39% ¹	N/A	N/A	(\$2,925)
After-tax interest cost	\$15,000	\$7,500	\$4,575
Total after-tax interest cost	\$15,000	\$12,075	

His financial adviser also suggests that:

- he use the income from the investments and the after-tax interest savings to pay off his home loan faster, and
- when his home loan is repaid, he use the investment income to purchase more investments and build even more wealth in the future.

Note: This case study illustrates the importance of speaking to a financial adviser and mortgage broker about how you may best use a windfall to achieve your wealth goals. They can also address a range of potential issues and identify other suitable strategies – see Tips and Traps.

Tips and traps

- An alternative to debt transformation is to use the financial windfall to pay down your home loan and not invest. While this strategy will reduce your inefficient (non-deductible) debt and save you interest, it may not be as effective in growing your wealth.
 - You could also transform your debts when selling existing investments by using the sale proceeds to reduce your home loan and borrow an equivalent amount to invest in other assets. Caution: If you sell an asset, recycle the proceeds through your home loan and borrow to buy back the same asset, the Australian Taxation Office may consider this a scheme to obtain a tax benefit and seek to apply penalties and deny your interest tax deduction. You should therefore consider seeking specialist taxation advice from a registered tax agent before using this strategy.
 - To make it easier to calculate how much of your interest is tax-deductible when completing your tax return, you should keep your investment loan separate from your home loan. This could be done by establishing a separate investment loan or, if offered by your lender, a loan that enables you to establish separate sub-accounts within the one loan facility. We recommend you speak to a registered tax agent
 - If you have debt, you should ensure you have enough insurance to protect your income and enable the loan to be repaid in the event of your death or disability.
- ¹ Includes Medicare levy.
- ² Assumes that the investments purchased with the borrowed money produces assessable income.

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Strategy 6 Build wealth via debt recycling

As you pay down your home loan, you may want to consider progressively redrawing the equity you create for investment purposes.

What are the benefits?

By using this strategy, you could:

- replace inefficient debt with efficient debt on a regular basis, and
- establish an investment portfolio to help build your long-term wealth.

How does the strategy work?

While it's important to reduce inefficient home loan debt as quickly as possible, it's also important to build wealth for the long term to meet your lifestyle goals, such as retirement.

However, many people wait until their home loan is paid off before thinking about investing. Unfortunately, this means they invest later in life and don't give their investments time to grow.

One solution is to transform your debts using a financial windfall. Another approach is to use what is known as debt recycling.

With debt recycling, you need to:

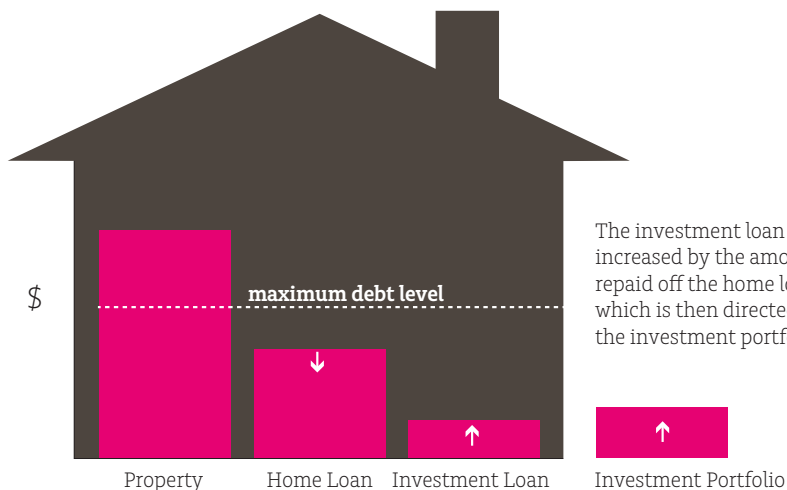
1. use the equity in your home to establish an investment loan (such as a line of credit)
2. invest the borrowed money in assets such as shares – either directly or via a managed fund, and
3. use the investment income from the geared investment, as well as your surplus cashflow, to reduce your outstanding home loan balance.

At the end of each year, you then need to borrow an amount equivalent to what you've paid off your home loan and use this money to purchase additional investments.

This process is then continued each year until your home loan is repaid. After that, your surplus income can be used to acquire additional investments or pay down your investment loan.

Note: Before you use a gearing strategy, you should ensure you have a suitable time frame (preferably five years or longer) and understand the risks.

For example, if your investments fall in value, your financial situation could be significantly worse than if you hadn't used a gearing strategy.



The investment loan is increased by the amount repaid off the home loan which is then directed into the investment portfolio.

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Case Study 6 Build wealth via debt recycling

Greg, aged 45, and Jackie, aged 44, own a home worth \$600,000 and they still owe \$300,000 on their mortgage. Their after-tax salaries are \$3,002 and \$1,571 per fortnight and their combined living expenses are \$4,800 per month.

They want to pay off their home loan quickly. To achieve their goal, they have been crediting their salaries into a 100% offset account.

They also want to maintain their lifestyle when they stop working. So, their financial adviser and mortgage broker in consultation suggest they use debt recycling to complement the wealth they are accumulating in superannuation.

They're comfortable with a total debt equivalent to 67% of their home value (ie \$400,000). Given they currently owe \$300,000, they use the equity in their home to establish an interest-only investment loan of \$100,000 and invest the money in Greg's name in a managed Australian share portfolio.

They also arrange for the investment income and tax benefits to be paid into (and the investment loan interest to be deducted from) their home loan offset account.

At the end of the first year, after reducing their home loan by \$41,877, they increase their investment loan by the same amount and use the money to purchase more units in Greg's share fund.

They continue this process each year until their home loan is paid off six years from now. Then, for the next 14 years, they invest all their surplus cashflow (including the investment income and tax savings) in the share portfolio.

The table below shows the benefits of this strategy over 20 years, when compared to paying off their home loan as quickly as possible and directing their surplus cashflow into a share fund once the home loan is paid off. By using debt recycling, Greg and Jackie will have an investment portfolio worth an extra \$891,347 after Capital Gains Tax (CGT) and loans are paid (despite taking slightly longer to repay their home loan).

After 20 years	Debt recycling	Repay home loan then invest
Time taken to repay home loan	6 years	5 years 7 months
Value of investment portfolio (net of CGT)	\$3,146,094	\$1,854,747
Outstanding debt	(\$400,000)	Nil
Net position after 20 years (after selling all investments, paying CGT and repaying the loan)	\$2,746,094	\$1,854,747

Note: This case study illustrates the importance of speaking to a financial adviser and mortgage broker about debt recycling and how it may help you fast track your wealth goals. They can also address a range of potential issues and identify other suitable strategies – see Tips and Traps.

Tips and traps

- If you take out an interest-only investment loan, you can use more of your cashflow to reduce your home loan.
- Arranging a higher investment loan limit could enable you to avoid additional paperwork and fees when adjusting your loan balances each year.
- While a line of credit (which has investment and home loan sub-accounts) could make it easier to do debt recycling, these loans generally have higher interest rates than standard home loans.
- With debt recycling, because some of your surplus cashflow must be used to meet the investment loan interest, it may take you slightly longer to pay off your home loan. However, the upside is you can acquire an investment portfolio sooner and potentially accumulate greater wealth.
- If you have debt, you should ensure you have enough insurance to protect your income and enable the loan to be repaid in the event of your death or disability.
- When you've paid off your home loan, you could use your surplus cashflow to add to your investments or reduce your investment loan balance. Assuming the after-tax return from your investments is greater than the interest cost (which may be tax deductible), you are generally better off investing, provided you're comfortable maintaining the total debt level.

Case study Assumptions: The Australian share fund provides an investment return of 9.5%pa (split 4.4% income 5.1% growth 77% franking). The home and investment loan interest rate is 7.5% pa. These rates are assumed to remain constant over the investment period. Greg earns a salary of \$110,950 pa and Jackie earns \$50,400 pa.

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Strategy 7 Offset your investment loan to retain cash-flow efficiency

If you have paid off your home loan, you can consider putting your emergency cash reserve in a 100% offset account linked to your investment loan.

What are the benefits?

By using this strategy, you could potentially:

- earn a higher after-tax return than a cash account, and
- withdraw the money for any purpose without affecting the tax deductibility of the loan.

How does the strategy work?

While you are still paying off your home loan you might want to hold your emergency cash reserve in your home loan or a 100% offset account linked to your home loan.

But what should you do if your home loan has been repaid and you only have an investment loan?

Holding your emergency cash in your investment loan or 100% offset account linked to your investment loan, could enable you to earn a higher after-tax return than using a separate cash account.

But if you want to access the money for non-investment purposes, paying it into a 100% offset account linked to your investment loan is likely to be a more tax-effective alternative than paying it into the investment loan itself.

The reason is that, because an offset account is separate from your investment loan account, you can make repayments (and access them if required), without affecting the size of the investment loan or the tax deductibility of the interest.

Conversely, if you pay money into the investment loan itself, you'll reduce the size of the loan and if you redraw the money for non-investment purposes, you can't claim the interest on the redrawn amount as a tax deduction.

This means you could end up in a situation where part of your interest is tax deductible and the rest is not (as the following case study shows).

- 1 Withdrawals for non-investment purposes are not tax deductible and generally do not impact on the tax deductibility of the interest for the portion of the loan for investment purposes.

	Investment loan	100% offset account linked to an investment loan
Can you access your emergency cash for any purpose?	Yes	Yes
Do withdrawals for non-investment purposes reduce the tax deductibility of the loan?	Yes	No ¹

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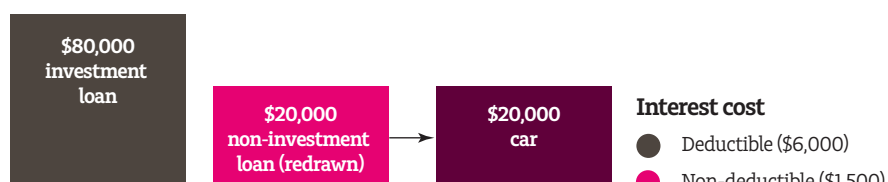
Case Study 7 | Offset your investment loan to retain cash-flow efficiency

After paying off her home loan, Laura, aged 45, used some of the equity in her home to set up an interest-only investment loan for \$100,000 and invested in a managed share fund. The interest rate on the investment loan is 7.5% pa.

She recently received an after-tax bonus of \$20,000 from her employer. She plans to buy a car in 12 months and wants to know what she should do with the money in the meantime.

If she pays the bonus directly into her investment loan, the balance will drop to \$80,000. However, when she redraws the \$20,000 to buy her car, she won't be able to claim the interest on this part of the loan as a tax deduction. As a result, she'll end up with a mixture of tax deductible and non tax deductible debts.

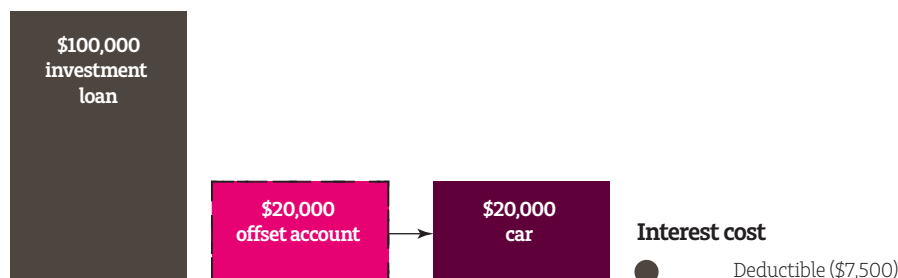
After withdrawing \$20,000 from investment loan



After assessing her goals and financial situation, Laura's financial adviser and mortgage broker in consultation suggest that she pay the bonus into a 100% offset account linked to her investment loan. By doing this, while her investment loan will stay at \$100,000, she'll save the same amount of interest. This is because interest is only payable on the difference between her loan account and the offset account (ie on \$80,000).

Also, when she withdraws the \$20,000 from her offset account to buy her car, the size of the investment loan will not be affected and the interest payments should continue to be fully tax deductible.

After withdrawing \$20,000 from offset account



Note: This case study illustrates the importance of speaking to a financial adviser and mortgage broker if you have an investment loan and want to know where you should hold any spare cash tax-effectively. They can also address a range of potential issues and identify other suitable strategies – see Tips and Traps.

Tips and traps

- To use this strategy, your investment loan must have a 100% offset account. If your current loan does not have this facility, you should check with your lender to see if it can be added.
- In many cases, the lender will only allow an offset account for the variable rate portion of the loan.
- Line of credit facilities don't generally offer a 100% offset account. Even if a personal sub-account is in credit, the lender may not offset this against the outstanding investment loan sub-account.
- If you need to borrow money for a non-investment purpose and don't have an offset account, it's usually better to borrow using a separate loan rather than redraw from your investment loan. This way it's easier to keep track of your deductible and non-deductible interest costs.
- If you have debt, you should ensure you have enough insurance to protect your income and enable the loan to be repaid in the event of your death or disability.

Important note: You should not enter into an investment loan arrangement if the dominant purpose of doing so is to obtain a tax benefit. Some structures have been considered by the ATO as being tax avoidance schemes and therefore you should consult with your financial adviser and a registered tax agent before entering into any new arrangement. We are not a registered tax agent.

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Strategy 8 Make gearing more efficient for a couple

If you have a partner, when using a gearing strategy you may want to consider investing your existing funds in the lower income earner's name and the borrowed funds in the higher income earner's name.

What are the benefits?

By using this strategy, you could potentially:

- achieve your wealth accumulation objectives in a more efficient way, and
- accumulate a larger amount of wealth.

How does the strategy work?

When using gearing, it's common to invest a combination of your own capital and borrowed money.

But if you have a partner, rather than investing the combined amount in one person's name, splitting ownership of the investments could improve the outcome considerably.

As a rule of thumb:

- holding the ungeared investments (ie your existing capital) in the name of the lower income earner could enable them to pay less tax on the investment income, and
- holding the geared investments (ie the investments purchased with borrowed money) in the higher income earner's name could enable them to benefit more when claiming the investment loan interest (and certain other costs) as a tax deduction.

People who are on lower marginal tax rates will generally pay less CGT than people on higher incomes/tax rates. Also, some people may have capital losses carried forward from other transactions that can be used to offset the capital gains.

Another consideration when structuring your investing activities is the yield. Some assets generate income (high yielding assets) whilst others generate capital growth (low yield). Assets with high yield can produce ongoing taxable income which means that they aren't as effective for people on high tax rates.

Conversely, there can be an advantage in investing the money in the lower income earner's name in higher yielding assets.

Note: Before you use a gearing strategy, you should ensure you have a suitable time frame (preferably five years or longer) and understand the risks.

For example, if your investments fall in value, your financial situation could be significantly worse than if you hadn't used a gearing strategy.

When determining how to structure your investments, it is important to consider a commercial purpose to your decisions. Structures or decisions that have a dominant purpose for obtaining a tax benefit can be considered to be tax avoidance schemes by the ATO which could result in you losing your interest deductions as well as having fines and penalties applied.

You should consult a registered tax agent before using this strategy.

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Case Study 8 Make gearing more tax-effective for a couple

Rob pays tax at a marginal rate of 39%¹, while his wife Angela has a marginal tax rate of 21%¹. They wish to accumulate wealth, ideally for retirement. They have \$40,000 in cash and want to borrow another \$60,000 so they can invest a total of \$100,000 in a managed Australian share fund.

They plan to hold the investment for 10 years and their financial adviser and mortgage broker in consultation present four different options, including:

1. Investing all the money (\$100,000) in a share fund in Rob's name, with Rob selling some of his investment at the end of the 10 years to repay the loan and CGT on the amount withdrawn.
2. Splitting ownership so the existing capital (\$40,000) is invested in Angela's name and the borrowed money (\$60,000) is invested in Rob's name. Rob will also sell some of his investment at the end of the 10 years to pay off the loan and any associated CGT.
3. Splitting ownership (as per option 2 above), but with Angela selling some of her investment at the end of the ten years to repay the loan and CGT.
4. Splitting ownership (as per option 3 above), but with Rob investing in a share fund that pays a lower yield.

The results from each of these strategies are shown in the table below. As you can see, it is possible to add thousands of dollars to the bottom line by making the right ownership decisions when gearing as a couple.

Option	Result
1. All investments in Rob's name	\$155,465
2. Split ownership (Rob repays the loan)	\$127,882
3. Split ownership (Angela repays the loan)	\$128,370
4. As above, but Rob invests in a lower yielding fund	\$135,252

Assumptions: In option 4, Rob (only) invests in a share fund with a total return of 9.5% (split 2% income 7.5% growth). In all other scenarios, Angela and/or Rob invest in a share fund with a total return of 9.5%pa (split 4.4% income 5.1% growth). Investment income is Franking at 77%. The loan interest rate is 7.5% pa. These rates are assumed to remain constant over the investment period. Where the investment income and the benefit of the tax deduction are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax advantages are reinvested.

- 1 Includes Medicare levy.
- 2 This assumes that you are eligible to contribute to super. To be eligible to claim your super contributions as a tax deduction, you will need to earn less than 10% of your assessable income, reportable fringe benefits and reportable employer super contributions from eligible employment and meet a range of other conditions (as at December 2016).

Note: This case study illustrates the importance of speaking to a financial adviser, mortgage broker and registered tax agent if you have a partner, about who between the two of you should own different investments when establishing a gearing strategy.

Tips and traps

- When splitting ownership, the lower income earner could invest the existing funds in their name and offer these investments as third-party security so that the higher income earner can take out a margin loan. With this approach, the owner of the existing funds may be required to act as guarantor to the loan facility.
- You may be able to avoid the need for a guarantor by using a home equity loan. In this scenario, it's possible for one member of the couple to invest joint borrowings secured against their home in their own name and still claim a full interest tax deduction.
- Rather than selling the geared or ungeared assets to pay off the investment loan, you may be able to redeem non-CGT assets (eg cash) or pre-CGT assets. Alternatively, you may be able to manage CGT if you sell investments in a low-income year, sell investments progressively, crystallise losses or contribute the sale proceeds into super² and claim a tax deduction.
- When reinvesting the proceeds from your gearing activities (such as dividends), you should treat the reinvestment of each amount as a new investment decision and look at how best to invest each time. This may include considering the factors of where to invest and how the investment will be structured (ie who will own the investment).
- You should also consider factors such as bankruptcy or litigation when making ownership decisions.

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Strategy 9 Leverage your investment via an internally geared share fund

If you are looking for a simple way to gear into the sharemarket, you may want to consider investing in an internally geared share fund.

What are the benefits?

By using this strategy, you could:

- access the power of gearing without having to arrange an investment loan yourself, and
- take advantage of potentially lower interest costs.

How does the strategy work?

Borrowing to invest (gearing) can be a potentially powerful way to build long-term wealth.

One option is to arrange the investment loan yourself—by either borrowing against the equity in your home or taking out a margin loan.

Another way to benefit from gearing is to invest in what is called an internally geared share fund—either within or outside superannuation.

With internally geared share funds, the manager borrows on behalf of investors to make a larger investment in Australian and/or global shares (see diagram below).

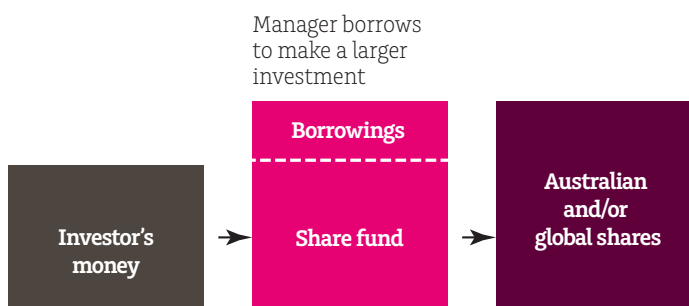
The manager typically borrows at wholesale interest rates, which can be significantly lower than what you could access yourself.

The loan is generally limited recourse in nature. This means that if the investments fall in value below the level of fund borrowings, you are not required to pay back the shortfall to the lending institution.

The fund is also usually structured so that the income exceeds the loan interest, as well as any fees. In other words, the fund is usually positively geared.

Tips and traps

- While internally geared share funds can magnify your investment returns, they can also magnify your losses.
- Since the borrowing is done by the manager, you can't choose the level of gearing.
- You can use borrowed money to invest in an internally geared fund, but this will significantly increase your investment risk.
- Some internally geared share funds allow you to invest fixed amounts on a regular basis, using a regular savings plan. This can take the guesswork out of trying to pick the right time to buy. It can also allow you to invest earlier as you don't necessarily need a substantial amount to get started.
- It's possible for super funds to borrow to invest in certain assets, provided certain conditions are met.
- Sometimes the tax deductibility of interest paid on such arrangements may be limited under the capital protected borrowing tax rules. You should seek advice from a registered tax agent.



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Strategy 10 Investing with borrowed money

This table summarises the key advantages and disadvantages of three forms of gearing.

	Home equity loan	Margin loan	Internally geared share fund
Description	<ul style="list-style-type: none"> Allows you to use the equity in your home to borrow money to invest where you choose. Can range from a standard principal and interest loan through to a line of credit (interest only). 	<ul style="list-style-type: none"> Allows you to borrow to invest in approved shares or managed funds, as a lump sum or in regular instalments. This is secured against the value of that investment and any other capital provided as security. 	<ul style="list-style-type: none"> A managed investment where the fund borrows money to make a larger investment in Australian and/or global shares. Usually managed so that it remains positively geared (ie fund income is sufficient to cover interest and fees).
Advantages	<ul style="list-style-type: none"> You have control over gearing levels No margin calls are required if there is an investment market downturn. Low interest rate (small premium for line of credit). Features can include a 100% offset account, redraw facility and salary crediting. Option of either a fixed, variable or split interest rate loan. No investment restrictions. Ability to make interest-only payments. Ability to pre-pay interest for up to 12 months and allowing you to manage your cash-flow more efficiently. Line of credit allows multiple loan accounts within a facility, so you can track deductible and non-deductible interest. If you are negatively geared, you may be able to offset excess deductions against other income. 	<ul style="list-style-type: none"> You have control over gearing levels Instalment gearing reduces risk through dollar cost averaging (investments are acquired at an average market price). Option of either a fixed, variable or split interest rate loan. Ability to make interest- only payments. Ability to pre-pay interest for up to 12 months and allowing you to manage your cash-flow more efficiently. If you are negatively geared, you may be able to offset excess deductions against other income. You may be able to arrange for another person (or company) to provide third-party security for your margin loan 	<ul style="list-style-type: none"> The fund is able to borrow at wholesale interest rates, which are generally lower than those available to individuals. No margin calls are required if there is an investment market downturn. The loan is limited recourse, which means your liability is limited to the value of your initial investment. Investing in the fund is much simpler than establishing a borrowing facility yourself. Enables you to access gearing in superannuation without having to establish your own super fund.
Disadvantages	<ul style="list-style-type: none"> Needs equity in a residential property. Interest premium with a line of credit. Where credit cards and cheque accounts are attached, you need discipline to prevent eroding your equity. 	<ul style="list-style-type: none"> Higher interest rate than standard home equity loan. Potential for margin calls if there is an investment market downturn. Maximum gearing ratio limited to around 75% (you need to make your own initial contribution). Investment options limited to investment menu of the lender (can include hundreds of direct shares or managed funds). 	<ul style="list-style-type: none"> Limited control over the gearing level. Limited number of providers and investment options. Interest on the fund borrowings is generally offset against fund income. No tax deduction for interest is available to investors unless they borrow personally to invest in these funds themselves, which can significantly increase risk.
Investors who may be suited to this approach	<ul style="list-style-type: none"> Investors who have equity in their home and are comfortable borrowing against it. Investors who have non tax deductible debt, as they can take advantage of the loan features for debt reduction and recycling. Investors who wish to avoid margin calls. 	<ul style="list-style-type: none"> Investors who do not own a home or do not have sufficient equity within their home. Investors who do own a home but are uncomfortable with using it as security. Instalment margin loans are suitable for investors with regular income but no lump sum to invest. 	<ul style="list-style-type: none"> Members of super funds that offer these options. Investors who do not own a home or do not have sufficient equity within their home. Investors who are uncomfortable with using their home as security. Investors looking for the simplicity of a pre-packaged geared investment. Investors who want to limit potential losses.

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