



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:

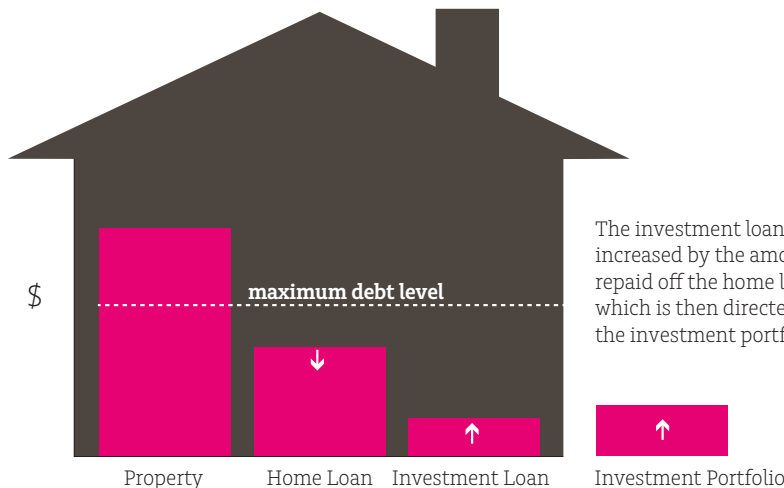
1. use the equity in your home to establish an investment loan (such as a line of credit)
2. invest the borrowed money in assets such as shares – either directly or via a managed fund, and
3. use the investment income from the geared investment, as well as your surplus cashflow, to reduce your outstanding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

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.

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.



For more information contact;

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Note: This is for general information purposes only and does not constitute advice. With all of these options there are a number of considerations outside the scope of what is covered in this article that you need to understand to ensure your personal circumstances are taken into consideration.





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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