OPTIMISING DEBT TO BUILD YOUR FAMILY'S WEALTH: CASE STUDY

CommSec Adviser Services

For many Australians owning a family home is only possible with the financial challenge of a large home loan. With a focus on reducing it as quickly as possible, wealth creation plans are often left until later in life, leaving little time to benefit from the compounding nature of investing. But with the right advice you can continue to focus on repaying your home loan while also investing to build wealth.


BEN AND JULIE

INTRODUCING BEN AND JULIE

Ben works as a physiotherapist and earns $80,000 a year. His wife Julie works as a registered nurse and earns $60,000 a year.

They have a $350,000 home loan and are currently making repayments of $30,090 each year, aiming to repay it in approximately 20 years. After reviewing their finances and setting a budget, they realise that while they expect to have surplus income of $18,516 this year, they have very little in the way of assets other than the family car and equity in their home.

They would like to increase their wealth over the long term and secure their young family's financial future, however they are unsure of their options. Should Ben and Julie use their surplus income to further reduce their home loan, should they start investing it, or is there a better solution?

WHAT IS DEBT OPTIMISATION?

Debt optimisation (sometimes referred to as 'debt recycling') is a financial strategy which creates wealth over time and improves an individual's debt structure. In the majority of cases this is achieved by:

- Using all surplus income to reduce the home loan (non-tax deductible 'bad' debt);
- Creating or increasing investment debt (tax deductible 'good' debt) by drawing against equity in the home; and
- Using this borrowed money to build an investment portfolio.

The strategy can be adapted to suit different goals and time horizons, however it is important to note that borrowing money to invest and budgeting are key components.

THE CHALLENGE

THEIR GOALS	
Short term (1-3 years)	• Seek financial advice and start investing • Accelerate home loan repayments
Medium term (3-7 years)	• Continue to build investment portfolio • Continue to reduce home loan
Long term (7 years+)	• Repay home loan • Maximise wealth

THEIR RESOURCES	
Income	• Ben's gross salary – $80,000 • Julie's gross salary – $60,000
Assets	• Home – $600,000 • Car – $20,000
Liabilities	• Home loan – $350,000

THE STRATEGY

Unsure of their options, Ben and Julie decide to seek advice from a financial adviser. During the appointment they discuss a range of alternatives including:

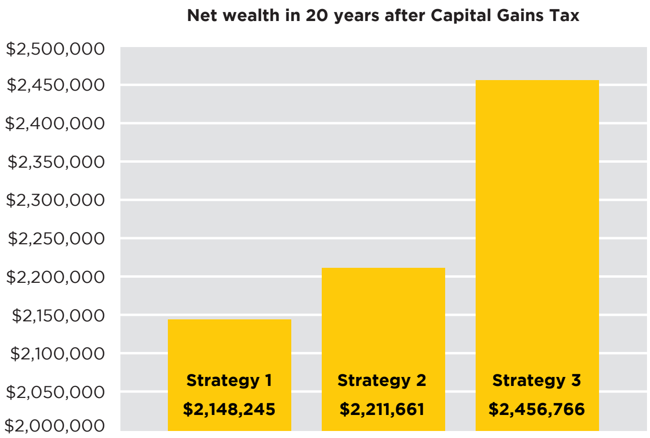
Strategy 1 – Add their expected surplus income each year ($18,516 this year) to their current home loan repayments of $30,090 p.a. and pay off their home loan in approximately nine years. Once their home loan is repaid, they would start investing their entire surplus cash flow in shares or managed funds over the remaining 11 years.

Strategy 2 – Continue to make their current home loan repayments of $30,090 p.a. and repay their home loan over 20 years. Invest their surplus income each year ($18,516 this year) in shares or managed funds over the next 20 years.

Strategy 3 – Undertake a debt optimisation strategy. In addition to making their home loan repayments of $30,090 p.a., Ben and Julie could use their surplus income ($18,516 this year) to further reduce their home loan. At the same time, they could re-borrow some or all of the increased equity in their home each year (using a separate investment line of credit or loan) and invest it in shares or managed funds.

After considering their options they decide on Strategy 3, the debt optimisation strategy, and make repayments totalling $48,606 to their home loan in the first year – $20,228 in interest and $28,378 as a principal reduction. Using an investment line of credit they re-borrow the $28,378 of principal paid off the home loan (the increased equity in their home) and invest it in shares. They decide to re-borrow and invest the amount of their increased equity as a result of their repayments in each subsequent year until the home loan is repaid. Once their home loan is repaid they start investing their entire surplus income over the remaining term.

THE RESULT



Assumptions: The graph compares Ben and Julie's expected wealth outcome for each strategy.

- Ben and Julie's wealth will be the value of their investment portfolio and home, less capital gains tax and all loans outstanding.
- Investment capital growth rate 4.50% p.a.; investment income yield 4.00% p.a.; franking level 70%; company tax rate 30%; property growth rate 3% p.a.; home and investment loan interest rate 6.00% p.a.; Medicare levy 2.00%; capital gains tax is calculated after 20 years using Ben and Julie's current marginal tax rate; the standard loan repayment is made each year; additional repayments are made where indicated; all loan repayments are transacted monthly; interest is calculated using the previous month's closing balance; Strategy 1: Once home loan is repaid, surplus cash flow and loan repayments are diverted into the investment portfolio for the remaining term; Strategy 2: After-tax investment income is reinvested; Strategy 3: During the home loan repayment period, after-tax investment loan interest is capitalised to the home loan and after-tax investment income is credited to the home loan.

If Ben and Julie had simply repaid the home loan before starting to invest (strategy 1), their net wealth after capital gains tax would have been $2.15 million after 20 years.

If Ben and Julie chose to make the minimum home loan repayment while investing the surplus income (strategy 2), their net wealth after capital gains tax would have improved to $2.21 million after 20 years.

But having followed their financial adviser's recommended debt optimisation strategy (strategy 3), Ben and Julie maximised their wealth over the 20 years. After nine years they managed to optimise their total debt by paying off their home loan (bad debt) and replacing it with tax deductible investment debt (good debt) of $350,000 which was invested during this period. After allowing for their investment line of credit and capital gains tax, they increased their net wealth to $2.46 million at the end of the 20 year period.

Please speak to your financial adviser for more information about how using a debt optimisation strategy can help you achieve your family's goals.

GETTING THE RIGHT ADVICE

As with any financial strategy, borrowing to invest is not without its risks. One of the key risks of this strategy is that just as it can multiply your gains when you invest successfully, it can also multiply your losses if your investments fall in value. That's why it's important to get the right advice to ensure gearing is appropriate for your particular situation. Your adviser can help you construct a personalised investment strategy that takes advantage of the benefits while minimising the risks.