Debt strategies

Build wealth with debt recycling

As you pay down your home loan, you may want to consider progressively redrawing the equity you create to help you build long-term wealth.

How does the strategy work?

With this strategy, known as debt recycling, you:

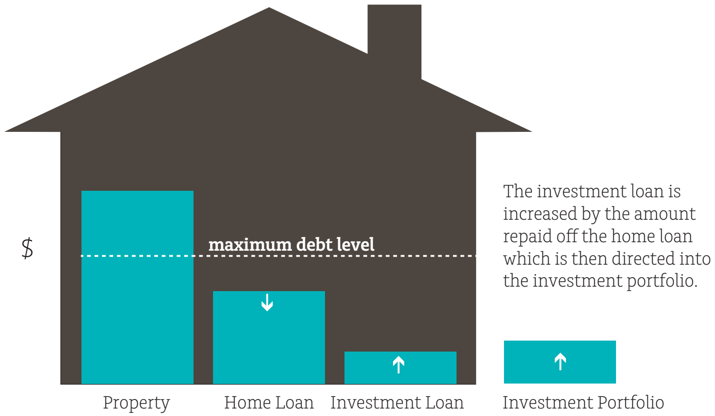
1. use the equity in your home to establish an investment loan (such as a line of credit)
2. invest the borrowed money in assets such as shares – either directly or via a managed fund, and
3. use the investment income from the geared investment, as well as your surplus cashflow to reduce your outstanding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

At the end of each year, you then 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.

By using this strategy, you can:

- progressively convert your non-tax deductible home loan into a tax deductible investment loan, and
- build up an investment portfolio over time to help meet your long-term goals.



Other considerations

- 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.
- You should ensure you have enough insurance to protect your income and cover 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 debt recycling suits your needs and circumstances.

Note: Before you borrow money 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.

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Case study

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 $3,000 and $1,600 per fortnight and their combined living expenses are $4,800 per month.

They want to maintain their lifestyle when they stop working. So, their financial adviser suggests 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 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 $40,299 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 $435,002 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 9 months
Value of investment portfolio (net of CGT)	$2,612,423	$1,777,421
Outstanding debt	($400,000)	Nil
Net position after 20 years (after selling all investments, paying CGT and repaying loan)	$2,212,423	$1,777,421

Case study assumptions: The Australian share fund provides an investment return of 9.4% pa (split 4.3% income, 5.1% growth and 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 and Jackie earn annual pre-tax salaries of $108,000 and $51,000 respectively. Salaries and combined living expenses are increased by 3% pa. CGT is calculated at a marginal tax rate of 47%, including the Medicare levy.

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