Strategy 6

Build wealth via debt recycling

As you pay down your home loan, you may want to progressively redraw 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
- Use the income and tax advantages from gearing to further reduce your inefficient debt.

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.

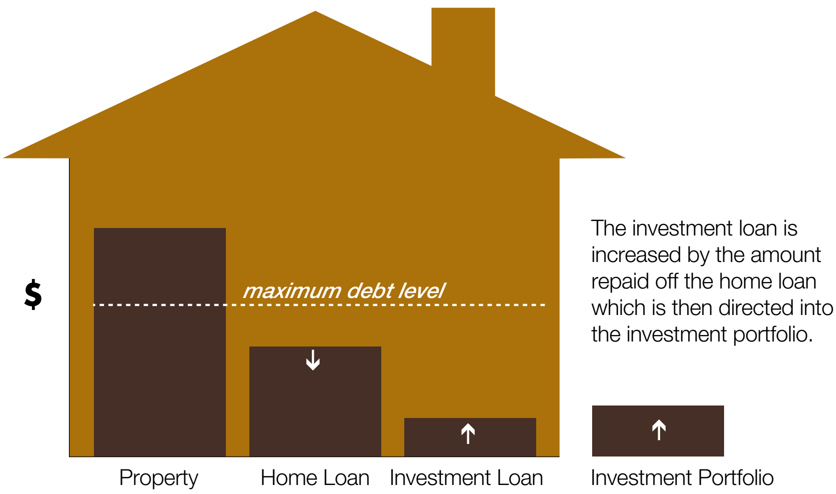
One solution is to employ a debt transformation strategy using a financial windfall (see Strategy 5). Another approach is to use what is known as debt recycling.

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 investment such as a unit trust, and
3. Use the investment income and tax advantages arising from the geared investment, as well as your surplus cashflow (see Strategy 3), 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 (including investment income and tax advantages) 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 timeframe (preferably five years or longer) and understand the risks (see FAQs on page 27). For example, if your investments fall in value, your financial situation could be significantly worse than if you don't use a gearing strategy.

Case study

Steve and Karen (from previous case studies), have a home worth $450,000 and an outstanding home loan of $220,000. They are keen to pay this off as quickly as possible and would like to start creating long-term wealth. Having spoken to their financial adviser, they have decided to employ a debt recycling strategy.

They use the existing equity in the family home to borrow for investment purposes. They're comfortable having a total debt level equivalent to 67% of the current value of their home (ie $300,000). Given their outstanding home loan is currently $220,000, they will initially borrow $80,000 via an interest only investment loan, and invest it in an Australian share fund via a unit trust.

Throughout the first year, they use all of their surplus cashflow, around $12,000 (less the interest on the investment loan), and the investment income and tax advantages, to pay down the home loan by $27,573 to $192,427. They then replace the amount paid down by borrowing an equivalent amount as an investment loan ($27,573) to purchase additional units in their share fund.

Note: Total borrowing is still capped at $300,000.

If they continue this process, their home loan will be paid off after 7 years. After recycling at the end of that year, the investment loan would be fully drawn to $300,000 and the value of the share fund would be $361,274. With the home loan paid off, they can direct all surplus cashflow, investment income and tax advantages into the share fund.

The table below illustrates the benefits of this strategy (over 20 years) when compared to using surplus cashflow to pay off the home loan as quickly as possible (as explained in Strategy 3), and after it's repaid, directing the rest into a share fund.

After 20 years	**Debt recycling**	**Repay home loan then invest**
Time taken to repay home loan	7 years	6.7 years
Value of investment portfolio	$1,618,989	$1,054,429
Outstanding debt	($300,000)	Nil
Net position after 20 years (after selling all investments, paying Capital Gains Tax, and repaying the loan)	$1,318,989	$1,054,429

Assumptions: The return on the Australian share fund is 8.5% pa (split 4% income and 4.5% growth). The franking level on income is 75%. The interest rate applying to the home loan and investment loan is 7% pa. These rates are assumed to remain constant over the investment period. The investments and loans are in Steve's name. Steve and Karen use salary crediting and credit cards (as shown in Strategy 3). At the end of 20 years, all investments are sold, Capital Gains Tax paid and loans repaid.

In the second scenario, although the home loan would have been paid off in around 6.7 years, the value of Steve and Karen's portfolio in year 20 would be only $1,054,429. By using debt recycling, however, Steve and Karen have an investment portfolio worth an extra $264,560 after all taxes and loans are paid (despite taking slightly longer to repay their home loan).

Tips and traps

- It's important your investment loan allows you to make interest-only repayments, so you can direct more cashflow into paying down your home loan. It can also be beneficial to have a higher pre-approved limit for your investment loan. This avoids additional paperwork and fees when adjusting your loan balances each year.
- A line of credit (which has investment and home loan sub-accounts) can be an efficient means of implementing debt recycling. Be aware that lines of credit generally have higher interest rates than standard home loans.
- With a debt recycling strategy, some of your surplus cashflow must be used to meet interest costs on your investment loan. It may therefore take you slightly longer to pay off your home loan than if you just used a surplus cashflow strategy (as described in Strategy 3). However, with a debt recycling strategy you can acquire an investment portfolio sooner.
- Having paid off your home loan, you generally have the choice of using surplus cashflow to purchase more investment assets, or reduce the debt on your investment loan. Assuming the after-tax return from your investment is greater than the interest cost (which is deductible), you are generally better off investing, provided you are comfortable with the total level of debt.