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Positive Gearing

Case Study

Objectives

Kyle graduated from university 7 years ago and now has an exciting job with a multinational IT firm. He earns a base salary of $95,000 with bonus potential if he exceeds work targets. Through employer contributions and salary sacrifice, up to 12% p.a. of his base salary goes into super.

Kyle could contribute more pre-tax salary to super but he has other more immediate goals. He is determined to buy an apartment in the next 5 years as well as recently enrolling in a Masters of Business Administration (MBA).

With bonuses and smart budgeting, Kyle has managed to save $55,000 outside of super. This is a good start, but Kyle realises he will need to be more assertive with his savings to truly reach his two goals. His super is invested for growth but Kyle is new to personal investing. One key concern for Kyle is ensuring he has sufficient cash flow to meet ongoing education expenses.

Recommendations

Given his circumstances and objectives, Kyle's adviser recommends borrowing to invest in a diversified portfolio of securities traded on the Australian Securities Exchange (ASX). His adviser uses the following information as an example to explain the strategy:

- Keep $5,000 cash for emergencies;
- Borrow 50% of the value of the proposed investment ($50,000 in the first year) through a margin loan; and
- Invest $100,000 in an exchange traded fund (ETF) that tracks a basket of ASX listed shares that are expected to pay stable dividends.

Kyle's adviser briefly outlines the reasons for his recommendation, informing Kyle that:

1. Australian shares are expected to grow in value over the medium to long term as well as potentially paying dividends;
2. Potential dividends are expected to at least offset the after-tax interest costs meaning Kyle can manage his budget;
3. By borrowing to invest, Kyle increases his share in any potential investment income and capital returns, but he must carefully assess and manage the risks of borrowing;
4. The ETF offers diversification which is a wise investment strategy and an important part of managing the risks of borrowing to invest;
5. The ETF is traded on the ASX making it a simple, low-cost way for Kyle to implement and monitor his investment plan; and
6. A margin loan is the most appropriate borrowing facility for Kyle because it gives him the tools to effectively manage the risks of borrowing to invest. Surprisingly, those tools include a professional margin call process; imposing sensible investment discipline if a market crash occurs.

In Detail

Assumptions	
Variable Interest Rate (indicative and subject to change at any time)	5.00% p.a.
Cash Dividend Yield	4.50% p.a.
Franking Level	50%
Marginal Income Tax Rate (including 2% Medicare Levy)	39.00%
Target Gearing Level (loan divided by value of investment)	50%

Kyle holds the investment on capital account, is eligible to claim franking credits and interest as income tax deduction.

- Each year Kyle changes the loan amount to maintain gearing at 50% of investment value. Each year, net after tax returns are re-invested.
- Each year 75% of the portfolio turns over incurring discounted capital gains tax.

Projected Cash Flow for the First Year	
Current Loan Interest (loan of $50,000)	$2,500 p.a.
Initial Cash Dividend (before-tax)	$4,500 p.a.
Franking Credits	$964 p.a.
Tax Payable before Franking Credit offset	$1,156
Net Tax Cost/(Benefit)	$192 cost
Net Annual after tax Cash Flow (cash dividend less interest and net tax payable)	$1,808 Inflow which is reinvested

The investment gives Kyle the potential to earn capital gains. His adviser does not recommend borrowing to pay interest (called capitalising interest) until his investment has had time to grow and gearing can remain close to his target of 50%. Variable interest is due monthly while dividends are typically paid twice a year and aren't guaranteed.

Managing Risks

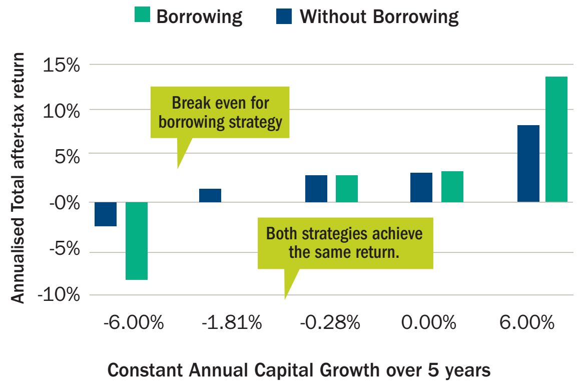
The ETF recommended by Kyle's adviser has a loan to value (LVR) of 75%. For an investment worth $100,000, the maximum Kyle can borrow is $75,000. Kyle intends to borrow only 50%. An initial loan of $50,000 and his capital of $50,000 means investable funds of $100,000. Given this gearing and investment profile, Kyle's investment would have to fall by over 41% (from $100,000 to $58,822) before he faces a margin call.

While it is possible for any investment to fall by more than 41%, such a significant fall in diversified investment is expected to happen over sufficient time for Kyle to adapt his gearing and investment profile.

Kyle agrees that if his gearing level increases to 60% he will sell sufficient investments, repaying part of the loan to bring his gearing level back to the target. This self-imposed margin call process is prudent investment discipline. No one wants to experience an investment loss, but if Kyle's strategy doesn't go as expected it's better to limit the loss. Conversely, if his gearing level falls to 40% he will borrow additional funds (no further than his approved credit limit) to align the investment with his goals and strategy.

Comparing Possible Capital Growth Outcomes

The chart shows annual total after-tax returns over 5 years assuming various constant annual capital growth rates.



The results highlight the benefit and risks of borrowing to invest. In this example:

- If the portfolio falls by more than 0.28% p.a. over 5 years, Kyle's strategy will be worse off than if he had not borrowed. If the portfolio is to fall at less than a rate of 0.28% p.a., or grows in value, Kyle's geared portfolio outperforms a similar investment without borrowing.
- Due to dividends and the potential tax benefit of franking credits and deductibility of interest, Kyle's portfolio must fall by more than 1.81% p.a. over 5 years before his strategy starts to lose money.

More information

If you have any questions, or would like to discuss how positive gearing can work for your clients, please contact us:

Call 1300 307 807

Email info@leveraged.com.au