

Using investment income to build a larger portfolio

For many Australians the idea of borrowing money to create a larger investment portfolio seems out of reach. With income allocated to rent or a mortgage, living expenses and the occasional holiday, finding the extra cash to meet interest costs seems almost impossible. But with the right financial advice many Australians can build a larger investment portfolio, by using investment income to meet interest costs.

Introducing Scott and Nicole

Scott and Nicole are a married couple in their early 30s with three young children. Scott works in the public service earning \$80,000 a year before tax.

Nicole was a nurse before the birth of their first child and plans to return to the workforce once their children have settled into primary school.

With their mortgage repayments and household expenses being met by Scott's salary, they are interested in creating a larger portfolio to help improve their family's financial position over time. While they can re-invest the income received from Scott's portfolio, is there another strategy which may help them despite the lack of surplus cash flow?



The challenge

Their goals	
Short term (1-3 years)	<ul style="list-style-type: none"> > Create a larger portfolio > Use any surplus cash flow on family holidays
Medium term (3-7 years)	<ul style="list-style-type: none"> > Continue with mortgage repayments > Maintain and grow portfolio
Long term (7 years+)	<ul style="list-style-type: none"> > Use Nicole's additional income to increase mortgage repayments > Maintain and grow portfolio

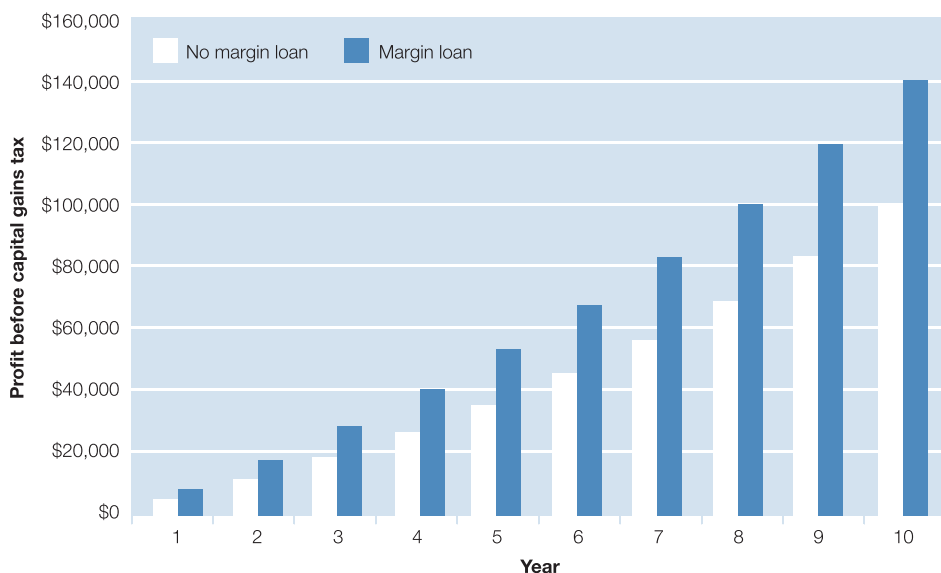
Their financial position	
Income	<ul style="list-style-type: none"> > Gross salary of \$80,000 a year > Investment income of \$1,750 a year
Assets	<ul style="list-style-type: none"> > Investment portfolio \$50,000 > Cash savings \$5,000 > Family home \$500,000
Liabilities	<ul style="list-style-type: none"> > Mortgage \$250,000

The strategy

Unsure of their options, Scott and Nicole decide to work with a financial adviser. After carefully considering their financial situation and goals, their adviser recommends they use a margin loan to borrow and invest another \$50,000, bringing the value of Scott's portfolio to \$100,000.

In addition to recommending the margin loan be in Scott's name to help maximise the value of tax deductions, their adviser also recommends they stop re-investing the income received from the portfolio. Instead he recommends the income be used to meet the interest costs on their \$50,000 margin loan. By leaving \$5,000 in the bank, Scott and Nicole will also have a cash reserve to cover any unexpected expenses.

The result



Assumptions: The graph compares the potential return on Scott's investment portfolio with and without a margin loan.

- > The calculations show the profit before capital gains tax of each strategy after loan and interest costs have been paid.
- > It assumes an average annual capital growth rate of 8.50%, an income yield of 3.50%, distributions are 80% franked, a company tax rate of 30%, an average annual margin loan interest rate of 9.15%, a marginal tax rate of 41.5% including Medicare levy of 1.5%, an initial client contribution of \$50,000, an initial margin loan gearing level of 50%, distributions are re-invested in the no margin loan scenario, distributions are not re-invested and are paid as cash in the margin loan scenario, brokerage and any other fees are excluded.
- > While capital gains tax implications have been ignored, they should be considered before investing.
- > This example is for illustrative purposes only.

If Scott and Nicole had decided to maintain their \$50,000 portfolio and continued re-investing the income received, their portfolio would have grown to a value of \$155,292 after 10 years. After deducting the initial value of Scott's portfolio and allowing for tax on the investment income received, the profit on Scott's portfolio would have been \$98,707 before capital gains tax.

But having followed their financial adviser's recommended strategy of borrowing an additional \$50,000 to invest and using the investment income to meet interest costs, Scott's portfolio grew to \$226,098 over the ten year period. After allowing for the initial value of Scott's portfolio, his margin loan, income received, interest paid and income tax, the profit on his portfolio was \$140,124 before capital gains tax.

The difference in the profit outcomes of both strategies was more than \$41,400 or 41% over the 10 year period. Most importantly, as Scott and Nicole had used investment income to meet interest expenses, surplus income from Scott's salary and Nicole's part time work over the 10 years was used to meet other goals such as reducing their mortgage and family holidays.

Getting the right advice

As with any financial strategy, using a margin loan to borrow and invest is not without its risks. One of the key risks of using a margin loan 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 a margin loan 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.

Please speak to your financial adviser for more information about how you can use a margin loan to accumulate more wealth without impacting on your cash flow.