


Debt Smart

Strategies for debt management

2007/2008





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Appreciating the value of debt

William Shakespeare wrote, 'Neither a borrower nor a lender be', but the fact is debt can be a very useful tool – when used properly.

Using debt, you could buy a house you may not be able to afford outright. You just need some equity and you can borrow the rest, assuming you can make the repayments.

Debt can also be used to buy investments with potential to grow in value, like shares and property. This strategy, known as gearing, may help you to build an investment portfolio faster than you could have otherwise.

To help repay the loan you'll have income generated by your investments and possibly some tax deductions. So, for many people, servicing an investment loan can be an achievable outcome.

In this booklet, we outline ten strategies proven to be highly effective in helping people make the most of debt. Individually, each strategy could significantly improve your financial position. By using a number of them in combination, you could optimise your finances and achieve financial independence.

To determine which of the strategies best suit your situation we recommend you consult your financial adviser.

Important information

The information and strategies provided in this booklet are based on our interpretation of relevant taxation laws as at 1 November 2007.

Because these laws are complex and change frequently, you should obtain advice specific to your personal circumstances, financial needs and investment objectives, before implementing any of these strategies.

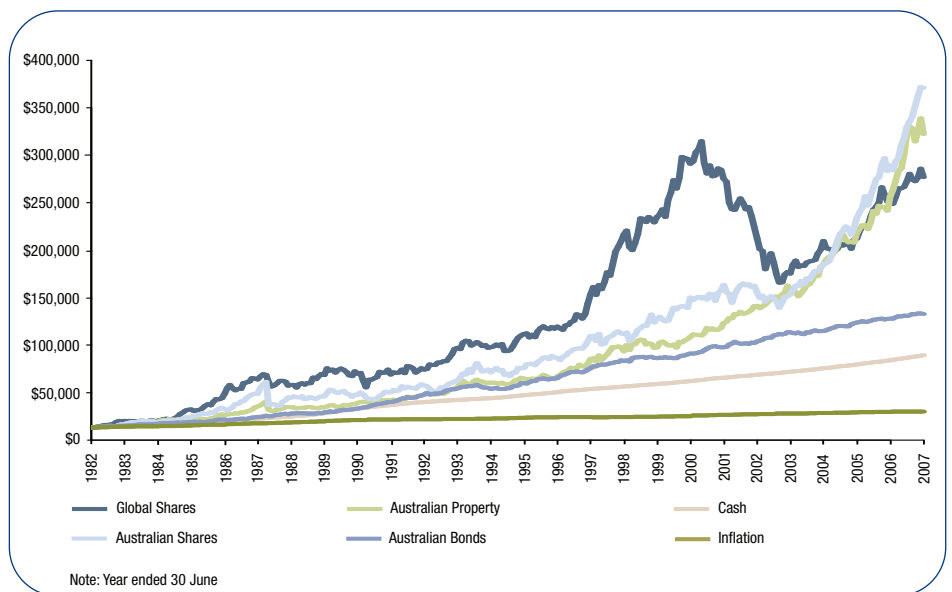
The investment returns shown in the following case studies are hypothetical. They do not reflect the historical or future returns of any specific financial products.

Investment basics

Choosing the right mix of assets can make a big difference to your success

As the graph below reveals, growth assets such as Australian shares, global shares and property have delivered higher returns for investors over longer time periods (ie seven years or more). These asset classes have also been more volatile than cash and bonds over the short term (ie one to three years).

Asset class comparison – \$10,000 invested



This comparison is based on historical performance and is not indicative of future performance. Future performance is not guaranteed and is dependent upon economic conditions, investment management and future taxation. Source data: Australian Shares: S&P/ASX 200 Accumulation Index (All Ordinaries Accumulation Index prior to April 2000), Global Shares: MSCI World Gross Accumulation Index (\$A), Property: ASX 200 Property Accumulation Index (Property Trust Accumulation Index prior to July 2000), Australian Bonds: UBS Composite Bond Index – All maturities (Commonwealth Bank Bond Index prior to November 1987), Cash: UBS Bank Bill Index (RBA 13 Week Treasury Notes prior to April 1987), Inflation: Consumer Price Index. Assumes income is re-invested.

So ...

When implementing a gearing strategy, choose investments that have the potential to grow in value (to increase your chance of making a profit) and that produce assessable income (for tax purposes). Share and property investments (purchased either directly or via a managed fund), are usually appropriate. Before you make your investment choice, you should also consider your goals, needs, financial situation, time horizon and comfort with market fluctuations.

To determine a mix of assets that suits your needs, you should speak to a professional financial adviser.

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The two types of debt

Inefficient debt

This is used to buy goods, services and assets that don't generate income, will depreciate in value, or have no value once they are used

You can't claim a tax deduction on the interest cost of the debt

You don't receive any income to help you repay the debt, so to service the debt you have to rely on your own resources

It's wise to reduce this kind of debt as quickly as possible

Examples

- A personal loan to buy a car is inefficient because the car depreciates in value, it doesn't generate any income and the interest is non-deductible.
- Using a credit card to pay for living expenses is inefficient if it's not repaid within the interest free period. This is because the interest on the debt isn't tax-deductible, and the things you buy generally have little or no re-sale value after use.
- Home loans are generally a less efficient form of debt because the home doesn't produce an income and therefore the interest cost in servicing the loan is non-deductible.

Efficient debt

This is used to acquire assets that have the potential to grow in value and generate assessable income

You can claim a tax deduction on the interest cost of the debt

You can use the income generated by the asset to help repay the debt

It's more easily serviceable, and it can be used to accelerate the creation of wealth

Examples

- Using an investment loan to acquire an asset, like shares or property (directly or indirectly via a managed fund), is efficient because the asset has potential to appreciate in value, it generates income and the interest on the loan is tax deductible.
- Another way to take advantage of efficient debt is to invest in an internally geared share fund. This is a managed fund that borrows to leverage its investments in Australian or global shares. As shares generate assessable income, the interest cost may be tax-deductible to the fund rather than investors directly. The share portfolio is also expected to grow in value over time at a greater rate than an ungeared investment.

Many people who become wealthy use debt to help them get there – but there are two kinds of debt, and only one can help you to become wealthy.



Strategies at a glance

Strategy	Key benefits	Page
1 Consolidate your debts to save money	<ul style="list-style-type: none"> • Reduce the interest rate applying to your debts • Pay off your inefficient debt sooner and save interest • Simplify your personal finances 	8
2 Use your emergency cash reserve more effectively	<ul style="list-style-type: none"> • Achieve a higher after-tax return on your money • Pay off your inefficient debt sooner and save interest (while retaining full access to your money) 	10
3 Harness your cashflow to reduce inefficient debt	<ul style="list-style-type: none"> • Pay off your inefficient debt sooner and save interest • Create equity in the family home that can be re-borrowed for investment 	12
4 Use borrowed money to build wealth	<ul style="list-style-type: none"> • Accelerate the creation of wealth by having more money invested • Minimise tax on other income through negative gearing 	14
5 Gear your investments gradually by borrowing in instalments	<ul style="list-style-type: none"> • Build wealth sooner in a disciplined and controlled manner • Have the flexibility to adjust your gearing strategy if necessary 	16
6 Transform your debt using a financial windfall	<ul style="list-style-type: none"> • Build wealth by replacing inefficient debt with efficient debt • Use the income and tax savings from gearing to further reduce inefficient debt 	18
7 Build wealth via debt recycling	<ul style="list-style-type: none"> • Build an investment portfolio sooner by replacing inefficient debt with efficient debt on a regular basis • Use the income and tax savings from gearing to further reduce inefficient debt 	20
8 Offset your investment loan to retain tax efficiency	<ul style="list-style-type: none"> • Save interest by making additional repayments into an investment loan offset account • Withdraw money for any purpose without affecting the tax-deductibility of the loan 	22
9 Make gearing more tax-effective for a couple	<ul style="list-style-type: none"> • Minimise income tax over the life of the investments • Save on CGT when redeeming the investments 	24
10 Leverage your investment via an internally geared share fund	<ul style="list-style-type: none"> • Reduce paperwork and borrowing costs • Allow super fund members to take advantage of gearing 	26

Consolidate your debts to save money

Inefficient debt is an obstacle to improving your financial position, and should be eliminated as quickly as possible.

One way to do this is minimise the amount of interest you're required to pay on your loans, so more of your loan repayments are used to reduce the actual debt.

A simple solution is to consolidate all inefficient debt into a loan with the lowest interest rate. As a guide, home loans generally offer the cheapest rate. Personal loans for cars or holidays charge a higher rate, and credit cards are the most expensive (if not repaid within the interest free period each month).

How does the strategy work?

With this strategy, you need to increase the mortgage on your family home (assuming you have sufficient equity) and use the funds to pay-off debt on personal loans and credit cards. The primary advantage is the lower interest rate on your home loan will apply to all debts. Assuming you continue to make the same overall repayments, you will eliminate your inefficient debt faster.

Before you do this, it's important to find out if your existing home loan offers features and flexibility to repay inefficient debt sooner, such as a 100% offset account, and the ability to make additional repayments (see Strategies 2 and 3). If it doesn't, it's probably better to consolidate your debt into a new home loan structure that offers these features.

Strategy

01

The benefits

- Save interest by reducing the interest rate that applies to all your debts.
- Pay off your inefficient debt sooner (if you maintain previous loan repayments).
- Simplify your personal finances by reducing the number of loans you have.

Case study

Steve (aged 37) and Karen (aged 35) are married with a young family. Their home is currently worth \$450,000 and they have the following debts.

Debts	Outstanding balance	Interest rate	Current repayments (pm)
Home loan (20 year term)	\$200,000	7.5%	\$1,611
Personal loan (5 year term)	\$25,000	12%	\$556
Credit cards	\$5,000	17%	\$66
Total	\$230,000		\$2,233

To minimise their total interest bill (and improve the manageability of their finances), they approach their lender about consolidating their debts. They want to increase the size of their home loan from \$200,000 to \$230,000 and use the additional funds to eliminate their personal loan and credit card debts.

Assuming the lender approves the application, the entire loan balance of \$230,000 will be subject to a 7.5% pa interest rate. This will result in a new minimum monthly payment of \$1,853 and a cashflow saving of \$380 in the first month alone.

The key to this strategy is to use the cashflow saving to pay off extra capital each month. For this reason, Steve and Karen decide to maintain the existing \$2,233 per month repayments on their consolidated loan – not just for the five years the personal loan would have lasted, but for the entire term of the consolidated loan. This will enable them to pay off the consolidated loan earlier and save \$13,170 in interest.

	Separate loans*	Consolidated loan*
Outstanding loan(s)	\$230,000	\$230,000
Monthly repayments	\$2,233	\$2,233
Remaining term	14.3 years	13.8 years
Total interest payments	\$153,064	\$139,894
Interest saving		\$13,170

* It is assumed in both options that repayments of \$2,233 per month are made for the life of the home loan. With the separate loans, once the personal loan is repaid these payments are re-directed to the home loan.

With this strategy, it's important the monthly cashflow savings are used to pay off capital. It can be tempting to keep the savings for private expenditure, but this will negate the advantages created by the strategy. For example, if Steve and Karen were to consolidate their debts but only make the minimum monthly repayments of \$1,853, they would take 20 years to repay the loan, and their total interest payments would be \$214,689 over the term of the loan.

Tips and traps

- Before implementing a consolidation strategy you should consider the potential cost of re-financing your loans (eg application fees, stamp duty and early termination fees).
- If you have surplus cash you should consider using it to reduce personal loans or credit card debt to avoid the need to consolidate your debts. If you are concerned about having access to emergency cash, you could consolidate your loans and place surplus cash into the loan (with a redraw facility) or a 100% offset account (see Strategy 2).
- Consider taking out income protection insurance to help meet your repayments if you are unable to work due to illness or injury.
- Life insurance ensures your dependants are not burdened with an outstanding loan in the event of your death, or forced to sell the secured asset (eg the family home) to repay the loan.

Use your emergency cash reserve more effectively

Holding a cash reserve for emergency purposes is always wise. You might need the money for an unplanned trip, urgent repairs to your home or an unexpected illness requiring hospitalisation.

Many people keep emergency cash in a cash account because it gives them immediate access to their money. But interest paid by a cash account is fully taxable at your marginal tax rate. Also, the rate of interest is usually much lower than the interest you pay on your home loan.

A much better vehicle for your emergency cash reserve is your home loan (either through a redraw facility or a 100% offset account, see Glossary on page 33).

How does the strategy work?

By depositing your emergency cash into your redraw home loan, or 100% offset account, you effectively reduce the principal owing on the loan, and the interest payable. Your emergency cash will therefore 'earn' the rate of interest charged by your home loan, which is much higher than the rate paid by a cash account.

If you then continue your repayments at the same level, you'll pay even more of the principal, and reduce the term of your loan. Importantly, unlike the interest on a cash account, these savings are not taxable. With a redraw facility or a 100% offset account you also have access to your emergency money, generally within 24 hours.

	Higher interest rate	Tax effective	Repay home loan sooner	Fast access to emergency funds
Cash account	x	x	x	✓
Home loan/100% offset account	✓	✓	✓	✓

Strategy #

02

The benefits

- Achieve a higher after-tax return by placing emergency cash into your home loan or a 100% offset account.
- Reduce the term of your loan and save interest while retaining easy access to emergency cash.

Case study

Steve and Karen (from Strategy 1) have an outstanding home loan of \$230,000. The current interest rate on their loan is 7.5% pa. They also have \$10,000 emergency cash sitting in a bank account, which is held in joint names and currently earns interest of 2% pa.

Given they both pay tax at a marginal rate of 31.5%*, the after-tax return from the bank account is 1.37% pa. This is considerably lower than the net return of 7.5% pa on their home loan.

To achieve a better return on their emergency cash, save interest and pay off their home loan sooner, they decide to transfer their emergency cash into the 100% offset account attached to their home loan. This immediately reduces the size of the home loan for interest calculation purposes to \$220,000.

Even though they are saving interest, Steve and Karen decide to maintain their monthly repayments of \$2,233. This reduces the principal further, and the term of their loan.

By implementing this strategy Steve and Karen reduce the term of their home loan by almost a year and save themselves over \$17,103 in interest payments, as shown in the table below.

* Includes the Medicare levy of 1.5% and assumes that Steve earns \$60,000 pa and Karen earns \$40,000 pa

	Before strategy	After strategy
Loan term	13.8 years	12.8 years
Total interest payments	\$139,894	\$122,791
Interest saving		\$17,103

This strategy also allows them to access their emergency cash at any time.

Tips and traps

- It may be better to deposit cash in a 100% offset account because of fees and restrictions that may apply to a redraw facility.
- If you don't have a 100% offset account, find out whether this can be added to your existing home loan. An offset account generally provides the flexibility of a bank transaction account (ie ATM access, BPay, the ability to transfer money to pay credit cards etc). Some providers also allow you to establish multiple offset accounts to help you better manage your cashflow.
- While there is no difference from an interest perspective in paying money directly into the home loan or a 100% offset account (both reduce the effective size of the loan), there can be an advantage in doing either, depending on the purpose of the loan. With an investment loan for example, there is a distinct advantage in paying surplus money into a 100% offset account (see Strategy 8).
- Be careful when selecting a fixed home loan interest rate over a variable rate, as a 100% offset account generally only applies to the variable interest rate portion of the loan.

Harness your cashflow to reduce inefficient debt

By using your cash flow effectively, it's possible to pay off your home loan sooner and save interest.

How does the strategy work?

The interest on many home loans is calculated on the outstanding daily loan balance, even though it may be charged against the loan account less frequently. You can reduce the average daily loan balance and save a considerable amount of interest by doing any of the following:

1. Increase the repayment frequency (eg from monthly to fortnightly)

This can reduce your average daily loan balance even though the level of repayments are the same each year (ie the total of 26 fortnightly payments equals the total of 12 monthly payments).

Note: These benefits are only available if you are currently receiving salary payments more frequently than you are making loan repayments.

2. Increase your regular repayments

This involves using your surplus cashflow to pay off the home loan sooner.

3. Salary crediting

This entails arranging to have your salary automatically credited to the loan or a 100% offset account.

The benefits of this strategy include:

- Your salary hits your loan account sooner, having the same effect as increasing the frequency of repayments.
- Your salary is immediately used to reduce the size of the loan, having the same impact as increasing your regular repayments.
- You may achieve a higher after-tax return on your money compared to directing your salary into a cash account (see Strategy 2).
- You can access your money (either from a 100% offset account or using the loan's redraw facility) to meet living expenses during the month.

4. Use a credit card to pay the majority of your living expenses

Provided the credit card is repaid within the interest free period, this strategy enables you to use the credit card provider's money to fund your living expenses, while applying your own funds to reduce your average daily loan balance.

Strategy #

03

The benefits

- Reduce the term of your home loan and save substantial interest.
- Create equity in the family home that can be used to build wealth tax-effectively via gearing (see Strategy 4).

Case study

Steve and Karen (from the previous case studies), have a home loan debt of \$220,000 (having transferred their \$10,000 emergency cash into a linked 100% offset account). They currently make regular monthly repayments of \$2,233.

Steve receives a fortnightly salary of \$1,788 after tax, and Karen receives \$1,275 after tax. Their living expenses (excluding loan repayments) are \$3,500 a month.

They recognise that using cashflow more effectively they can pay off their home loan sooner and save a considerable amount of interest. They are considering the following options:

- Increasing the frequency of their loan repayments from monthly to fortnightly (ie paying \$1,031 per fortnight instead of \$2,233 per month).
- Reducing their living expenses to increase the repayments by \$20 to \$1,051 per fortnight.
- Crediting their salary into a 100% offset account and withdrawing money as required to meet their living expenses.
- Using a credit card to pay the majority of their living expenses (75%) and then transferring money from the offset account to the credit card within the interest free period.

The incremental advantage of adopting each of these strategies is shown in the table below.

	Loan term	Total interest payments
Before strategy	12.8 years	\$122,791
Changing payment frequency	12.8 years	\$122,213
Increasing regular repayments	12.4 years	\$117,884
Salary crediting	7.8 years	\$71,523
Credit cards	7.7 years	\$68,822

As you can see, by adopting these strategies, Steve and Karen can reduce the term of their home loan to less than eight years and pay only \$68,822 interest over the life of the loan. This is a considerable improvement from their starting position in Strategy 1 of paying off their home loan over 14.3 years and paying \$153,064 in interest!

Most importantly, by paying off their non-deductible home loan debt as quickly as possible, they'll build a considerable amount of equity in the family home each year. Assuming they then wish to create wealth by acquiring investments, they could use this equity as security for a tax-effective investment loan (see Strategy 4).

Tips and traps

- To accelerate the repayment of inefficient debt, it is essential that income is maximised, expenditure is contained, and that you claim all the tax deductions and offsets to which you are entitled.
- Many home loan simulations show a dramatic reduction in the loan term as a result of changing the payment frequency from monthly to fortnightly. These simulations often divide the monthly repayment by two (eg \$500 per month to \$250 per fortnight). This results in annual repayments of \$6,500 pa compared to \$6,000 pa with monthly payments.
- If you are considering a salary crediting arrangement, check your payroll provider can pay your salary either directly into your home loan or 100% offset account.
- Your lender may not allow you to make additional repayments into the fixed rate component of the loan (if applicable), or to reduce the outstanding balance of your home loan with a 100% offset account (see Strategy 2).
- It is possible to arrange with some providers to automatically transfer money from your offset account to repay your credit card (in full) within the interest-free period.
- You may be better off establishing an interest-only home loan, investing surplus cash in super and then using your super to pay off your home loan (see your financial adviser for more information).

Use borrowed money to build wealth

Once you have inefficient debt under control, you should consider borrowing money for investment purposes. This wealth creation strategy, known as gearing, can multiply your profits since:

- You have more money invested than if you hadn't borrowed.
- You may benefit from a number of tax concessions (see FAQs on page 31).

The downside is gearing can multiply your losses if your investments fall in value.

For gearing to be successful in the long-term, the investments you acquire with borrowed money must generate a total return (income and growth) that exceeds the after-tax costs of financing the investment (including interest on the loan).

It is therefore generally recommended the borrowed money is invested in quality share or property investments (either directly or via managed funds).

Shares and property have the potential to grow in value over the longer term and they typically produce assessable income (which means you should be able to claim the interest on the investment loan as a tax deduction).

How does the strategy work?

There are a variety of ways you can borrow money to invest:

- 1. You can borrow against the equity in your home.** This approach offers the benefit of a low interest rate and there are no restrictions on which investments you can buy.
- 2. You can take out a margin loan with a lending institution.** With a margin loan, the investments you purchase are used as security for the loan. The lending institution will typically lend you up to 75% of the value of approved assets.

For example, if you have \$25,000 and you want to invest in an approved asset with the help of a margin loan, you may be able to borrow up to \$75,000, making a total investment of \$100,000. It's also possible to gear on a regular basis by implementing what is known as instalment gearing (see Strategy 5).
- 3. You could invest in an internally geared share fund.** These are funds that borrow to leverage an investment in Australian or global shares (see Strategy 10).

To work out whether gearing suits you, we recommend you seek financial advice.

Strategy

04

The benefits

- Increase the amount of money you have to invest and potentially boost your returns.
- Reduce tax on your other income through negative gearing (see FAQs on page 31).

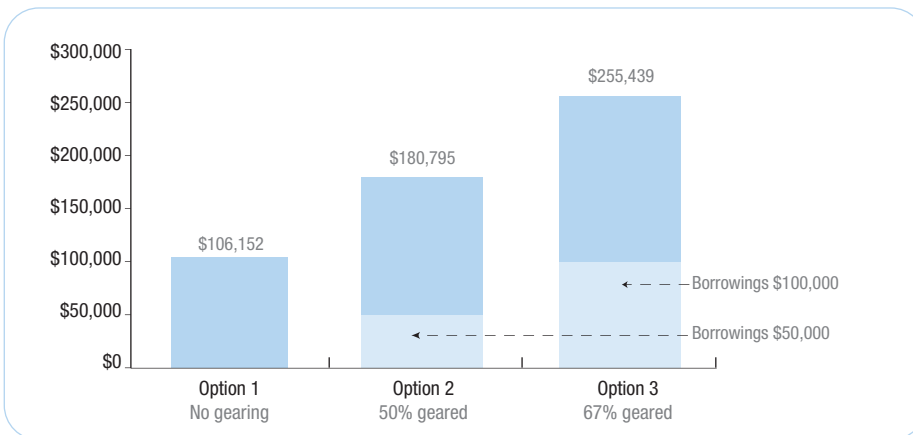
Case study

Jenny has \$50,000 invested in an Australian share fund and would like to use gearing. She considers the following three options provided by her financial adviser:

1. Maintain her investment at its current level of \$50,000
2. Double her investment by borrowing \$50,000 (ie 50% gearing)
3. Increase her investment even more by borrowing \$100,000 (ie 67% gearing)

In options 2 and 3, Jenny will use an interest-only home equity loan with an interest rate of 7.5% pa. The following graph illustrates the potential outcome of the three options after ten years.

Value of investment after ten years



Assumptions: Investment return is 8.5% pa (split 3% income and 5.5% growth). The franking level on income is 75%. Interest on the loan is 7.5% pa. Jenny's marginal tax rate is 41.5% including Medicare levy. These rates are assumed to remain constant over the investment period. With options 2 and 3, where investment income and tax benefits are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax savings are reinvested.

Clearly, the higher the gearing ratio, the greater the potential gains. It must be remembered, however, that Jenny still has an outstanding loan in options 2 and 3 of \$50,000 and \$100,000 respectively. If she withdrew a portion of her investment after ten years to repay the outstanding debt and pay Capital Gains Tax (CGT) on the amount withdrawn, the value of her investment is shown in the table below.

Value of investment after repayment of loan

No gearing	50% geared	67% geared
\$106,152	\$126,089*	\$146,027*

* After CGT on the amount withdrawn.

As you can see, Jenny's financial position could improve by using a gearing strategy if the value of her investments rise sufficiently.

Caution: 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 32). For example, if your investments fall in value, your financial situation could be significantly worse than if you don't use a gearing strategy.

Tips and traps

- Gearing should be seen primarily as a wealth creation strategy rather than a way to save tax. If you invest in assets that fail to produce enough income or capital growth over the longer term, your losses could outweigh any reduction in your tax bill.
- If you take out a margin loan, you may need to meet a margin call if your investments fall in value (see FAQs on page 32). To reduce the likelihood of a margin call, you should maintain a conservative loan-to-valuation ratio. You should also hold significant cash (or other liquid assets) to meet margin calls if required.
- Where a couple is involved, you may want to invest the existing funds in the name of the lower income earner and the borrowed funds in the name of the higher income earner (see Strategy 9).
- You can manage interest rate risk by taking out a fixed rate investment loan. These loans can also allow you to pre-pay interest up to 12 months in advance so you can bring forward your tax deductions. However, if you take out a fixed rate loan, you may incur penalties if you repay the loan prior to the end of the fixed rate period.
- Take out income protection insurance to cover the risk of you being temporarily disabled and unable to earn an income.
- Consider additional life insurance if the lending institution requires the entire loan to be paid back in the event of your death.

Gear your investments gradually by borrowing in instalments

Strategy 4 highlights the potential benefits of borrowing a lump sum to invest. However, not everyone has an asset (such as equity in a home) to borrow against and even if they do, they may prefer to gradually build the level of their geared investments rather than invest a large amount of borrowed money in one transaction.

You can achieve this by using a strategy called instalment gearing. This is done by periodically drawing on an investment loan to build your investment portfolio.

With instalment gearing you can make adjustments to your gearing and investment arrangements if needed. For example, you may be able to increase or reduce your regular loan drawdown or make changes to your investment strategy along the way.

How does the strategy work?

The first step is to apply for an investment loan that allows you to borrow regular amounts up to a borrowing limit. The limit will depend on the type of loan and the assets used as loan security.

You then arrange to drawdown on the loan in regular instalments to invest (usually into shares or managed funds).

You can further boost your regular investments by adding your own money to each instalment of borrowed money, helping build your wealth sooner in a disciplined and controlled manner.

Establishing a margin loan is usually the most efficient way to implement an instalment gearing strategy.

This is because a margin loan generally enables you to make regular contributions directly into an investment, using a combination of your own funds drawn from a bank account (or similar) and money lent to you by the margin lending provider.

Another way to use instalment gearing is to draw money regularly from a line of credit secured by your home. With this approach, the drawdowns from your bank account and purchasing of investments will need to be arranged separately.

Strategy

05

The benefits

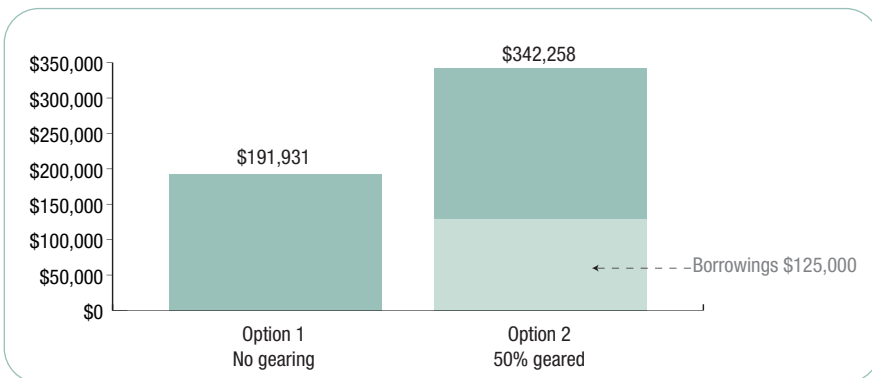
- Build wealth in a disciplined and controlled manner.
- Take the guesswork and emotion out of picking the right time to buy through investing regularly.
- Have the flexibility to adjust your gearing level if necessary.

Case study

Jack wants to implement a regular savings plan. He wants to invest in an Australian share fund and is considering the following options:

1. Investing \$1,000 per month from his surplus cashflow in addition to an initial lump sum of \$5,000 – investing a total of \$125,000 over ten years.
2. Using an instalment gearing strategy, initially investing \$10,000 (ie \$5,000 of his money, plus \$5,000 of borrowed money), followed by monthly investments of \$2,000 (ie \$1,000 per month of his money, together with \$1,000 per month of borrowed money using a margin loan). Over ten years, the total amount invested will be \$250,000 (ie \$125,000 of his money, plus \$125,000 of borrowed money). The investment will therefore be 50% geared.

The following graph compares the value of Jack's portfolio for the two options after ten years.



Assumptions: Investment return is 8.5% pa (split 3% income and 5.5% growth). The franking level on income is 75%. Interest on the margin loan is 8% pa. Jack's marginal tax rate is 41.5% including Medicare levy. These rates are assumed to remain constant over the investment period. With option two, where investment income and tax benefits are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax savings are reinvested.

If Jack decides to pay back the \$125,000 loan in option 2 at the end of ten years by selling units in the Australian share fund (and paying Capital Gains Tax on the amount withdrawn), the value of his investment is shown in the table below.

Value of investment after repayment of loan

Option 1 – no gearing	Option 2 – 50% geared
\$191,931	\$206,805*

* After CGT on the amount withdrawn.

When compared to the 'No gearing' scenario, instalment gearing has clearly made a significant difference to Jack's financial position.

Caution: 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 32). For example, if your investments fall in value, your financial situation could be significantly worse than if you don't use a gearing strategy.

Tips and traps

- Instalment gearing enables you to 'average' the price you pay for your investments and takes the guesswork and emotion out of picking the right time to invest.
- When using a margin loan for instalment gearing, your investments are restricted to managed funds approved by the lender.
- You may be required to meet a margin call if the value of the managed funds falls below a certain level. For more information on margin calls see FAQs on page 32.
- Margin lending facilities can have minimum and maximum loan limits applying to the initial application or ongoing drawdown.
- Another way of gearing in instalments is to regularly invest your savings into an internally geared share fund (see Strategy 10).

Transform your debt using a financial windfall

While paying off your home loan, it's possible you will receive a financial windfall eg a work performance bonus, an ex gratia payment on changing employers, or an inheritance.

Should you use this money to pay off some of your home loan, or should you invest it to help build your wealth?

The answer may be to do both by using a strategy known as debt transformation. This is the process of using a financial windfall to reduce inefficient debt and replace it with efficient debt.

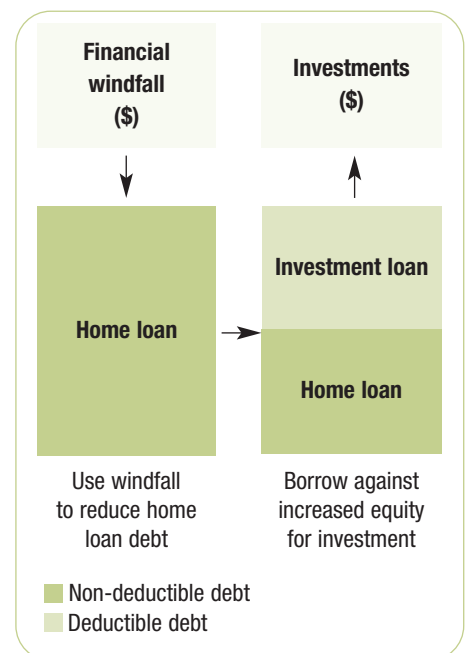
How does the strategy work?

When you receive a cash lump sum, you need to pay it into your home loan account to reduce the outstanding balance. This provides you with additional equity you can redraw (via an investment loan) to purchase an investment.

The benefit is that, although your overall debt level remains constant, the interest on the investment loan should be tax-deductible – provided the investment produces assessable income.

This means you may be able to reduce the amount of tax you pay each year, and have an investment portfolio to build wealth.

Also, the income and tax savings from your geared investment can be used to reduce your home loan debt more quickly.



Strategy

06

The benefits

- Create wealth in a tax-effective way sooner, by using a financial windfall to replace non-deductible (inefficient) debt with deductible (efficient) debt.
- Use the income and tax benefits from your geared investment to further reduce your inefficient debt.

Case study

Daniel has a home loan of \$200,000 (with a current interest rate of 7.5% pa) and he pays tax at a marginal rate of 41.5%*. He has just received an inheritance of \$100,000 and he would like to use this money to acquire an investment portfolio.

If he uses the inheritance to purchase the investments directly (see option 1 in the table below), his home loan will remain at \$200,000, the interest payments will be non-deductible and the after-tax interest cost will be approximately \$15,000 pa.

After speaking to his adviser, Daniel decides to use the \$100,000 inheritance to pay down the home loan and borrow against the increased equity in his home to purchase the investment portfolio (see option 2).

By using this approach, he will have a home and an investment loan with \$100,000 in each and the after-tax interest cost of the home loan will be \$7,500. However, as the investment loan interest (also \$7,500) is tax deductible#, the after-tax cost of this loan will only be \$4,388 pa.

After using this strategy, while he still acquires an investment portfolio worth \$100,000 and has a total debt of \$200,000, the total after-tax interest cost will be reduced from \$15,000 pa to \$11,888 pa.

* Includes Medicare levy of 1.5%.

Assumes that the investments purchased with the borrowed money produce assessable income.

	Option 1 Without debt transformation	Option 2 With debt transformation	
Loan type	Home loan only	Home loan	Investment loan
Loan amount	\$200,000	\$100,000	\$100,000
Interest payable @ 7.5% pa	\$15,000	\$7,500	\$7,500
Less tax saving at 41.5%	N/A	N/A	(\$3,112)
After-tax interest cost	\$15,000	\$7,500	\$4,388
Total after-tax interest cost	\$15,000	\$11,888	

After implementing this strategy, the investment income and tax savings could be used to pay-off his home loan sooner. Once the home loan has been repaid, Daniel could then use the investment income and tax savings to purchase more investments and build even more wealth in the future.

Caution: 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 32). For example, if your investments fall in value, your financial situation could be significantly worse than if you don't use a gearing strategy.

Tips and Traps

- An alternative to debt transformation is to use a financial windfall to pay down the home loan and not invest at all. While this has the advantage of reducing non-deductible debt (thereby saving you interest), it may not be as effective in accelerating the creation of wealth.
- The concept of debt transformation can also be applied to existing investments you want to sell. If you sell an investment, you could use the proceeds to pay down your home loan, and borrow an equivalent amount to invest in other investments. This strategy will reduce your non-deductible debt, and replace it with deductible debt.

Caution: If you sell an asset, recycle the proceeds through your home loan and then borrow to buy the same asset back, the Australian Tax Office may consider this a scheme to obtain a tax benefit and seek to apply penalties and to deny the interest deduction.

- To avoid problems in determining which portion of an interest cost is deductible, keep your investment loan (which is tax deductible) separate from your non-deductible home loan. You should take out a separate loan, unless your existing loan allows for separate sub-accounts within the loan.

Build wealth via debt recycling

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).

Many people tend to wait until their home loan is paid off before thinking about investing. Unfortunately, this means they tend to 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, as discussed in Strategy 6.

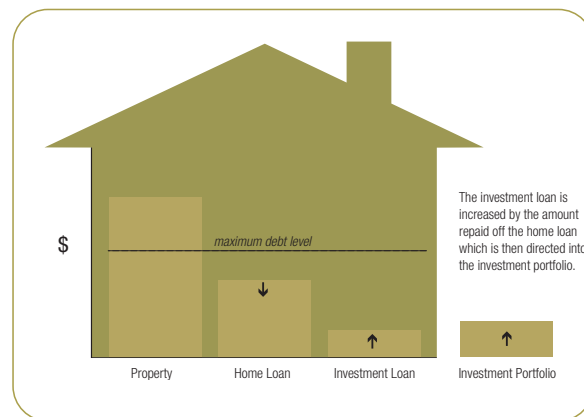
Another way to reduce inefficient debt as quickly as possible, and build long-term wealth tax-effectively, is to use a strategy known as debt recycling.

How does the strategy work?

This strategy has three steps:

1. Use the equity in your home to borrow for investment.
2. Use the investment income and tax savings arising from the geared investment, as well as your surplus cashflow (see Strategy 3), to reduce your outstanding home loan balance.
3. At the end of each year, borrow an amount equivalent to what you paid off your home loan during the year and use this to purchase additional investments.

This process is continued until your home loan is repaid. After that, your surplus income (including investment income and tax savings) can be used to acquire additional investments or pay down your investment loan.



Strategy

07

The benefits

- Create an investment portfolio sooner by replacing inefficient debt with efficient debt.
- Use the investment income and tax benefits from your geared portfolio to reduce your inefficient debt faster.
- Accelerate the creation of wealth and attain your lifestyle goals sooner.

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 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 (\$450,000) 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.

Throughout the first year, they use all of their surplus cashflow, around \$10,000 (less the interest on the investment loan), and the investment income and tax savings, to pay down the home loan by \$24,047 to \$195,953. They then replace the amount paid down by borrowing an equivalent amount as an investment loan (\$24,047) 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 8.8 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 \$410,352. With the home loan paid off, they can direct all surplus cashflow, investment income and tax savings into the share fund.

To illustrate the benefits of this strategy, compare it (over 20 years) 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	8.8 years	7.7 years
Value of investment portfolio	\$1,248,658	\$730,345
Outstanding debt	(\$300,000)	Nil
Net position after 20 years (after selling all investments, paying capital gains tax, and repaying the loan)	\$948,658	\$730,345

Assumptions: The return on the Australian share fund is 8.5% pa (split 3% income and 5.5% growth). The franking level on income is 75%. The interest rate applying to the home loan and investment loan is 7.5% 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 eight years, the value of Steve and Karen's portfolio in year 20 would be only \$730,345. By using debt recycling, however, Steve and Karen have an investment portfolio worth an extra \$218,313 after all taxes and repaying all loans (despite taking slightly longer to repay their home loan).

Caution: 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 32). For example, if your investments fall in value, your financial situation could be significantly worse than if you don't use a gearing strategy.

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 used just 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.
- As an alternative to debt recycling, you may want to establish an interest only home loan, invest your surplus cashflow in superannuation and use your super to repay your home loan in retirement (see your financial adviser for more information).

Offset your investment loan to retain tax efficiency

In Strategy 2 we explained an effective way to use your emergency cash if you have a home loan. But what should you do if your home loan has been repaid and you only have an investment loan?

By holding your emergency cash (and your surplus cashflow) in your investment loan or 100% offset account linked to your investment loan, you can save interest and earn a higher after-tax return.

However, if you want to access your repayments for non-investment purposes, paying into a 100% offset account is likely to be a more tax-effective alternative.

How does the strategy work?

Because an offset account is separate from your investment loan account, you can make repayments (and access them if required), without affecting the size of the investment loan or the tax deductibility of the interest.

If you pay money into the loan itself, you'll reduce the size of the loan. Also, if you redraw the money for non-investment purposes (eg to buy a car or renovate your home), you can't claim a tax deduction for the interest on the amount redrawn. So only part of the interest on the loan will be tax deductible.

Paying into the offset account can therefore save you a considerable amount of money.

	Investment loan	100% offset account
Can you access your emergency cash for any purpose?	Yes	Yes
Do withdrawals for non-investment purposes reduce the tax deductibility of the loan?	Yes	No

Strategy

08

The benefits

- Save interest by making additional repayments into an investment loan offset account.
- Withdraw money for any purpose without affecting the tax-deductibility of the loan.

Case study

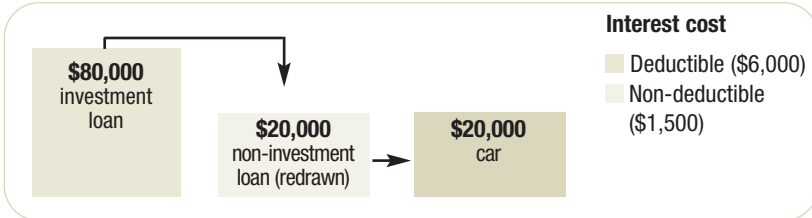
After paying off her home loan, Laura (aged 45) used some of the equity in her home to set up an interest only investment loan for \$100,000, and invested in a share fund. The interest rate on the investment loan is 7.5% pa.

She recently received an after-tax bonus of \$20,000 from her employer and plans to use the money to buy a car in 12 months. In the meantime, she wants to reduce the interest payments on her investment loan and is considering the following options:

1. Paying the bonus directly into the investment loan
2. Paying the bonus into a 100% offset account linked to the investment loan.

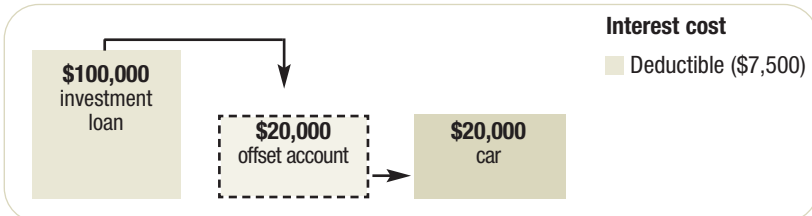
If she chooses option 1, the balance of her investment loan will drop to \$80,000. However, when she redraws the \$20,000 to buy her car, she won't be able to claim the interest on this part of the loan as a tax deduction. As a result, she'll end up with a mixture of deductible and non-deductible debts.

Option 1: after withdrawal of \$20,000 from the investment loan



With option 2, the balance of her investment loan will stay at \$100,000, but she'll save the same amount of interest as option 1, as interest is only payable on the difference between her loan account and offset account (ie on \$80,000). Also, when she withdraws the \$20,000 from her offset account to buy her car, the size of the investment loan will not be affected and the interest payments will continue to be fully tax-deductible.

Option 2: after withdrawal of \$20,000 from the offset account



Tips and traps

- To take advantage of this strategy your investment loan must have a 100% offset account. If your current loan does not have this facility, check with your lender to see if it can be added. In many cases the lender will only allow an offset account for the portion of the loan subject to a variable interest rate.
- Line of credit facilities don't generally offer a 100% offset account. Even if a personal sub-account is in credit, the lender may not offset this against the outstanding investment loan sub-account.
- If you need to borrow money for a non-investment purpose and don't have an offset account, then it's usually better to borrow using a separate loan rather than redraw from your investment loan. This way it's easier to keep track of what interest costs are deductible and non-deductible when completing your tax return.
- Once you have paid off your home loan, it can be a good idea not to cancel the mortgage. This may allow you to use the equity in your home to borrow for investment or non-investment purposes (up to your original pre-approved borrowing limit), without additional State Government mortgage duty or Land Titles Office registration fees.

Make gearing more tax-effective for a couple

When implementing a gearing strategy it's common to invest a combination of borrowed funds and your own capital. If you have a partner, you should consider splitting the geared and ungeared investments into two separately owned pools of money. As a couple, this could enable you to use a range of strategies to help manage your investments tax-effectively.

How does the strategy work?

As a general rule, the ungeared investments (ie your own capital contribution) should be placed in the name of the lower income earner to minimise tax on the investment income. It's also a good idea to invest the geared investments (ie the investments that are purchased with borrowed money) in the higher income earner's name so they can take greater advantage of the gearing related tax deductions (eg investment loan interest).

By splitting ownership, you can save on income tax over the life of the investment, as well as have flexibility to decide who should sell some of their investment when paying off the loan. In practical terms, this should generally be the person with the lowest marginal tax rate.

The amount of income generated by the investments can also make a significant difference to the outcome. For example, it can be more tax-effective for the higher income earner to invest borrowed money in lower yielding assets (ie those that generate a lower income). Conversely, there can be an advantage in investing the money in the lower income earner's name in higher yielding assets.

Strategy #

09

The benefits

- Minimise income tax over the life of the investments.
- Save on capital gains tax (CGT) when redeeming the investments.

Case study

Rob pays tax at a marginal rate of 41.5%*, while his wife Angela has a marginal tax rate of 16.5%*. They have \$40,000 in cash and want to borrow another \$60,000 to invest a total of \$100,000 in an Australian share fund. They plan to retain the investments for a ten-year period and are considering four different strategies.

1. Investing all the money (\$100,000) in a share fund in Rob's name, with Rob selling some of his investment at the end of the ten years to repay the loan and CGT on the amount withdrawn.
2. Splitting ownership so the existing capital (\$40,000) is invested in Angela's name and the borrowed money (\$60,000) is invested in Rob's name. Rob will also sell some of his investment to pay off the loan and any associated CGT.
3. Splitting ownership (as per option 2 above), but with Angela selling some of her investment to repay the loan and CGT.
4. Splitting ownership (as per option 3 above), but with Rob (only) investing in a share fund that pays a lower yield.

The results from each of these strategies are shown in the table below. As you can see, it is possible to add thousands of dollars to the bottom line by making the right ownership decisions when gearing as a couple.

* Includes Medicare levy of 1.5%.

Option	Result
1. All investments in Rob's name	\$108,847
2. Split ownership (Rob repays the loan)	\$116,983
3. Split ownership (Angela repays the loan)	\$120,506
4. As above, but Rob invests in a lower yielding fund	\$123,969

Assumptions: In option 4, Rob (only) invests in a share fund with a total return of 8.5% (split 1.5% income and 7% growth). In all other scenarios, Angela and/or Rob invest in a share fund that produces a total return of 8.5% pa (split 3% income and 5.5% capital growth). The income is franked at 75%. The loan interest rate is 7.5% pa. These rates are assumed to remain constant over the investment period. Where the investment income and tax benefits are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax savings are reinvested.

Tips and traps

- When using this strategy, a lower income earner could invest the existing funds in their name and offer these investments as third party security for a margin loan in the name of the higher income earner. With this approach, the owner of the existing funds may be required to act as guarantor or third-party mortgage provider to the loan facility.
- You may be able to avoid the need for a guarantor by using a home equity loan. In this scenario it is possible for one member of a couple to invest joint borrowings secured against their home in their own name (exclusively) and still claim a full interest tax deduction.
- Rather than selling the geared or ungeared assets to pay off the investment loan, you may be able to redeem non-CGT assets (eg cash) or pre-CGT assets. Alternatively, you may be able to manage CGT if you sell investments in a low-income year, sell investments progressively, crystallise losses or (if eligible) contribute the sale proceeds into super and claim a tax deduction to offset the taxable capital gains.
- When gearing in the name of a higher income earner, consider re-investing the income from this investment into the name of a lower income earning partner. This can reduce the future tax payable on the reinvested amount.
- You should also consider factors such as the protection of assets (eg in the event of bankruptcy or litigation) when making ownership decisions.

Leverage your investment via an internally geared share fund

Rather than you taking out an investment loan, there is a potentially simpler way to implement a gearing strategy. It involves investing in an internally geared share fund. This is a managed investment where the manager borrows on behalf of investors.

The fund typically borrows at wholesale interest rates, which can be significantly lower than the interest rate you'd pay if you arrange an investment loan yourself (eg via a margin loan or home equity facility).

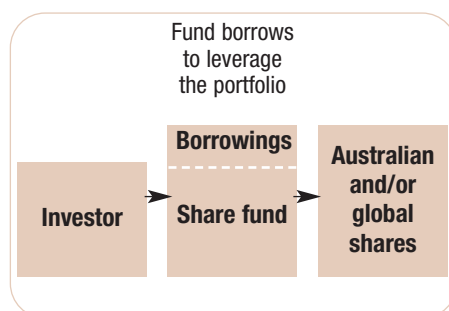
Internally geared share funds are available outside super (through a unit trust, for example). However it's also possible to access these types of investments through certain super funds. This is a significant benefit, as super funds are not permitted to borrow money directly.

How does the strategy work?

When you invest in an internally geared share fund, the manager pools your money with other investors into a professionally managed share portfolio. Before the money is invested, the fund borrows so it can make a larger investment.

If the value of the investments fall to a level below the fund borrowings, investors are not required to pay back the shortfall.

The fund is usually structured to be positively geared (ie the fund income exceeds the loan interest, as well as any fees). Where the fund income exceeds the loan interest and fees, the net income is distributed to investors.



Strategy

10

The benefits

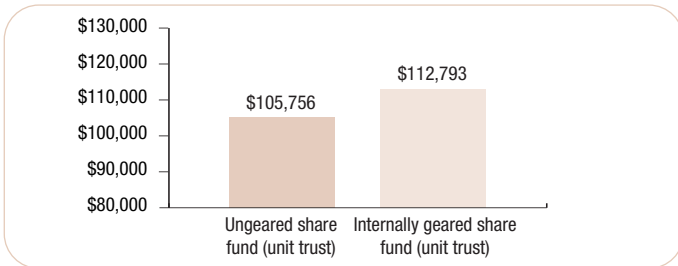
- Reduce paperwork by not having to arrange your own investment loan.
- Reduce borrowing costs by taking advantage of wholesale interest rates.
- Access the power of gearing via super.

Case study

Tony (aged 40) has \$50,000 to invest in Australian and global shares. After reviewing his financial objectives with his adviser, he decides to invest in an internally geared share fund via a unit trust. The internally geared share fund is able to borrow at a wholesale interest rate of 6.5% pa.

He invests his \$50,000, to which the fund adds another \$15,000 of borrowed money. His total investment is now \$65,000, with a gearing ratio of 23% (ie $\$15,000/\$65,000 \times 100$). He also had the option of investing in an ungeared share fund. If this trust has the same underlying investments, which generate the same return (see assumptions below), the following graph shows how this compares to the internally geared share fund after ten years.

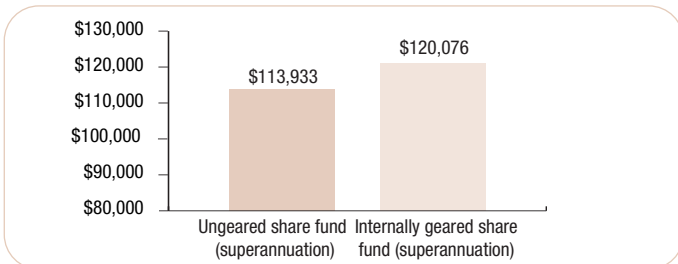
Value of investment after ten years (unit trust)



As you can see, Tony's financial position can improve significantly through investing in an internally geared share fund.

Tony also had the option to invest the \$50,000 in an internally geared option within super. If he chose to do this instead, the next graph compares the value of his benefit to an ungeared super investment.

Value of investment after ten years (superannuation*)



* Based on his date of birth, Tony can't generally access his super benefit until he has retired after age 60.

Assumptions: Investment return is 8.5% pa (split 2.5% income and 6% growth). The franking level on Australian income is 75%. Interest on the loan is 6.5% pa. Tony's marginal tax rate is 41.5% including Medicare levy. These rates are assumed to remain constant over the investment period. With the internally geared investments, where investment income and tax benefits are insufficient to meet interest payments and other expenses, units may be issued to the lender or manager to cover the shortfall. Net income remaining is distributed to the investor (for unit trust investors) or credited to their account (for superannuation fund members).

Again, the geared investment has the potential to significantly improve his position.

Tips and traps

- Gearing can magnify the returns of an investment, however it can also magnify losses.
- Since the borrowing is done by the internally geared share fund, you can't choose the level of gearing.
- Most funds of this type generally remain positively geared (see FAQs on page 31) and therefore the tax advantages from negative gearing will not be available to you.
- You can use borrowed money to invest in an internally geared fund, but you need to exercise caution as this will significantly magnify investment risk.
- You can reduce volatility by investing in an internally geared share fund diversified across Australian and global shares.
- Some internally geared share funds allow you to invest modest amounts on a regular basis (known as a regular savings plan). This can take the guesswork out of trying to pick the right time to buy. It can also allow you to start investing earlier as you don't necessarily need a substantial amount to begin.

Investing with borrowed money

There are a number of ways to use efficient debt to help you build wealth tax-effectively. You can either borrow personally (eg via a home equity or margin loan) or invest in a geared vehicle such as an internally geared share fund.

Home equity loan

Description	<p>Allows you to use the equity in your home to borrow money to invest where you choose.</p> <p>Can range from a standard principal and interest loan through to a line of credit (interest only).</p>
Advantages	<ul style="list-style-type: none"> • You have control over the gearing levels. • No margin calls are required if there is an investment market downturn. • Low interest rate (small premium for line of credit). • Features can include a 100% offset account, redraw facility, salary crediting etc. • Option of either a fixed, variable or split interest rate loan. • No restrictions on investment choice. • Ability to make interest only payments (on a line of credit). • Ability to pre-pay interest for up to 12 months and bring forward your tax deduction (only for fixed rate options) if deriving assessable income. • Line of credit allows multiple loan accounts within a facility – this allows you to separately track deductible and non-deductible debt. • If you are negatively geared, you may be able to offset excess deductions against other income.
Disadvantages	<ul style="list-style-type: none"> • Need equity in a residential property. • Interest premium on a line of credit. • Where credit cards and cheque accounts are attached, you need discipline to prevent erosion of your equity.
Investors who may be suited to this structure	<ul style="list-style-type: none"> • Investors who have equity in their home and are comfortable borrowing against it. • Investors who have non-deductible debt – they can take advantage of the loan features for debt reduction and recycling. • Investors who wish to avoid margin calls.

The table below summarises the key advantages and disadvantages of each of these three popular forms of gearing. A financial planner can assist you in determining the most appropriate gearing option for your circumstances.

Margin loan

Allows you to borrow to invest in approved shares or managed funds, as a lump sum or in regular instalments. This is secured against the value of that investment.

- You have control over the gearing levels.
- Instalment gearing reduces risk through dollar cost averaging (investments are acquired at an average market price).
- Option of either a fixed, variable or split interest rate loan.
- Ability to make interest only payments.
- Ability to pre-pay interest for up to 12 months and bring forward your tax deduction (only for fixed rate options) if deriving assessable income.
- If you are negatively geared, you may be able to offset excess deductions against other income.
- You may be able to arrange for another person (or company) to provide third-party security for your margin loan.

- Higher interest rate than standard home equity loan.
- Potential for margin calls if there is an investment market downturn.
- Maximum gearing ratio limited to around 75% (investors need to make their own initial contribution).
- Investment options limited to investment menu of the lender (can include hundreds of direct shares or managed funds).

- Investors who do not own a home or do not have sufficient equity within their home.
- Investors who are uncomfortable with using their home as security.
- Instalment margin loans are suitable for investors with regular income but no lump sum to invest.

Internally geared share fund

A managed fund that contains internal gearing (ie the fund borrows money) to leverage the investment in Australian and/or global shares.

The fund is usually managed so that it remains positively geared (ie the fund income is sufficient to cover interest and fees).

- The fund is able to borrow at wholesale interest rates. This is generally lower than that available to individuals.
- No margin calls are required if there is an investment market downturn.
- The loan is limited recourse, which means your liability is limited to the value of your initial investment.
- Investing into the fund is much simpler and quicker than establishing a borrowing facility as an individual.
- Allows superannuation funds to leverage investments without breaching the borrowing restrictions that apply to them.

- Limited control over the gearing level.
- Limited number of providers and therefore investment options.
- Interest on the fund borrowings is generally offset against fund income. No tax deduction for interest is available to investors unless they borrow personally to invest in these funds.

- Members of super funds.
- Investors who do not own a home or do not have sufficient equity within their home.
- Investors looking for simplicity of a pre-packaged geared investment.
- Investors who want to limit potential losses.
- Investors who are uncomfortable with using their home as security.

FAQs

What are the current marginal tax rates?

The table below summarises the marginal tax rates in 2007/08:

Taxable income range	Tax payable (by residents)
\$0–\$6,000	Nil
\$6,001–\$30,000	15%* on amount over \$6,000
\$30,001–\$75,000	\$3,600 + 30%* on amount over \$30,000
\$75,001–\$150,000	\$17,100 + 40%* on amount over \$75,000
\$150,001 +	\$47,100 + 45%* on amount over \$150,000

* These rates do not include the Medicare levy (see below).

What is the Medicare levy?

The Medicare levy is a levy of 1.5% that is payable on your taxable income on top of normal marginal tax rates. An additional 1% is charged for couples with a combined income over \$100,000 (\$50,000 for singles) who have no private health insurance. If you earn less than \$16,741 pa (\$28,248 for couples) you are exempt from the levy.

How does dividend imputation work?

Imputation or franking credits (see Glossary on page 33) may be available on dividends from Australian shares. The following example illustrates the advantages of dividend imputation, assuming shareholders on different marginal tax rates receive a fully franked dividend of \$70.

Marginal tax rate	15%	45%	This, in very simple terms, is how dividend imputation works
Dividend	\$70	\$70	❶ A company pays a fully franked dividend*
Franking credit	\$30	\$30	❷ You add the franking credit† to your dividend
Assessable income	\$100	\$100	↔ to get your assessable income.
Gross tax	\$15	\$45	❸ Then you calculate the gross tax based on your tax rate
Less franking credit	(\$30)	(\$30)	and subtract the franking credit
Net tax payable	nil	\$15	↔ to get your net tax payable.
Excess franking credit	\$15	nil	If your franking credit is larger than your gross tax, the ATO will offset (ie refund) any excess (available for certain tax payers only).
Net income received	\$85	\$55	↔ Deduct your net tax from your dividend, or add your excess franking credit to your dividend, to get your after-tax income.

* This is the after-tax income distributed by the company.

† This is the tax already paid by the company at the company tax rate of 30%.

Note: Certain investors who are unable to use all their franking credits can claim a refund of these credits in their annual tax return.

What is capital gains tax (CGT)?

Broadly, CGT is a tax on the growth in the value of certain assets or investments acquired after 19 September 1985, and is generally only payable when a gain is realised. This usually occurs when an asset is sold or where there is a change in ownership. However, when you invest via a unit trust, you may also receive realised capital gains via the distribution(s) if the fund manager sells underlying investments for a profit.

A capital gain will arise where the proceeds received on disposal exceed the tax cost base of the asset. For assets disposed of on or after 11.45 am (ACT time) 21 September 1999, CGT is usually payable by individuals and trusts on 50% of the nominal gain (ie the difference between the sale price and the tax cost base) where the asset has been held for more than 12 months. As only half the gain is taxable, the effective tax rate for an individual on the highest marginal tax rate (including Medicare levy) of 46.5% is reduced to 23.25%.

For assets acquired before 21 September 1999, certain investors can choose between two methods when working out their CGT liability:

1. They can choose to be taxed on 100% of the real gain (ie the difference between the sale price and the frozen indexed cost base as at 30 September 1999).
2. They can choose to be taxed on 50% of the nominal gain.

If an asset is held for 12 months or less, neither the 50% discount nor indexation applies (ie the investor is taxed on the full nominal gain).

How are capital losses treated for tax purposes?

A capital loss occurs when the proceeds received on disposal of an asset are less than the reduced cost base. A capital loss can be offset against current year capital gains, but cannot be used to reduce other sources of assessable income (eg salary). Broadly if there is a net capital loss for the income year, the loss can be carried forward and offset against gains in future years.

What is gearing?

Gearing simply means borrowing money to invest. You can benefit from gearing if the growth in the value of the investment and the income you receive is greater than the after-tax cost (including interest on the loan).

How does negative gearing work?

Negative gearing arises when the interest payments (and other costs) on your investment loan in a particular year are more than the assessable income received from your geared investment. In this situation, the cash-flow shortfall can generally be claimed as a tax deduction to offset other sources of assessable income.

For example, if you invest \$100,000 of your own money plus \$100,000 of borrowed money (at an interest rate of 7.5% pa) into an asset that produces an annual income of 3%:

- Your interest bill for the year will be \$7,500.
- Your investment income will be \$6,000.
- The cash-flow shortfall of \$1,500 can be deducted from other assessable income (eg salary) in your annual tax return.

If you are on the top marginal tax rate of 46.5% (including Medicare levy), this strategy will save you \$697 in tax in that year.

Caution: Investors who negatively gear should ensure they can meet cash-flow shortfalls during the year.

What is positive gearing?

Positive gearing occurs when the assessable income from your investments is greater than the interest and other costs you pay on the borrowed money.

For example, if you invest \$100,000 of your own money plus \$50,000 of borrowed money (at 7.5% pa interest), your investment income will be \$4,500 (at 3% pa) and your interest bill will be \$3,750, leaving you with a cash-flow surplus of \$750 pa.

How can gearing help you save tax?

Gearing not only increases your potential to make money, it can also minimise your tax. The potential advantages of gearing include:

- Where the interest expense (plus costs) exceeds the assessable income in a particular year (ie the investment is negatively geared), the excess expense is generally tax-deductible and can be used to reduce the tax payable on your other income such as salary.
- If you invest the borrowed money in Australian shares directly or via unit trusts (eg through an Australian share unit trust), the income you receive may have franking credits attached (see page 30). These credits can be used to offset other tax payable, with any excess franking credits refunded to you, where you are an individual.
- You may claim a tax deduction for the interest expense in the current financial year, but defer capital gains tax until you dispose of the investment. The investment may also be sold in a low-income year (eg post retirement) to minimise capital gains tax, where you are an individual.
- Where the investment is held for more than 12 months, only 50% of the capital gain needs to be included in assessable income.
- You may be able to pre-pay interest costs on fixed rate loans up to 12 months in advance, giving you a greater potential tax deduction in the current financial year.

- Negative gearing will reduce your taxable income, which could assist in minimising the Medicare levy surcharge and your capital gains tax liability.

Note: You need to carefully consider in whose name the geared investment should be held. It may be better to hold the investment in the name of a higher marginal tax rate payer (to maximise the value of tax deductions in a negative gearing scenario). However, it could be equally advantageous to have the investment in the name of a low marginal tax rate payer (to reduce the amount of capital gains tax payable at the end of the investment period).

Is gearing right for you?

The following questions highlight some of the key requirements you should consider before embarking on a gearing strategy:

- Do you have a regular, secure income stream (eg a salary)?
- Do you intend to invest for at least five years?
- Can you tolerate short-term fluctuations in the value of your investment?
- Do you have sufficient surplus cashflow (eg to service all debts if the loan interest rate was to rise)?
- Do you have income protection insurance to protect your income in the event of injury or illness preventing you from working?
- For margin loans, do you have immediate access to sufficient funds to meet a margin call if the investment was to fall in value?

What are the risks of gearing?

In addition to the usual investment risks (eg market volatility), any gearing strategy carries additional risks. Depending on your circumstances and the type of gearing arrangement, these may include:

- A fall in investment income, particularly if you're relying on that income to fund your interest payments.
- A sustained fall in the investment value leading to potential capital losses or a margin call (on a margin loan).
- A rise in interest rates, which may affect your ability to pay interest or repay the loan.
- Loss of your regular income due to illness, injury or unemployment, resulting in you not being able to service the loan.

How can you manage these risks?

You can reduce the risk of gearing by:

- Maintaining a conservative loan to valuation ratio. This allows you to access the benefits of gearing without overexposing yourself to the risks. This will also reduce the likelihood of a margin call on a margin loan.

- Using instalment gearing. This allows you to acquire investments at an average price and avoid any need to time the investment acquisition. As investment values fall you acquire more assets for a given investment and as they rise so does the value of your existing holdings. Instalment gearing also allows you to defer or stop loan drawdowns if your circumstances change (see Strategy 5).
- Diversifying across a range of investments to minimise investment fluctuations. This can be achieved easily with managed funds, which can offer diversification across asset classes, countries or regions and fund manager styles.
- Having ready access to cash to meet margin calls on a margin loan. This means you are not forced to sell some of the investment if prices fall substantially.
- Ensuring the investments are liquid (ie they can easily be sold) so you can exit the investment if you need to.
- Taking out a fixed rate investment loan to manage interest rate risk.
- Taking out life insurance if the lender requires the loan to be repaid on death. The investments can then be transferred to your beneficiaries upon death.
- Taking out income protection insurance to cover the risk of being unable to work due to illness or injury.
- Limiting losses to the value of your investment by investing in an internally geared share fund.

What is a margin call?

A margin call is a demand from a margin lender that you make an immediate loan repayment or deposit additional money to cover a fall in the value of your investment. This occurs when the ratio of your loan (ie borrowed money) to security (ie your total investment) exceeds an agreed amount. The lending institution usually allows a certain buffer before demanding a margin call.

Different margin lenders and margin loans have very different terms and conditions. Some have 5% buffers, others have 10%, some require margin calls to be paid within 24 hours and others give you a few days grace. You should seek professional financial planning advice before you commit to a margin lending strategy.

Options when a margin call is due include:

1. Repay part of the loan.
2. Invest more money to increase the investment value.
3. Provide additional assets as security.
4. Sell assets to repay the loan.

Glossary

Assessable income – Income, including capital gains, on which you pay tax (ie your total income before deducting allowable deductions).

Borrowing limit (pre-approved) – An amount the lender has agreed to lend you based on a current loan application. This may be drawdown in instalments or never drawdown at all.

Capital – Cash or assets that can be applied towards a particular purpose.

Capital Gains Tax (CGT) – A tax on the growth in the value of assets or investments, payable when the gain is realised. If the assets have been held for more than one year, the capital gain may receive concessional treatment.

Cashflow – The amount of money received in a certain period. Surplus cashflow refers to the net inflow of money (ie income received net of tax and non-discretionary expenditure).

Debt – An outstanding liability that must be repaid.

Debt recycling – The process where an investor increases an investment loan (ie where the interest is tax deductible) by the same amount that they have reduced a non-deductible loan (eg a home loan) over a given period.

Dividend – Distribution of part of a company's profits to shareholders expressed as a number of cents per share. Companies typically pay dividends twice yearly – an interim dividend and a final dividend.

Dollar cost averaging – The practice of investing amounts of money at regular intervals regardless of whether the market is going up or down, resulting in an average cost per unit of investment.

Efficient debt – Debt that can assist you to build wealth. It can be characterised by the fact that the assets acquired with it are both income producing (making the interest tax deductible) and expected to grow in value over time.

Equity – The interest or value which an owner has in an asset over and above the debt against it. For example, the equity of a homeowner is the value of the home less any outstanding loan.

Franking/imputation credits – Credits for company tax paid that are passed onto shareholders who have received franked dividends from Australian resident companies.

Franked dividends – Dividends on shares with franking credits attached. The tax paid at the company level is credited to shareholders. Tax is assessed on the total amount of the dividend and the imputation credit, and they can claim a tax offset equal to the imputation credit. A company is able to declare that a percentage (up to 100%) of a dividend is franked depending on the amount of tax the company has already paid.

Gearing – Borrowing money for investment purposes.

Guarantor – A party who agrees to be responsible for the payment of another party's debts.

Home equity loan – A loan secured against the equity in the home. This can generally be used for any purpose (eg for investment).

Home loan – A loan taken out to acquire a home.

Income producing asset – An asset that generates income for the owner (eg a share that pays a dividend). The interest on a loan taken out to acquire an income producing asset is generally tax deductible.

Income protection insurance – A policy that pays you a portion of your lost income in the event of you being unable to work due to illness or injury.

Inefficient debt – This type of debt can be characterised by the fact that the assets acquired with it are not income producing (meaning the interest is not tax deductible). The assets may also depreciate in value or be consumed (ie they have no monetary value).

Instalment gearing – A loan that allows you to leverage your regular investments with regular drawdowns on an investment loan.

Interest – The amount a borrower pays to a lender for the use of borrowed money.

Interest only loan – A loan where the principal is paid back at the end of the term and only interest is paid during the term.

Internally geared share fund – A managed fund which contains internal gearing (ie the fund borrows money) to leverage the investment in Australian and/or global shares.

Investment loan – A loan with the specific purpose of acquiring investments in order to create wealth.

Limited recourse loan – A gearing arrangement, such as an internally geared share fund, where the investor's liability is limited to the value of the initial investment.

Line of credit – Overdraft facility which is secured by a mortgage over a residential property. With a line of credit it is possible to drawdown over time to the set borrowing limit as required.

Loan to valuation ratio (LVR) – The ratio of the amount lent to the valuation of the security (eg your home).

Managed investment – An investment vehicle (eg unit trust), which pools the assets of multiple investors with a common investment objective and strategy. A sector specific fund invests in only one asset class (eg global shares) while a multi-sector (or diversified) fund invests in a number of asset classes.

Margin call – With a margin loan the lender is prepared to lend to a maximum limit (expressed as a ratio of borrowing versus equity). When this limit is exceeded, you will be required to meet a margin call, which means you must either repay part of your loan or increase your loan limit by providing further security.

Margin lending – A means of borrowing money in order to increase your investment in growth assets such as shares. The geared asset (eg the shares) becomes the security for the loan.

Marginal tax rate – The stepped rate of tax that you pay on your taxable income.

Mortgage – A loan in which you provide the lender with a certain asset as security. The security is generally released upon repayment of the loan.

Mortgage duty – A Government charge on the establishment of a new loan arrangement or the extension of an existing loan.

Offset account (100%) – A separate savings account run in conjunction with your home or investment loan. Any money you put in the offset account is deducted from your loan balance before interest is calculated. It also operates like a transaction account.

Redraw facility – A loan facility whereby you can make additional repayments and then withdraw these extra funds if and when necessary. They will often have limitations such as a minimum redraw amount and a fee for each withdrawal.

Tax deduction – An amount that is deducted from your assessable income before tax is calculated. You can claim deductions in your annual tax return or, if your deduction is significant, you can apply to the Tax Office for a variation of PAYG tax.

Taxable income – Assessable income (including capital gains) after deductions.

Tax offset – An amount deducted off the actual tax you have to pay. You may be able to claim a tax offset in your end of year tax return (eg franking credits). Sometimes a tax offset may be taken into account in calculating your PAYG rates.

Unit trust – An investment that allows individual investors to pool their funds, by purchasing units, to enable the trustee of the trust to invest in shares, fixed interest and property (eg a property unit trust).

Speak to your financial adviser about managing your debt and creating wealth with these investment solutions.



Strategies 4-10



Strategies 1-9



Strategies 1-9

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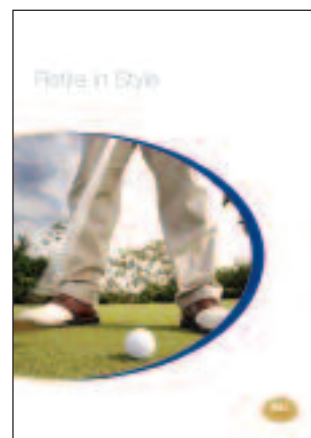
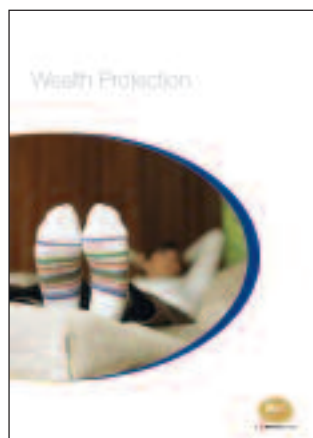
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