exclusivity

kimmorley financial management

Guide To…

Investing with borrowed money

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

Home Equity Loans

Allow you to use the equity in your home to borrow money to invest where you choose. This can range from a standard principal and interest loan through to a line of credit (interest only).

Advantages

- You have control over the gearing levels;
- No margin calls are required if there is an investment market downturn;
- Low interest rate (small premium on 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 prepay interest for up to 12 months and claim a tax deduction in the current year (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

- 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

- 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 reductions and recycling;
- Investors who wish to avoid margin calls.

Margin Loans

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

Advantages

- 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 prepay interest for up to 12 months and claim a tax deduction in the current year (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.

Disadvantages

- 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 70% (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 may be suited to this structure

- 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 funds

A managed fund that contains internal gearing (i.e. 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 (i.e. the fund income is sufficient to cover interest and fees).

Advantages

- 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.

Disadvantages

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

Investors who may be suited to this structure

- 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.

If you have any queries in relation to the content of this material, please do not hesitate to contact Kate Kimmorley the Principal Financial Adviser at Kimmorley Financial Management on (07) 5591 1725.