

# Creating a Portfolio with Gearing: Case Study



Even with a good income and some goals, building wealth can be a slow process. For decades many Australians have accelerated their wealth by borrowing money to invest (gearing). The strategy of borrowing money to invest in property has been very popular and a similar approach can be used for investing in shares, Exchange Traded Funds (ETFs) and managed funds using an Investment Loan.

## Jeff - 38 Years

Jeff currently has a cash holding of \$40,000 and believes it's the right time to switch into equities. He would like to maximise his investment returns and discusses various strategies with his adviser that would suit his risk profile. Jeff's adviser recommends he use a Commonwealth Bank Geared Investments Loan to borrow \$40,000 and together with his \$40,000 cash invest \$80,000 into ASX listed securities. Jeff's adviser helps him construct a diversified portfolio of stocks that are selected with the goal of outperforming the market over the longer term while still providing a good dividend yield.



Jeff

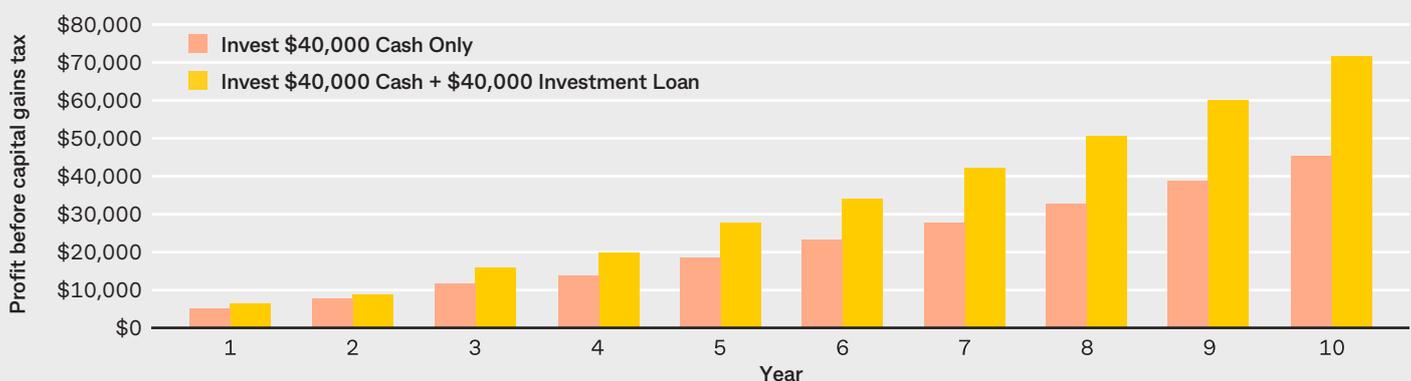
## Jeff's Portfolio

Jeff's cash contribution	\$40,000
Jeff's investment loan	\$40,000
<b>Secured portfolio value</b>	<b>\$80,000</b>

## Assumptions

Capital Growth Rate	4.50% p.a.
Dividend Yield	4.00% p.a.
Dividend Franking	70%
Investment Loan Interest Rate (indicative variable interest rate)	8.00% p.a.
Jeff's Marginal Tax Rate (including Medicare Levy)	39.0%
Dividends are re-invested	

## Jeff's Position After 10 Years



	Non-g geared strategy	Geared strategy
<b>Portfolio Value after 10 years</b> includes re-invested dividends of:	\$90,493	\$180,879
	\$23,736	\$47,472
less Cash Contribution	\$40,000	\$40,000
less Investment Loan	\$0	\$40,000
less Interest paid	\$0	\$32,000
less Income tax on investment activities	\$12,034	\$11,588
add Franking credits tax offset	\$7,121	\$14,242
<b>Profit before CGT</b>	<b>\$45,526</b>	<b>\$71,532</b>
Strategy outperformance		+ \$26,006 or 57%
<b>Annualised return p.a.</b>	<b>11.4% p.a.</b>	<b>17.9% p.a.</b>

Brokerage and any other fees are excluded. While capital gains tax implications have been ignored, they should be considered before investing. The results above are calculated on the hypothetical assumptions shown in this example, different assumptions would lead to markedly different results. This example is for illustrative purposes only. It does not reflect any particular person or situation and should not be taken as an accurate forecast of any outcome.

Jeff's decision to use gearing to increase his initial portfolio size allowed him to achieve a much greater return on his \$40,000 equity. By using gearing he achieved a profit of \$71,532 after 10 years which was \$26,006 or 57% more than the profit he would have achieved if he simply invested his \$40,000.

### Other Strategies to Consider

- If Jeff chose to take his dividends as cash instead he would have achieved a positive cash flow of \$11,663 over the 10 years after paying interest and income tax. However, his Profit before CGT would have been lower at \$55,900.
- If Jeff chose to initially gear his portfolio at 60% by borrowing \$60,000 instead, for a total investment of \$100,000, he would have achieved a greater Profit before CGT of \$84,535 or return of 21.1% p.a.

### What are the Risks Involved?

Borrowing to invest can multiply your investment returns in a rising market. However, if your investments perform poorly, it can also multiply your investment losses.

Other risks associated with an investment loan include:

- borrowing limits may be reduced, increasing the potential for a Margin Call.
- the variable interest rate may increase resulting in higher interest costs.
- margin calls may require investments to be sold quickly at unfavourable prices if you are unprepared.
- tax legislation or marginal tax rates may change.

There are a number of things you can do to reduce the risks associated with an investment loan. For example, borrowing less than the maximum allowed reduces the risk of a margin call.

Before you apply for an investment loan, you should speak to your financial adviser who will be able to help you put an appropriate strategy in place. Investors should also obtain professional taxation advice that addresses their individual circumstances before taking out an investment loan.

Please speak to your adviser for more information about how a Commonwealth Bank Geared Investments Loan can help you accelerate your wealth.

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