Using Investment Income to Build a Larger Portfolio: *Case Study*

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

But with the right financial advice many Australians can build a larger investment portfolio, by using investment income to meet interest costs.

Scott and Nicole

Introducing Scott and Nicole

Scott and Nicole are in their mid 30s and have two young children. Scott works in the public service earning $120,000 a year before tax. Nicole was a nurse before the birth of their first child and plans to return to the workforce once their children have settled into primary school.

With their mortgage repayments and household expenses covered by Scott's salary, they are interested in growing their investment portfolio to help improve their family's financial position. They currently re-invest the income received from Scott's portfolio but wonder if there is a strategy that can accelerate their wealth despite their minimal surplus income.

The Challenge

Their Goals	
Short term (1-3 years)	• Grow their investment portfolio • Use any surplus cash flow on family holidays
Medium term (3-7 years)	• Continue with mortgage repayments • Maintain and grow investment portfolio
Long term (7 years+)	• Use Nicole's additional income to increase mortgage repayments • Maintain and grow investment portfolio

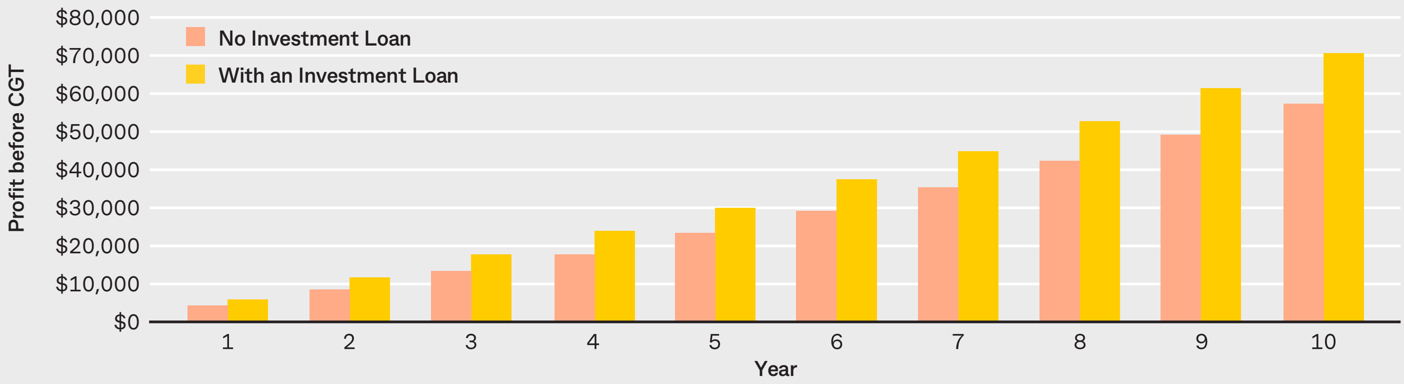
Their Financial Postion	
Income	• Gross salary of $120,000 a year • Investment income of $2,000 a year
Assets	• Investment portfolio $50,000 • Cash savings $5,000 • Family home $800,000
Liabilities	• Mortgage $300,000

The Strategy

Unsure of their options, Scott and Nicole decide to speak with a financial adviser. After carefully considering their financial situation and goals, their adviser recommends they use a Commonwealth Bank Geared Investments Loan to borrow and invest a further $50,000 in diversified high yielding shares, ETFs or managed funds, bringing the value of Scott's portfolio to $100,000.

Their adviser also recommends they stop re-investing the income received from Scott's portfolio. Instead he recommends the income be used to meet the interest costs of their $50,000 investment loan. By leaving $5,000 in the bank, Scott and Nicole will also have a cash reserve to cover any unexpected expenses.

The Result



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

- The calculations show the profit before capital gains tax of each strategy after loan and interest costs have been paid.
- It assumes an average annual capital growth rate of 4.50% p.a., an income yield of 4.00% p.a., distributions are 70% franked, a company tax rate of 30%, an average annual investment loan interest rate of 8.00% p.a., a marginal tax rate of 39.0% including Medicare levy of 2.0%, an initial client contribution of $50,000, an initial investment loan gearing level of 50%, distributions are reinvested in the no investment loan scenario, distributions are not re-invested and are paid as cash in the investment loan scenario, brokerage and any other fees are excluded.
- While capital gains tax implications have been ignored, they should be considered before investing.
- This example is for illustrative purposes only. It does not reflect any particular person or situation and should not be taken as an accurate forecast of any outcome.

If Scott and Nicole had decided to simply maintain their $50,000 portfolio and continued re-investing the income received, their portfolio would have grown to $113,049 after 10 years. After deducting the initial value of Scott's portfolio and allowing for tax on the investment income received, the profit from Scott's portfolio would have been $56,907 before capital gains tax.

But having followed their financial adviser's recommended strategy of borrowing an additional $50,000 to invest and using the investment income to meet their interest costs, Scott's portfolio grew to $155,297 over the ten year period. After allowing for the initial value of Scott's portfolio, his investment loan, income received, interest paid and income tax, the profit from his portfolio was $69,875 before capital gains tax.

The difference in the profit outcomes of both strategies was $12,968 or 23% over the 10 year period.

After-Tax Cash Flow from Investments

Their Goals	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Maintain $50,000 portfolio (with income re-invested)	-$414	-$449	-$487	-$529	-$574	-$623	-$675	-$733	-$795	-$863	-$6,142
$100,000 portfolio using Investment Loan (income NOT re-invested)	$723	$875	$1024	$1180	$1343	$1513	$1691	$1877	$2071	$2274	$14,578

Most importantly, Scott and Nicole were able to use an Investment Loan to build a larger investment portfolio and meet their interest costs using their investment income. In fact, they managed to achieve a positive cash flow each year after interest costs and income tax.

This surplus income allowed them to further reduce their mortgage and also take that occasional family holiday.

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 financial adviser for more information about how you can use investment income to build a larger investment portfolio.

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