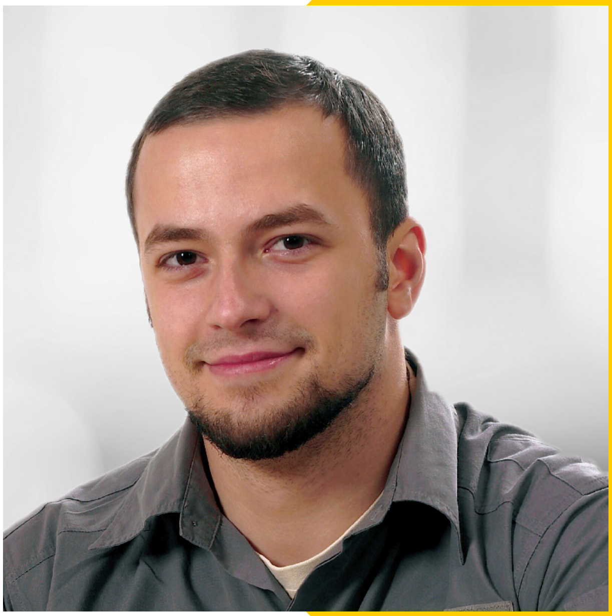
Using Your Shares to Build Wealth: *Case Study*

Many Australian own shares simply because they have participated in a share float or have received shares through an employee share scheme. Some have also discovered the benefits of using these shares to help them reach their wealth creation goals.



Anthony
Electrician

Introducing Anthony

Anthony is a 25-year-old electrician working for an Australian mining and exploration company. Despite earning a good income Anthony hasn't spent much time thinking about his financial future. He has $5,000 of cash savings and through an employee share scheme has $10,000 of shares in the company he works for. After speaking with his brother and remembering his New Year's resolution to take his finances a little more seriously, Anthony decides he'd like to start investing and sets himself a budget. After allowing for his living expenses including rent, he realises that he will have surplus income of $1,500 a month. To find out how to get started, Anthony contacts a Financial Adviser.

The Strategy

After carefully considering his situation, Anthony's adviser recommends he invest into managed funds and offers two strategies:

Option 1 – Invest with no borrowed money

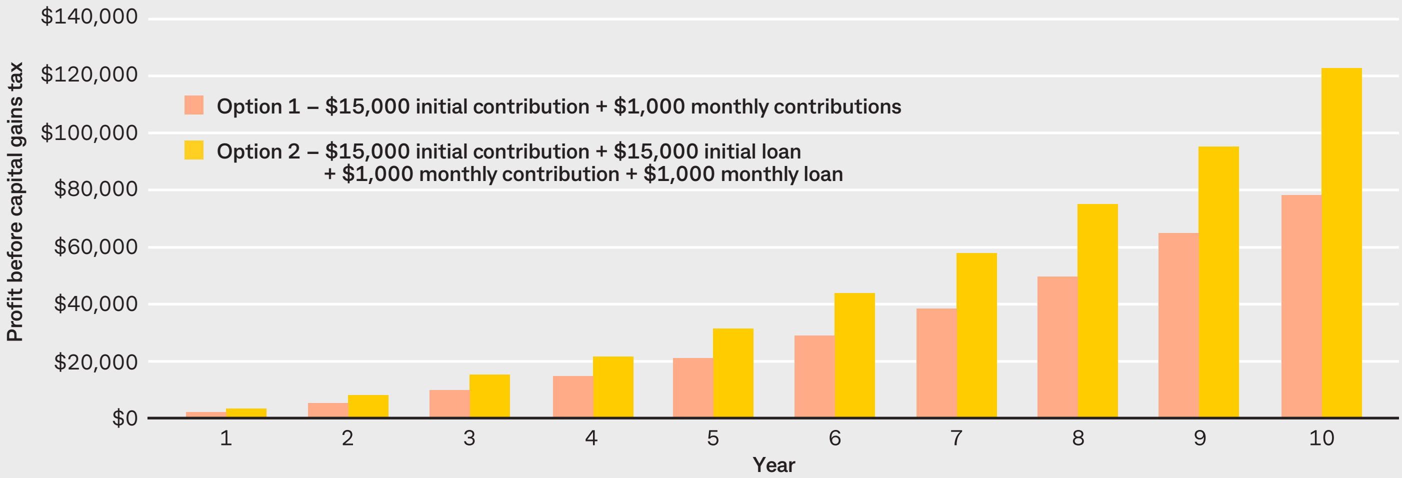
- Invest $5,000 of own money into managed funds.
- Continue holding $10,000 of existing company shares.
- Total investment portfolio is $15,000.
- Invest $1,000 a month into managed funds as a regular investment.
- All investment income is re-invested.

Option 2 – Invest with borrowed money

- Invest $20,000 into managed funds ($5,000 own money & $15,000 borrowed money).
- $30,000 of investments will be used as security against the loan ($20,000 of purchased managed funds + $10,000 of existing company shares).
- Invest $2,000 a month as a regular investment ($1,000 own money & $1,000 borrowed money).
- Save $500 a month to help pay interest costs.
- All investment income is re-invested.

After discussing the potential risks and returns, Anthony agreed to go ahead with option 2 and used a Commonwealth Bank Geared Investments Loan to increase the size of his investment.

The Result



Assumptions: Average annual capital growth rate of 4.50% p.a., an income yield of 4.00% p.a. with all income reinvested, distributions are 70% franked, a company tax rate of 30%, a marginal tax rate of 39.0% including Medicare levy of 2.0%, an average annual Loan interest rate of 8.00% p.a., an initial Loan gearing level of 50%, brokerage and any other fees are excluded. While capital gains tax implications have been ignored for the purposes of this case study, 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 Anthony had chosen to only invest his $5,000 in savings and $1,000 a month, his portfolio including his original $10,000 shareholding would have grown to $222,728 after 10 years. After deducting his contributions (initial and ongoing) and allowing for tax on his investment income, the profit on his portfolio would have been $78,898 before capital gains tax.

But having followed his financial adviser's recommended strategy of borrowing to invest to increase his exposure to growth assets, Anthony's portfolio grew to $445,457 after 10 years. After allowing for his contributions (initial and ongoing), his Geared Investments Loan, dividend income, interest paid and income tax, the profit on his portfolio was $121,440 before capital gains tax. The difference in the profit outcomes of both strategies was more than $42,542 or 54% over the 10 year period.

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 using a regular gearing plan can help you build a larger investment portfolio and achieve your goals.