**Wealth Creation**

# Home equity gearing

Aon Hewitt Financial Education Series

Home equity gearing is where you borrow money against an existing property, usually your home, to invest into growth assets directly such as into shares, property or through managed funds. The advantage of using your existing property as security is that the interest rate will usually be less than for alternative types of gearing.

## Risks of Gearing

While the rewards from gearing can be high, there are also a number of risks that you need to be aware of:

- **Gearing can magnify losses:** As gearing magnifies the potential return you may receive on your investment, it can also magnify the losses if your investment declines in value.
- **Risk of interest rate changes:** You need to ensure that you could manage the interest repayments if interest rates were to increase.
- **Investment Income risk:** Gearing costs money. Each year you need to pay the annual interest on the loan. If the investment you have geared into isn't growing in value then you should reconsider the strategy.
- **Risk of loss of cash flow:** You should only borrow to invest if you have the financial ability to absorb the effect of potential falls in investment value. It is important that you have a regular and independent income you can rely on to deliver a surplus cash flow to cover the interest payments on the loan. Another risk is that the income from the investment (rent or dividends) may decrease or temporarily cease, which may place a burden on your cash flow.

Please refer to the 'Gearing Overview' fact sheet under the Wealth Creation Financial Education Series for more details on each of the above risks.

## Example

Alan and Sarah are both aged in their early 40's and own their own home valued at $600,000. They have managed to reduce their home mortgage to $100,000 and are now starting to think seriously about how they will fund their retirement.

They have surplus cash flow of $2,000 per month and are comfortable investing for the long term as they won't need the money for at least 10 years.

They see their financial adviser who suggests they take out a loan against their home and invest the money into a number of different managed funds that invest in shares and property. After a detailed discussion they agree to see their bank manager about taking out a second loan on their home for $300,000 for investment.

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Please note that it is important that the home loan and the investment loan are separate facilities. This doesn't mean two separate mortgages but simply one loan with two different facilities or accounts. Your lender can discuss this with you in more detail.

Let's take a look at the impact on Alan and Sarah's cash flow in year 1:

| | No Gearing | With Gearing |
|---|---|---|
| **Salary income combined** | $100,000 | $100,000 |
| **Income from investments at 3.5%** | $0 | $10,500 |
| **Annual interest cost at 7%** | $0 | ($21,000) |
| **Less tax saving at 32.5%*** | $0 | $3,413 |
| **Cost of gearing in year 1** | N/A | ($7,087) |

*Tax saving is the income from the investment less the interest cost multiplied by their marginal tax rate of 32.5%

So at the end of year 1, the net cost to Alan and Sarah will be $7,087. However let's assume that the income was reinvested into the investment and they funded the $21,000 interest cost from their own cash flow. Then the cost of the strategy would be $17,587 per annum.

This means that each year Alan and Sarah need their $300,000 investment to increase by more than $17,587 for them to make money from the strategy.

So let's look at their $300,000 investment. Let's assume that each year it increases by 7% net of fees, and this is 3.5% income and 3.5% growth.

| Year | Opening Balance | Income at 3.5% | Growth at 3.5% | Closing Balance |
|---|---|---|---|---|
| **1** | $300,000 | $10,500 | $10,500 | $321,000 |
| **2** | $321,000 | $11,235 | $11,235 | $343,470 |
| **3** | $343,470 | $12,021 | $12,021 | $367,513 |
| **4** | $367,513 | $12,863 | $12,863 | $393,239 |
| **5** | $393,239 | $13,763 | $13,763 | $420,766 |
| **6** | $420,766 | $14,727 | $14,727 | $450,219 |
| **7** | $450,219 | $15,758 | $15,758 | $481,734 |
| **8** | $481,734 | $16,861 | $16,861 | $515,456 |
| **9** | $515,456 | $18,041 | $18,041 | $551,538 |
| **10** | $551,538 | $19,304 | $19,304 | $590,145 |

At the end of 10 years their investment has grown to $590,145, and their loan is $300,000. If they were to sell their investment, they would realise a capital gain of $145,073 and assuming the investment was held in their joint names, the capital gains tax would be estimated at $11,790 each or $23,580. Note that this is assuming a 32.5% tax rate.

This means they would have $266,565 in cash after repaying their loan and paying any tax, which could be used to fund their retirement.

| | Amount |
|---|---|
| **Total value of investment** | $590,145 |
| **Repay loan** | ($300,000) |
| **Less tax** | ($23,580) |
| **Net investment return** | $266,565 |

If the investment had returned more than an average 7% per annum, then their gain would be even higher.

Before considering a gearing strategy, we strongly recommend that you read the ‘Overview of Gearing’ fact sheet under the Wealth Creation Financial Education Series and discuss this with your financial adviser.