Wealth Creation

Debt recycling

Aon Hewitt Financial Education Series

What is a debt recycling gearing strategy?

A debt recycling gearing strategy converts non tax-deductible debt into tax-deductible debt. This makes your debt more tax-effective enabling you to maximise the repayment of your non tax-deductible debt.

As you pay down your non tax-deductible debt (for example a home loan) using your surplus income, you borrow back the increased equity and invest in shares and/or property either directly or via managed funds. The income and tax savings generated from the investment are used to reduce your home loan further. You then borrow back the increased home equity and re-invest in the investment portfolio.

This is continued until your home loan is repaid. After that, your surplus income (including investment income and tax savings) can be used to acquire additional investments.

One important thing to note with this strategy is that this is a long-term investment focus and your debt level remains constant. If your aim is to eliminate all debt as quickly as possible then this strategy is not suitable for you. For more guidance in this area, please speak to your financial adviser.

Risks of Gearing

While the rewards from gearing can be high, there are 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.
- **Importance of gearing into growth assets**: 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 'Overview of Gearing' fact sheet under the Wealth Creation Financial Education Series for more details on each of the above risks.

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Case Study

Barry and Cathy have a home worth $450,000 and an outstanding home loan of $220,000. They use existing equity in the family home to borrow for investment purposes. They are comfortable having a total debt level equivalent to 67% of the current value of their home (i.e. around $300,000).

Given their outstanding home loan is currently $220,000; they will initially borrow $80,000 via an interest only investment loan, and invest it in a diversified managed fund.

Throughout the first year, they use all of their surplus cash flow, around $10,000 (less the interest on the investment loan), and the investment income and tax savings, to pay down the home loan by $24,000 to $196,000. They replace the amount paid down by borrowing an equivalent amount as an investment loan ($24,000) to purchase additional units in their managed fund.

If they continue this process, their home loan will be paid off after 8.8 years. After recycling at the end of that year, the investment loan would be fully drawn to $330,000 and the value of the share fund is projected to be $410,000. With the home loan paid off, they can direct all surplus cash flow, investment income and tax savings into the managed fund.

Please refer to the ‘Overview of Gearing’ fact sheet under the Wealth Creation Financial Education Series for more details on borrowing to invest, including the risks of gearing.

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