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Fact Sheet

# Debt Recycling

Traditionally, people wait until their home loan is repaid before they start investing for the future. Unfortunately, due to the growing size of home loans, people start investing later in life. As people are now also retiring earlier, the time between paying off the home and retirement has been eroded, limiting the growth potential of their investments.

Debt recycling strategies challenge traditional financial planning strategies by commencing the wealth creation process immediately. Using debt recycling, you can simultaneously pay off your home loan and create wealth.

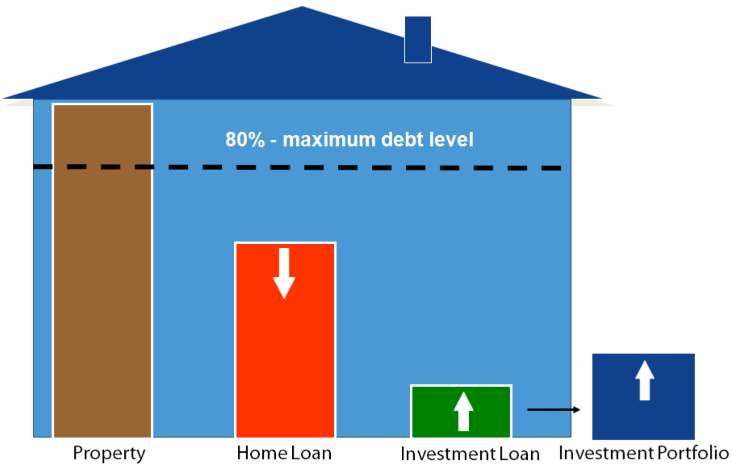
## Traditional debt management and wealth creation

Traditional debt management and wealth creation strategies focus on paying off the home loan as quickly as possible by increasing the frequency and amount of the repayments. Once the home is repaid the wealth creation process commences, using the previous loan repayments to purchase investments.

## Debt recycling

Debt recycling strategies allow you to start investing for the future now whilst continuing to pay off your home loan. Cash flow freed up, using traditional debt management strategies, is used to service an investment loan. All additional income (ie. dividends, tax savings, surplus cashflow) is paid off the home loan and periodically redrawn and added to the investment. Over time, the non-deductible (bad) debt is converted to deductible (good) debt, hence the term debt recycling.

The borrowed funds are invested into a diversified portfolio of assets, generally with a bias towards investments that will provide regular distributions and tax benefits.




## This fact sheet explains...

- Traditional debt management
- Debt recycling
- Benefits of debt recycling
- Considerations of debt recycling
- Case study Adam and Michelle

## Benefits of debt recycling

- Commences the wealth creation process immediately, allowing for long term growth of the investments.
- Replaces non deductible (bad) debt with tax deductible (good) debt on a regular basis, providing long term investment funds, investment income and tax benefits.
- Helps you reach your lifestyle goals sooner.
- Budgeting may help free up more funds to recycle, reducing debt even faster
- Starts using equity in your home straight away, taking advantage of current opportunities in the market.
- Takes advantage of dollar cost averaging into the market.
- Provides a diversified investment portfolio outside the family home.
- Tax deductions can be claimed for interest paid on investment loan.
- You are able to access your portfolio if necessary (liquid asset).

## Considerations for debt recycling

- Risk is increased via exposure to market volatility, however this can be partially reduced through diversification.
- As debt recycling involves gearing any capital gains made on the investment are magnified. However, the opposite is also true with capital losses also magnified as compared to non-geared strategies.
- Interest only means that unless discipline is maintained with the regular debt recycling you are not guaranteed of repaying your home loan.
- Due to high level of debt, employment security is especially important when considering a debt recycling strategy.
- Regular contributions can be adjusted to suit changed circumstances (eg family).
- You need to be at least a Balanced investor to support this strategy.
- Some funds can remain in redraw for emergency purposes and to assist with other lump sum lifestyle objectives.

## Meet Adam and Michelle

Adam is 40 and Michelle is 38. They're married and have a young family. They do not currently save any surplus. Below is a summary of their financial situation

| | Adam | Michelle |
|---|---|---|
| Salary | $75,000 p.a. | $25,000 p.a. |
| Ongoing super contributions (at 9% p/a) | $6,750 p.a. | $2,250 p.a. |
| Superannuation balance | $90,000 | $35,000 |
| Emergency funds | $5,000 | |
| Home value | $520,000 | |
| Home loan | $280,000 | |
| Car loan | $24,500 | |
| Total loan repayments | $2,900 p.m. ($2,170 p.m. minimum P&I home loan repayments) | |
| Credit card | $5,500 | |
| Living expenses | $44,200 p.a. | |

### Strategy considerations

1. Consolidate debts into new loan to release cashflow.
2. Consider making home loan interest only to free-up maximum cashflow (depending on risk tolerance).
3. Consider using an offset account for emergency funds.
4. Consider borrowing a lump sum to invest (eg. $100,000).
5. Direct all income from investments and tax savings into the home loan as well as any additional surpluses like bonuses, pay rises etc.
6. Regularly (monthly if possible) redraw funds that have been repaid into the home loan and add to the investment portfolio
7. Once all debt is converted to deductible debt, the dividends and tax savings can be deposited into the investments.

### Outcome of debt recycling for Adam and Michelle

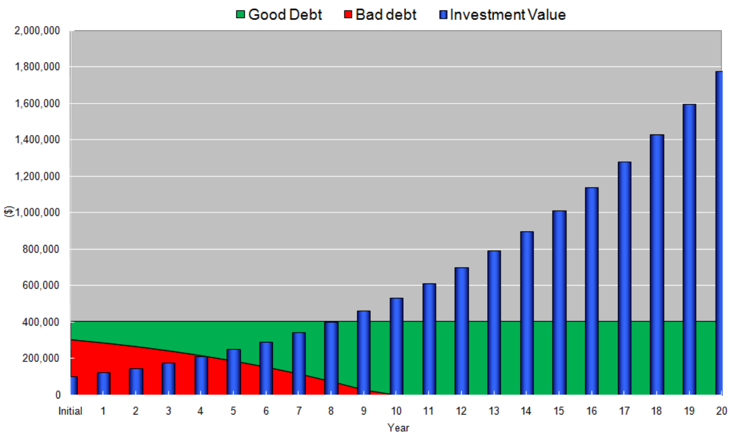
Based on the strategy considerations outlined above, the benefits of debt recycling over a 20 year period can be compared with their current situation and traditional strategies. By implementing the debt recycling strategy, Adam and Michelle's net wealth will increase significantly (after paying off the investment loan).

**Adam and Michelle's net position after 20 years**

| | current | traditional strategies | debt recycling |
|---|---|---|---|
| time to repay home loan | 20 years | 10 years | 10 years |
| value of investment | $0 | $983,152 | $1,773,964 |
| outstanding investment loan | ($0) | ($0) | ($405,000) |
| value of superannuation | $969,279 | $969,279 | $969,279 |
| value of home | $939,178 | $939,178 | $939,178 |
| NET ASSETS | $1,908,355 | $2,891,609 | $3,277,421 |

Without finding any additional funds, Adam and Michelle are **$1,369,066 better off** than if they continued with their current situation and $385,812 better off than if they only implemented traditional debt management strategies.

**Investment value vs debt**




Adam and Michelle will maintain the same level of debt over the 20 years but will gradually be converting bad debt to good debt over time.

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**What you need to know**

The return on the investment managed fund is 8.43% p.a. (4.27% income, 4.16% growth), plus 26.18 franked, 3.2% tax deferred. The return on the superannuation fund is 8.02% (4.73% income, 3.29% growth). The interest rates applying to the car loan and credit card are 10.5% and 18% respectively. The interest rate applying to the home loan and investment loan is 6.00%. The growth rate for the home is 3% p.a. The inflation rate is 2.6%. The returns in the case study are not guaranteed and are used for illustration purposes only.