

Using your shares to build wealth

Many Australian's 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.

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 \$3,000 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 Years resolution to take his finances a little more seriously, Anthony decides he'd like to start investing and sets a budget. After allowing for living expenses including rent, he realises that he will have \$1,000 a month available. He wonders what is the best way to get started?



Getting started – investing and borrowing

Australians start investing at different points in their lives and for a range of different reasons. For many people the first asset/ investment they buy is a property ... but what if you don't want to buy a property, already have one, or instead want to start investing in shares or managed funds?

Even with a good income and some goals, building wealth can sometimes be a slow process – especially when it comes to saving enough to get started. For decades many Australians have overcome this by using other people's money (or borrowing to invest) to create wealth. There are a range of reasons why people use this approach, which includes being able to:

- > Invest more than they could have by just using their own money.
- > Gain more income from the larger investment.
- > Receive a tax deduction for interest on the loan.

While the strategy of borrowing money to invest in property has been used for decades, it is only in recent years the same approach has been adapted to allow people to invest in shares and managed funds. A margin loan is a commonly used product that allows you to buy shares or managed funds and then use them as security (instead of property). While a margin loan has a range of features, one of the most popular is a regular gearing plan.

A Regular Gearing plan offers a simple and automatic approach to investing. It allows you to increase the size of your monthly investments into managed funds by adding a borrowed amount to your personal contributions.

Investing monthly will allow you to average the entry price of your investment and eliminate the worry of trying to time your entry into the market.



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The strategy

After seeing a brochure in the lunchroom Anthony contacts his company's human resources team and is introduced to a financial adviser. After carefully considering his situation, the adviser recommends Anthony invest in managed funds and offers two strategies:

Option 1 – Invest with no borrowed monies

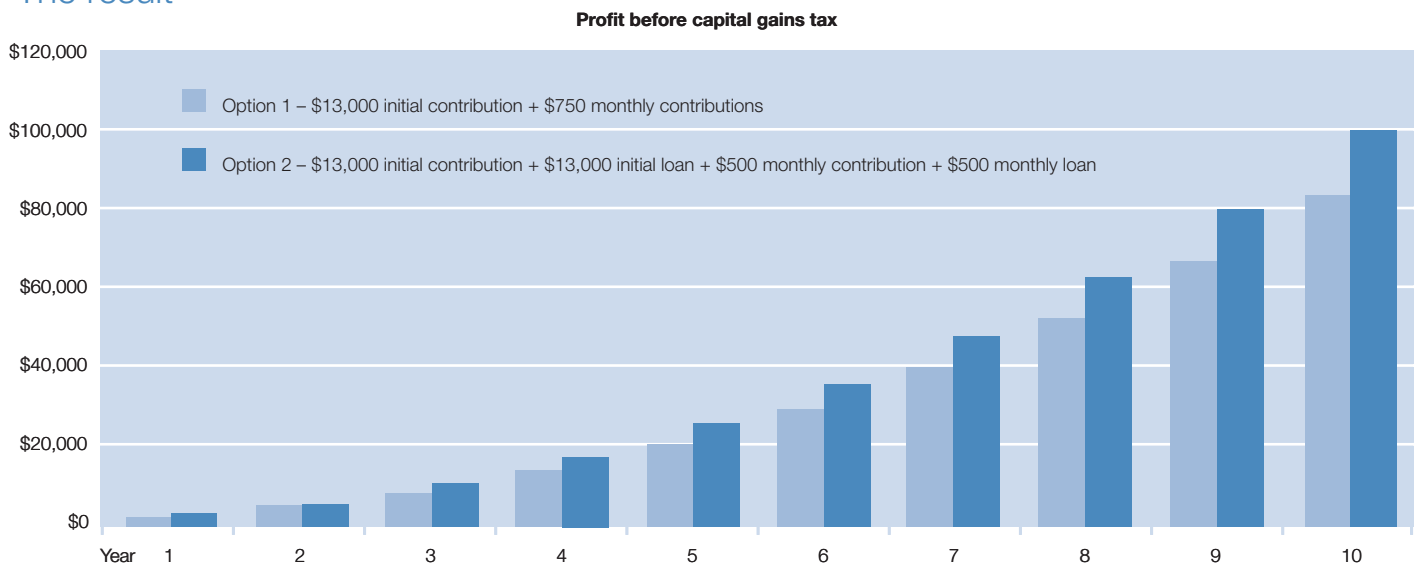
- > Retain \$10,000 of company shares.
- > Invest \$3,000 as a starting point.
- > Invest \$750 a month as an ongoing contribution.

Option 2 – Invest with borrowed monies

- > Retain \$10,000 of company shares and use them as security against a margin loan.
- > Invest \$16,000 as a starting point (\$3,000 own money & \$13,000 borrowed).
- > Invest \$1,000 a month as an ongoing contribution (\$500 own money & \$500 borrowed).
- > Save \$250 a month to help fund interest costs.

After discussing the potential risks and returns, Anthony agreed to go ahead with option 2 and used a margin loan to increase the size of his investment.

The result



Assumptions: Its Average annual capital growth rate of 7.00%, an income yield of 3.50% with all income reinvested, distributions are 70% franked, a company tax rate of 30%, a marginal tax rate of 38.5% including Medicare levy of 1.5%, an average annual margin loan interest rate of 9.50%, an initial margin loan gearing level of 50%, brokerage and any other fees are excluded. While capital gains tax implications have been ignored, they should be considered before investing.

If Anthony had chosen to only invest his \$3,000 in savings and \$750 a month, his portfolio would have grown to \$192,060 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 \$82,880 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 \$279,602 after 10 years. After allowing for his contributions (initial and ongoing), the margin loan, investment income, interest paid and income tax, the profit on his portfolio was \$99,392 before capital gains tax. The difference in the profit outcomes of both strategies was more than \$16,500 or 20% over the 10 year period.

Risks and management

As with any investment strategy, borrowing to invest with a regular gearing plan has some risks. Just as it can accelerate your profits when your investments are successful, it can also multiply your losses if they fall. There are several ways you can reduce these risks. They include:

- > Borrowing less than the maximum allowable.
- > Diversifying your investments to help reduce volatility.
- > Using your distributions to reduce your loan balance.
- > Working with your financial adviser to review your loan on a regular basis.

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.

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