Mortgage Reduction Strategy

THE MORTGAGE REDUCTION STRATEGY

WHAT THE BANKS DON'T WANT YOU TO KNOW !

The mortgage reduction strategy is a viable, but often misunderstood strategy that incorporates both key elements of tax and investing to help you reduce your non deductible home loan debt and generate wealth for your retirement.

Most banks would prefer you to stay in debt as long as possible (as they continue to earn interest off your home loan). Here we find ways to use your existing equity in your home to help you on your way to financial independence.

HOW DOES THE MORTGAGE REDUCTION STRATEGY WORK

Many clients adopt a conventional approach to investing — paying off their non-deductible debt before making investments. However, this approach largely ignores tax efficiency, which is where the strategy of mortgage reduction can come into its own.

The mortgage reduction strategy is a wealth accumulation strategy. It is about investing now rather than investing later by creating a well-structured, diversified portfolio over growth assets. By investing now you convert inefficient non-deductible debt to efficient deductible debt.

That's what the strategy is all about; getting more tax efficiency with your debt.

With non-deductible debt, the interest payments on a home loan are paid from after-tax dollars. In addition, the interest payments are not tax-deductible. However, deductible debt is investment debt used to buy assets that generate taxable income, therefore the interest payments are generally fully tax-deductible.

The mortgage reduction strategy works by replacing non-deductible (inefficient or 'bad') debt with deductible (efficient or 'good') debt and investing now.

How does the mortgage reduction strategy works

The mortgage reduction strategy works by using surplus income to reduce "bad" debt such as the home mortgage, and in doing so, the equity in the investment is generally increased. This is further explained in the following four steps:

1. You direct all surplus income into the home mortgage.

2. At the end of the financial year, you borrow back the increased equity via a separately identifiable investment loan and invest in growth assets such as shares, property or managed funds.

3. Earnings from the investment portfolio are directed into the home mortgage to reduce the outstanding debt (in addition to other surplus income).

4. At the end of the next financial year, the client borrows back the increased home equity via the investment loan and purchases additional investments.

The process can be continued until the mortgage is repaid, and the entire debt is essentially converted into tax-deductible debt. Once all non-deductible debt is repaid, surplus income, including investment income and tax savings, can be used to buy more investments or to pay down the investment loan.

Once clearly identified, any income and tax savings or other income derived from the investment can be used to reduce the existing non-deductible home loan.

The ATO will assess tax-deductibility by looking at the purpose of a loan and whether the aim of the investment is to generate assessable income. You can only claim a tax deduction on an investment, whether it is shares or property or other investments, if there is an intention to generate taxable income on it.

The mortgage reduction strategy can incorporate principles of dollar cost averaging (DCA) to reduce timing risk in a turbulent market. Dollar cost averaging is a simple but effective technique that allows investors to take a long-term investment approach, investing at regular intervals and on a continuous basis at many price points — both high and low. It's generally used with unitised investments such as shares and managed funds, and the ultimate effect is to buy more units when prices are lower and fewer units when prices are higher.

Using the mortgage reduction strategy, funds are redrawn and invested at least annually which is a very prudent strategy to consider in a turbulent market. Clients need not worry because they're buying in at regular intervals.

THE BENEFITS OF THE MORTGAGE REDUCTION STRATEGY

The mortgage reduction strategy requires discipline, as it uses regular investments backed by gearing to gain exposure to the market over time. However, there are many benefits to the strategy, including:

> **Tax advantages.** Mortgage reduction strategies replace inefficient debt with efficient, tax- deductible debt, thereby maximising the tax-effectiveness of the client's debt.

> **Wealth accumulation.** Wealth is built using investment income and tax benefits and to reduce inefficient debt faster.

> **Investing now.** Mortgage reduction strategies allows investors to establish an investment portfolio sooner, compared with the conventional approach of paying off the mortgage and then investing — therefore giving the power of compounding much more time to take effect and grow the portfolio.

Any income and tax savings derived from the investment can reduce the existing non deductible home loan. After each year (or regular period), an additional amount is borrowed to top-up the income producing investment. The amount reduced from the home loan is effectively replaced with a deductible debt.

This creates greater tax efficiency for the client and allows their net position, after deducting all debts, to increase over the long term.

EXAMPLE OF THE MORTGAGE REDUCTION STRATEGY

Bill, aged 45, has a home worth $750,000 with an attached non –deductible loan of $250,000. His income after tax is $80,000 per year. He has $30,000 p.a worth of expenses, just over $21,000 on principal and interest repayments and his surplus cash flow is about $29,000. Bill is comfortable with his total debt up to $450,000.

In this scenario, there are 2 strategies open to Bill.

1. Strategy 1 is to pay off the home loan and then consider investing at a later stage.

2. Strategy 2 involves using a mortgage reduction strategy.

Figure 1:

Delayed investing discharging mortgage vs the mortgage reduction strategy

After 25 years	**Strategy 1**	**Strategy** 2
Home loan paid in year	6.3	6.7
Investment value	$1,933,752	$2,634,723
Value of debt	0	$449,576
Net investment value(after-tax)	$1,933,752	$2,185,147

This example makes the following assumptions:

> *Interest rate on both main residence loan and investment loan is 7.3%*
> *4.5% p.a. capital growth*
> *4% p.a. income return*
> *70% franked dividends on share investments.*

In Figure 1, the analysis of the two strategies is conducted after 25 years. Strategy 1 results in the home loan being repaid in 6.3 years, after which period, Bill directs surplus income into other investments. The value of the investment assets at the end of the 25-year period is just over $1.9 million, which represents the net investment value because gearing hasn't been used in the strategy.

If Bill were to undertake Strategy 2 using the mortgage reduction strategy, he would borrow a sum of money and use the earnings, the income from that investment and the tax savings generated by that investment to reduce the non-deductible loan. Then at the end of that year, Bill would borrow an additional amount based on what has been paid off the nondeductible loan. If Bill were to keep doing that year on year, it would reduce his nondeductible debt and increase the deductible portion over time. The home loan would therefore be repaid in 6.7 years.

Figure 1 shows that if Bill were to execute Strategy 2, his investment value would grow to just over $2.6 million with an attached loan of just under $450,000 — the total net investment value would be worth just over $2.1 million. Therefore, Bill is $250,000 better off financially by implementing the mortgage reduction strategy!

THE RISKS OF THE MORTGAGE REDUCTION STRATEGY

A major risk to the mortgage reduction strategy is over-borrowing. If an investor borrows at too high a level, they will be more exposed to market volatility and variations in interest rates. An appropriate debt ratio for investors who are new to the mortgage reduction strategy might be 50%, which equates to 50% in borrowings and 50% equity. More aggressive investors may be comfortable with higher debt ratios, however, higher levels of gearing carry higher levels of risk and the portfolio becomes more sensitive to market movements.

An over-reliance on unstable income streams to meet the cost of borrowing can also present its problems. Where a strategy is reliant on investment income, if dividends or distributions were to suddenly stop, the borrower might not be able to meet loan repayments.

There are also risks associated with asset ownership and whether the ownership of the investment should be in one client's name, their partner's name or in joint names. In this case, there are two factors that need to be considered based on the client's circumstances.

These are:

> Tax deductions are more valuable on a higher marginal tax rate.

> Capital gains — the lower the marginal tax rate, the lower the capital gain.

However, where there is likely to be large capital gains at the end of the mortgage reduction strategy and there is one person on a low marginal tax rate, the tax paid on the realised capital gain will actually be lower where the asset is in the name of a person with a lower marginal tax rate.

Joint ownership may be a disadvantage where one of the parties is a non-income earner, such as a stay-at-home parent, as they won't benefit from the tax-deductibility aspects of the strategy.

INVESTOR SUITABILITY

The mortgage reduction strategy is most suited to investors with risk profiles that show they can tolerate volatility - the ups and downs in markets. Typically, these investors are considered growth type or aggressive investors.

These investors would be earning a stable medium-to-high income. You must be able to meet interest repayments, regardless of the income generated from the investment.

Conversely, mortgage reduction strategies won't work for investors who don't have surplus cash flow and can't meet servicing requirements. It also won't work for investors who fall within the definitions of a balanced or conservative investment style, as they're not going to be comfortable with taking on board additional risk.

It's also important that the investors are disciplined, focused and will stick to their investment strategy. If you chop and change the investments you are more than likely to accumulate capital losses and either increase the level of debt that you currently have, or decrease the underlying value of the asset you've purchased with the loan.

Mortgage reduction strategies also won't suit those who aren't prepared to take out insurance. Once we've set up this strategy, you need to protect it and we do that by looking at life insurance, income protection and total and permanent disablement insurance. This will safe guard the strategy in the event of something happening to you.

WRAP UP

Mortgage reduction strategies needs to be treated in exactly the same way as any other financial planning advice.

A thorough investigation, research and risk profile assessment needs to be conducted with clients. It is importantly that you as a client understand the advantages and disadvantages of debt recycling.

For clients with suitable risk profiles who can adopt a long-term focus, then adopting a debt recycling strategy with a moderate level of borrowing and a diversified portfolio along with insurance can generate wealth over the long term.

WHAT NEXT

Building and maintaining wealth is an ongoing journey. Stay proactive and keep looking for ways to make the most of what you have.

In planning your way to wealth you should take a holistic approach, looking at your debts and assets, present and future needs, and considering tax implications and how decisions could impact on entitlement to government benefits.

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