Positive Gearing
THE BETTER KIND (WITH NO MARGIN CALLS)

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WealthHub Securities Limited
ABN 83 089 718 249
AFSL No. 230704

GPO Box 4545
Melbourne
VIC 3001

Telephone 1300 190 425
nabtrade.com.au

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Borrowing to invest is a hugely popular strategy for building wealth in Australia. Record low interest rates and legislative changes making superannuation less attractive have increased enthusiasm for a strategy that often opens up a world of potential investment opportunities; however margin lending is still a scary prospect for many. For those who can't afford or don't wish to buy property, a new product can take the stress out of borrowing to invest.

There are many paths to building wealth. The well trodden paths of superannuation and property investment are generally most favoured in Australia: for those nearing retirement, superannuation has almost unbeatable tax benefits; for those with longer timeframes, negative gearing into property remains hugely popular. Recent trends and developments, however, are forcing investors to look beyond these strategies, and consider other ways to achieve their objectives.

For those looking to save for retirement, lower contribution caps and the introduction of a cap on concessionally taxed pension savings from 1 July 2017, have limited the attractions of super. This is particularly challenging for those nearing retirement, particularly if they have a large gap between their current and required retirement savings. Many investors have found that their plans to make large pre- and post-tax super contributions as they near retirement are no longer viable.

For many who prefer to invest outside superannuation, record low interest rates have made borrowing to invest irresistible, particularly for residential property. As a result, buying a first home or investment property has become prohibitively expensive for many investors, even with borrowed funds. The median house price now exceeds $1.1million in Sydney and $840,000 in Melbourne, well beyond the reach of those in the early years of their career and others, without large cash savings. Simply building a deposit can seem impossible, and even those who planned to use the tax concessions associated with borrowing to buy an investment property may find their investment of choice beyond their means. As a result, many feel the wealth built through property by prior generations is unattainable.

The flip side of record low interest rates on loans is correspondingly low rates on deposits. This can make the challenge of saving even more difficult for those with specific goals to achieve. Most investors understand that they will need to take some risk in order to achieve an after-tax rate of return that meaningfully exceeds inflation, whether this be investing in growth assets such as shares, or borrowing to increase the size of their potential gain.

In this context, investing in equities offers many attractions: long term growth potential, strong yields, low barriers to entry, high liquidity, tax concessions in the form of franking, and the opportunity to grow an investment through regular savings or reinvestment. For those with longer timeframes, small investments in growth assets, compounded over time, can be incredibly powerful. For those who wish to reach their goals sooner, or with larger goals to achieve, there is considerable appeal in increasing their exposure to the sharemarket through borrowing, understanding, of course, that borrowing will also magnify any losses as well as any gains. This strategy may be particularly interesting right now, as the aforementioned low interest rates, actually work for you in this scenario, by delivering lower borrowing costs. It is now quite possible to achieve positive gearing rather than negative gearing. Positive gearing is the scenario where the income (dividend yield + franking in this case) produced from the investment is **more** than the cost to hold (interest). This 'positive carry' can be used to accelerate the loan repayments, or reinvested to generate more growth.

Any deductions potentially available for the cost of borrowing further add to the appeal of this strategy.

There are risks associated with borrowing to invest. Some of these include, but are not limited to rising interest rates, changes in taxation law and movements in the prices of your investments which may have an effect on your financial position. It's recommended you speak to a financial adviser before deciding to invest.

Many who have considered borrowing to invest in shares either experienced or are familiar with the very real losses that were inflicted upon those who used margin loans during the Global Financial Crisis, and have no other assets to use as security for an investment loan. This has previously made borrowing to buy equities and managed funds untenable.

Against this backdrop, nab has launched a new product called Equity Builder, which allows investors to borrow to invest in a range of managed assets; Managed Funds, ETFs, SMAs, LICs, without the risk of a margin call. This product is best understood as an investment loan with a fixed term and a traditional principal and interest schedule. Equity Builder is in fact very similar to an investment property mortgage. Borrowers pay the loan off over time, creating wealth in two ways:

1. Increased equity via the repayment structure and
2. Rising asset prices.

While many investors who gear prefer to pay interest only in order to maximise their tax deduction Equity Builder requires repayment of capital and is designed to achieve a fully paid investment over time reducing this LVR. This works particularly well where the investor has a specific goal to achieve.

Scenarios where this strategy could be appropriate are many.

Young investors saving for a home could consider borrowing and investing in the sharemarket with a term linked to their preferred purchase date for a property (eg 7 years). This has the advantage of giving the investor greater capital exposed to the market from day 1, and a deduction for borrowing costs such as interest during the term of the loan. This is a more tax effective strategy than simply saving in cash, particularly for higher income earners, and has the potential to create greater gains than a regular investment plan. As the loan will be repaid by the end of the term, the full value of the investment, less any capital gains tax payable, will be available to make a deposit on a home.

Young parents may use this strategy to save for private school fees or university tuition, targeting the year their children will commence their studies.

Pre-retirees who are no longer able to contribute to superannuation (having used their non-concessional cap or having exceeded their Total Super Balance cap of $1.6m) may also consider borrowing to boost their retirement savings using this strategy, with a loan term that expires at their preferred retirement date. For many, this strategy is another way to diversify their overall financial plan, giving them a tax effective way to access growth assets, without the risk of a margin call.

Obviously gearing is not without risk, and even with the repayment of principal over the loan term, losses will be magnified in the event of a market downturn, or asset devaluations. Investors who borrow should be comfortable with the risk they are taking, and understand that gearing magnifies both gains and losses in assets which can both increase and decrease in value. This sounds obvious but many have learned their risk tolerance through bitter experience, overestimating their comfort with loss.

Where Equity Builder differs from other structures is in its absence of margin calls, and its disciplined savings requirement, through the P&I structure. This allows investors to stick to their plan, without short term market volatility impacting on their long term investment goals.

For more information, visit **nabtrade.com.au/equitybuilder**

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Important Information

The information provided in this brochure is intended to be of a general nature only.

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