Financial **Focus**

Summer 2017

Welcome to Financial Focus. I hope you enjoy the articles and find them interesting and informative. If you have any feedback, questions, or would like to review your financial plan, please feel free to contact me.

Adviser Details

PHONE:

MOBILE:

EMAIL:

ADDITIONAL INFO:

Keys to de-stressing a mortgage

"Don't sail out farther than you can row back." This Danish saying is sound advice for anyone thinking of borrowing to buy a home, particularly now that interest rates are low and house prices are generally rising.

According to a paper[1] for the Centre of Policy Development and University of Canberra, Australians have a tendency to be over-confident in our ability to repay loans. We also underestimate the likelihood of things potentially going wrong in our lives.

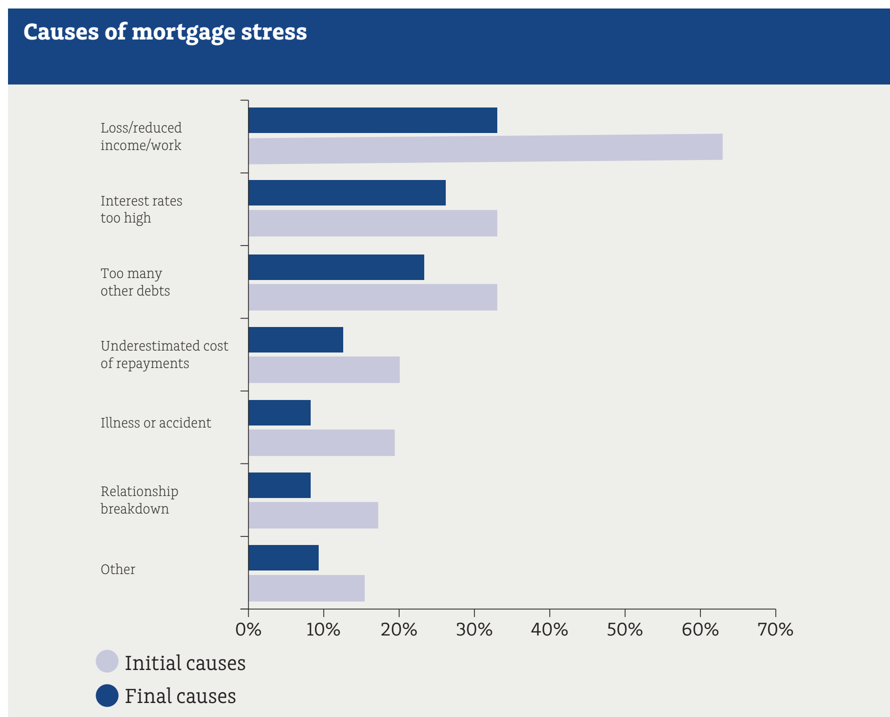
Have you ever heard yourself or someone else say "I'll be able to repay my loan, provided I keep my job, don't get sick and I'm not hit with any large unexpected bills"? Chances are you probably have. But things can and often do go wrong.

Causes of mortgage stress

A study[2] was completed for the Royal Melbourne Institute of Technology (RMIT), which looked at the specific triggers that have resulted in Australian households being unable to meet their mortgage repayments. Survey respondents were asked the initial causes and, if they changed, what the final causes were. They were also able to identify more than one cause. The graph on the next page shows the results.

[1] Understanding human behaviour in financial decision making: Some insights from behavioural economics. Paper to accompany presentation to No Interest Loans Scheme Conference "Dignity in a Downturn" June 2009. Ian McAuley, Centre for Policy Development and University of Canberra.

[2] Mortgage default in Australia: nature, causes and social and economic Impacts. Authored by Mike Berry, Tony Dalton and Anitra Nelson for the Australian Housing and Urban Research Institute, RMIT Research Centre, March 2010.



How to reduce stress

Like most things in life, it's difficult to make borrowing a stress-free exercise, but there are a few things you can do to reduce the angst.

1. **Don't borrow the maximum amount**
   Most financial institutions determine the maximum loan they will provide based on a multiple of your income and other factors. But if you borrow the maximum amount, you may find you are stretched from day one unless you are very disciplined with your budgeting.
2. **Build up a buffer**
   It's a good idea to hold (or build up) a cash reserve in a mortgage offset account to provide a buffer that can be drawn upon to meet your loan repayments if you become ill or are off work for other reasons.
3. **Take out mortgage protection insurance**
   Many lenders offer insurance when you take out a home loan that covers the mortgage (often up to a specified amount and for a particular period of time) if you die, become disabled or your employment ends involuntarily.
4. **Take out personal insurances**
   While mortgage protection insurance can provide peace of mind for a limited time frame, other types of insurances should be considered. These include:
   - **Income Protection Insurance** which can replace up to 75% of your income if you are unable to work due to illness or injury. This can ensure you are able to continue meeting the majority of your living expenses, not just your loan repayments.
   - **Critical Illness Insurance** which can help you service or pay off your loan and meet a range of expenses in the event you suffer a specified illness, such as cancer or a heart attack.
   - **Total and Permanent Disability Insurance** which can help you service or pay off your loan and provide an ongoing income if you become totally and permanently disabled.
   - **Life Insurance** which can be used to service or pay off your loan and provide your family with an ongoing income if you pass away.
5. **Fix the interest rate**
   Fixing the interest rate on your home loan can provide protection against rising interest rates. The downside is there are often restrictions on making additional payments into a fixed rate loan, which would limit your capacity to build up a buffer. Many people find a combination of fixed and variable rate loans works best, as additional repayments can be made into the variable rate portion of the debt.
6. **Don't add fuel to the fire**
   Over 40% of the people who completed the RMIT survey responded to the initial difficulty in meeting mortgage repayments by using credit cards more often than they normally would. Using debt to service debt is very likely to compound the problem.
7. **Seek advice**
   At the first sign of a problem, it's essential to seek financial advice, as there may be a range of potentially viable options to explore. Better still, you may want to seek financial advice before you decide how much to borrow.

   An adviser can help you assess your budget and determine your affordability level. They can help you to focus on other goals you may want to achieve in the short, medium and long term and the cash flow that may be required to meet them. They can also assess your insurance needs and advise you on a range of other financial matters.

Offset accounts: A better way to manage your mortgage

If you want to repay your mortgage quickly and still have easy access to your additional repayments, an offset account may be worth using.

What's an offset account?

An offset account is a transaction account that is linked to your home loan and the money you deposit in it offsets the loan balance before interest is calculated. For example, if you owe $400,000 on your home loan and have accumulated $50,000 in an offset account, interest will be calculated on $350,000.

Benefits over regular savings accounts

If you hold your surplus cash in an offset account you can save interest at home loan rates, and no tax is payable on the interest savings. This is effectively like 'earning' the home loan interest rate tax-free.

Alternatively, you could hold your surplus cash in a regular savings account but the interest rate you earn is usually much lower than what you pay on your home loan. Plus, every dollar in interest you earn is taxable at your marginal rate, which could be up to 47%[1].

Benefits over direct loan repayments

When you make additional repayments directly into the loan you can achieve similar benefits to having an offset account. However, limits often apply to the frequency and amount of withdrawals you can make and withdrawal fees are usually charged. With offset accounts, you typically have ready access to the money via an ATM, cheque book and internet, and withdrawal fees are generally not charged.

[1] Includes the Medicare Levy.

The best of both worlds

You may even want to have your salary paid directly into an offset account and withdraw money as needed to meet your living expenses. This can enable you to make the interest savings available with direct loan repayments and have easy access to your money.

	What interest rate is earned/saved?	Would interest earned/saved be taxable?	Would you have ready access to the money?
Cash account	Deposit rates	Yes	Yes
Direct loan repayment	Home loan rates	No	No
Offset account	Home loan rates	No	Yes

Other things to consider

- If you'd prefer not to have easy access to your additional loan repayments, you may want to make repayments directly into the loan where you are less likely to spend the money impulsively.
- If you would like to credit your salary into an offset account, you should check that your payroll provider is able to do this.
- Some lenders allow you to establish multiple offset accounts to help you better manage your cash flow.
- Some lenders pay an interest rate on the balance of the offset account that is less than the home loan rate. These are known as 'partial' offset accounts and are not as effective in saving you interest as an offset account which offsets 100% of the home loan interest rate.
- Offset accounts can usually only be linked to loans with variable interest rates, not fixed rate loans.
- To maximise your interest savings you may want to pay for the majority of your living expenses on a credit card and repay the card in-full before the end of the interest-free period. This enables you to use the credit card provider's money to fund your living expenses, while applying your own funds to reduce your average daily loan balance.
- If you want to invest some of the money held in an offset account, you should consider paying the money directly into your home loan and establishing a separate loan to fund the investments. By taking out a new loan for investment purposes, the interest would usually be tax deductible.

Why you may want to take another look at margin loans

Margin lending can offer you considerable flexibility to build your investment portfolio, just the way you want it.

A margin loan is a little bit like having an overdraft for investments, says Adrian Hanley, NAB's General Manager of Self Directed Wealth. It means you have a revolving line of credit – an amount of funds you can use to purchase shares (domestic and international) and other investments whenever it suits you.

Just like an overdraft, a margin loan gives you the flexibility to invest in the latest stock market opportunity, whether you have the spare cash or not. And just like an overdraft, it's possible to pay down your debt as soon as possible to avoid paying unnecessary interest.

Securing your loan

The big difference is that your margin loan is secured by shares or managed funds, and how much you can borrow will depend on their 'security value'.

To buy a home worth $500,000, you might borrow $400,000 to help pay for it. That's because the home is the security for your loan and the bank is only prepared to lend you a percentage of the house's value, in this case 80 per cent or $400,000.

In a similar manner, if you wish to buy $500,000-worth of shares in a blue-chip company, a margin lender may be prepared to lend you 80 per cent of the total amount (or $400,000), based on the security value of your portfolio of shares.

The main difference here is that while the security value of your home is fixed, your margin lender will revalue your shares on a daily basis, to make sure the security value doesn't fall below the lender's requirements.

Purchasing power

In addition to giving you considerable flexibility, a margin loan can improve your portfolio liquidity and diversity.

"Lots of people are faced with a dilemma when an opportunity presents itself," Hanley says. "Do I have to sell some of my existing shares to take advantage of this other investment opportunity or can I simply borrow against my existing shares and take advantage of that new opportunity?"

Of course, it can also help you build your exposure to the stock market.

"You can borrow $100,000 against your existing share portfolio and turn a $100,000 portfolio into a $200,000 portfolio," Hanley explains.

You don't have to stop at equities, though. The terms of a margin loan allow you to use part of the loan to fund investment activities outside the share market.

Positive gains

There are potential tax benefits as well. Maybe you have shares that have risen in price but you happened to purchase them less than a year ago. Says Hanley: "You might be sitting on quite a nice capital gain but if you sell the shares now, because you've held them for less than 12 months, you're not going to be able to get the capital gains tax concession."

A margin loan may enable you to delay selling them. And there's another advantage to consider.

"As an individual, if you borrow funds in Australia," Hanley explains, "and you're using those borrowed funds to invest in an asset with the ability to generate assessable income, then you may be able to claim a tax deduction in the same way people do who've borrowed funds to purchase an investment property."

As with all things tax, you need to consult your own adviser, as these comments are general in nature only.

Often it's the case, however, that people who take out margin loans don't end up being negatively geared, Hanley says.

"This is because of the healthy yield environment in Australia when it comes to investing in shares. A lot of people who borrow money in Australia have portfolios that are positively geared."

Mind the gap

Shares don't always go up and there is a risk that the value of your share portfolio will start to drift downwards instead.

"If that happens, a margin lender will allow you to have a small value deficit, which is called a buffer," Hanley says. "But if you go below that buffer you can have a margin call. It's not a default event; it's a notice from the lender that you have to bring your portfolio back into line."

You have the choice of injecting additional cash into your loan or increasing your security's value by including more shares, he says. You can also choose to sell some of your shares.

"Typically customers inject more cash," Hanley adds.

Room to move

Most people don't reach that point, however.

"People who take out margin loans in Australia, will typically exercise a level of conservatism," Hanley says. "So, while they like the idea of increasing their exposure to the share market, they'll do it in a way that will leave them enough room to absorb any fluctuations or volatility in the share market."

It may be worth it for a little peace of mind, but everyone's circumstances are different, so talk to your financial adviser about whether this type of investment is suitable for you.

Important information and disclaimer

This Financial Focus newsletter has been prepared by GWM Adviser Services Limited (ABN 96 002 071 749, ASFL 230692) ('GWMAS'), a member of the National Australia Bank group of companies ('NAB Group'), Registered office 105–153 Miller Street, North Sydney 2060, for use and distribution by its authorised representatives and the representatives or authorised representatives of National Australia Bank Limited, Godfrey Pembroke Limited, Apogee Financial Planning Limited, Meritum Financial Group Pty Ltd and Australian Financial Services Licensees with whom it has a commercial services agreement.

Any advice in this publication is of a general nature only and has not been tailored to your personal circumstances. Please seek personal financial and/or legal advice prior to acting on this information. Any general tax information provided in this publication is intended as a guide only and is based on our general understanding of taxation laws. It is not intended to be a substitute for specialised taxation advice or an assessment of your liabilities, obligations or claim entitlements that arise, or could arise, under taxation law, and we recommend you consult with a registered tax agent.

Information in this publication reflects our understanding as at the date of issue. In some cases the information has been provided to us by third parties. While it is believed the information is accurate and reliable, the accuracy of that information is not guaranteed in any way. Opinions constitute our judgement at the time of issue and are subject to change. Neither GWMAS nor any member of the NAB Group, nor their employees or directors give any warranty of accuracy, nor accept any responsibility for errors or omissions in this document. A139599-1117

working with nab