SHAREMARKET

PORTFOLIO CAN PAY BIG DIVIDENDS

Enjoy the best of both worlds: once your home loan is under control, set up a regular investment plan – and even borrow extra funds – to increase your long-term wealth.

JO McCREERY

Paying down your mortgage as fast as you can – faster than minimum repayments – is a great investment plan that can save you thousands in interest costs over the term of your loan.

However, if your mortgage is at a comfortable level – so that you could afford an interest rate increase or a period where, if you are a couple, one of you is between jobs – then it's worth thinking about broadening your investment strategy.

Saving for short-term goals is best done in your mortgage offset account, but if you are willing to invest for the long term (more than 10 years) then a share portfolio is a great option. Investing regularly – say monthly – into a portfolio is also a good way to mitigate risk. This way you invest in the ups and downs of the market, reducing the risk of buying at just the wrong time.

Set up a savings plan

1. INVESTMENT PLATFORM

The best way to save is to automate the process so that it happens monthly, without you having to think about it. The easiest and cheapest way is to invest via a platform that offers a range of managed funds, allowing you to easily diversify your investment. This is also an excellent way to control risk.

Choose one that offers a monthly savings plan with no transaction fees. You will pay the buy spread on the underlying funds, but that cost would be no more than 80¢ on a $400 investment (compared with $10 to $30 brokerage per transaction, if you invest directly into the sharemarket).

You also pay fund management and administration fees ranging from about 0.7% to 1.2% a year ($35pa to $60pa on an investment of $5000), depending on the funds you choose. Fund managers such as Colonial, BT, MLC and Macquarie all have platforms that you can open with $5000 or less and that offer monthly savings plans.

As your initial investment, I would choose either a diversified index fund or a combination of indexed and global share funds, depending on your risk profile.

Indexed strategies are low cost and have low taxable gains on an annual basis (allowing you to defer a lot of the capital gains tax until you sell the investment). Having some Australian shares in the mix will provide you with some franking credits, which helps reduce the tax on income.

This is a really easy way to build an investment portfolio. You do pay the platform provider an administration fee, but for many people it will be well worth the convenience, and for savings plans that start small it will also be cheaper than investing via a share trading account.

2. SHARE TRADING ACCOUNT

An alternative to using an investment platform is to invest directly in shares or exchange traded funds (ETFs) through a share trading account. This is a more hands-on approach that can't be set on autopilot like the platform option. There is no automated way to do this, and to minimise brokerage I would recommend building up funds in a savings account and then investing every quarter or six months. You should also be prepared for a fair amount of mail associated with the investment (dividend and holding statements, etc).

If you choose to invest directly and your portfolio is starting out relatively small, I would go for a broadly diversified exchange traded fund such as the Vanguard Diversified Growth Index ETF (ASX: VDGR, fee 0.27%pa). Once your savings grow, you could add other funds such as the BetaShares Australia 200 ETF (A200, 0.07%pa) for a broad Australian share exposure and the Vanguard International Shares Index Fund (VGS, 0.18%pa) for global developed market shares.

Those who are risk tolerant could also consider an emerging market fund such as iShares MSCI Emerging Markets ETF (IEM, fee 0.69%pa). To reduce the risk in your portfolio, you can add some investment-grade bonds via an ETF such as the Vanguard Australian Fixed Interest Index Fund (VAF, fee 0.24%pa).

There are also actively managed listed funds that give you exposure to a more select portfolio of shares, and some of these funds should do better than an indexed fund over the long term. But if they are high-turnover strategies, you may find they also result in you having to pay more tax on the annual distributions than with indexed funds. These types of funds need to be chosen with care and reviewed periodically.

POTENTIALLY INCREASE LONG-TERM RETURNS BY ALSO INVESTING BORROWED FUNDS

With either of these approaches, you can potentially increase your long-term return by investing borrowed funds alongside your savings. I prefer to use home equity loans rather than a margin loan because the interest rate is usually much lower.

You would have to wait until you have some equity in your home and then ask your bank to create a new loan account that you use only for investment purposes. To keep it simple, you could add a deposit from your home equity loan to your investment portfolio each year.

Naturally, borrowing to invest is a lot riskier than investing savings, and if there's a sharemarket fall you could find you have more debt than equity. So if you're not highly risk tolerant, keep the level of debt low compared with the amount invested.

IS THE OUTCOME LIKELY TO BE BETTER THAN JUST PAYING DOWN YOUR HOME LOAN?

Achieving a successful outcome for this borrowing-to-invest approach will depend on a number of factors:

- You stay disciplined with the investment – don't sell shares when there's a dip. Stay focused on the long term and keep adding to the investment regularly.
- Your long-term portfolio returns, after fees and tax, are higher than your mortgage rate.

To put some numbers to this approach, we will assume:

- You have a $400,000 loan with a 30-year term at an interest rate of 4.5%pa.
- You have $100 a week to invest in a portfolio (or you could use that to increase your loan repayments).
- Strategy 1 – pay more into your loan, then when it has been paid off early, invest the repayment amount in an investment portfolio earning 6%pa after fees and tax until the original end date of the 30-year loan.
- Strategy 2 – make minimum repayments on your loan and invest $100 a week into a portfolio earning 6%pa, after fees and tax, every year for 30 years.

The chart compares the two strategies – it shows the addition of the value of the loan remaining and the investment account balance. Given the assumptions, Strategy 2, investing from the start, provides a better outcome. Note that, in reality, investment returns are not this smooth and there will be times when your portfolio value falls and other times when it increases by more than 6%pa. You should also be aware that the right investment strategy for you will most likely change over time as factors such as your time to retirement, mortgage rates, your disposable income and your risk profile change.

The table compares the final outcome under different return scenarios. It shows that if you earn only 4%pa, you would have been better off simply paying down your home loan.

The table also shows that gearing can potentially increase your return, but it also increases the risk. In the case that returns are only 4%pa and you had borrowed to invest, you are a lot worse off than you would be by just saving without borrowing. If, however, you earn 6% or more a year, it's a worthwhile strategy.

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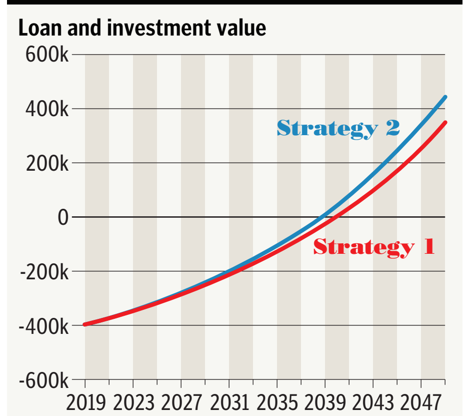
Note that this is general advice and you should consult a financial adviser about how appropriate these strategies may be for your own situation.

Power of investing



How to get ahead

	Saving from the start is ahead by:	
Investment return after fees and tax	No borrowing to invest	Borrowing to invest
4%	-$19,329	-$67,821
5%	$22,330	$5056
6%	$75,893	$97,855
7%	$144,284	$215,494

Assumptions in the borrowing scenario: you borrow $52,00pa and invest that in your portfolio as well as saving $100pw ($5200pa); the loan interest rate is 5%pa and you pay the interest from your investment account. Note that there is likely to be capital gains tax payable when you sell down your investment portfolio. This can be mitigated to some extent through a staggered selldown.