KABEL CONNECT

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"INVESTMENT GEARING - DOES IT STILL MAKE SENSE?"

PAGE 2

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In our last newsletter we addressed how you could improve your financial position with low and medium levels of financial activity (additional super contributions and /or mortgage repayments). In this newsletter we look at gearing – what we categorize as a "high" level of activity, and whether it is a strategy worth considering.

Global Outlook

Currently interest rates are low with forecasts of a slow, steady rise. Property markets (in Sydney in particular) are starting to cool. Equity markets are artificially high with views that this might continue if global markets survive the twitter-happy President in the US, political games in Europe and the empowered North Korean Leader, Kim Jong Un. Global economies are performing well, which may suggest that equity earnings may continue at current levels.

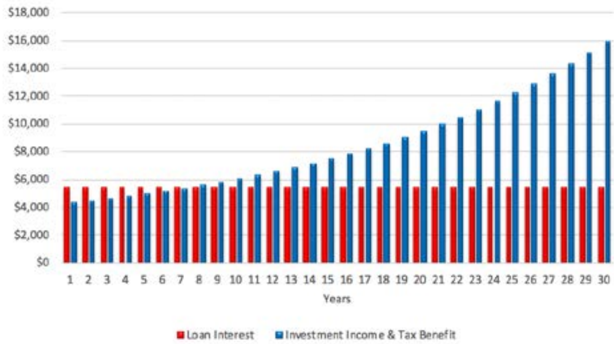
Investment Gearing - does it still make sense?

Investment gearing strategies have made sense in the past, so is the argument for this potentially high-risk strategy still compelling? As with most financial planning strategies the answer is…it depends!

The concept behind cashflow gearing is the treatment of the investment (property or shares) as a "business" and not a speculative "bet". The objective is to derive an increasing profit stream after expenses. Central therefore to this strategy are earnings/profit growth and interest rates. Without earnings growth a gearing strategy will consistently lose money – where then, is the return for taking the risk?

The following graph shows the possible return using a gearing strategy.

Cashflow Gearing - Investing for Profit



Assumptions include: Original investment = $100,000 Interest rate = 5.5% Dividend Income = 3% 50% franked Growth = 4.5%

You can see that until year 8 the interest expense is higher than the return, and it is the cumulative effect of compound growth that makes this strategy worthwhile in the long term. Should interest rates rise it could take longer than 8 years for the 'cross over' to happen.

Factors to Consider

The following questions should be considered before you commit to any gearing strategy.

1. Do you understand and accept the risk involved with this strategy, and is it a necessary pathway for you to achieve your financial goals?

2. Are you prepared to be an investor with a 10+ years' time-frame to realise the benefits or are you a speculator focusing mainly on short term asset price appreciation?

3. Do you have access to meaningful levels of debt and sufficient cashflow/savings capacity to make it happen?

4. Do you have reliable, consistent income?

Case Study

Now, revisiting the scenarios from our previous newsletter, the table below shows the potential financial situation improvements based on our four active strategies.

Active Strategies	Details	Improvement
Low	*Scenario 1:* Minimum super contributions, pay off mortgage asap and then maximise super contributions when mortgage is repaid.	0% (base case)
Medium	*Scenario 2:* Make minimum mortgage repayments and maximise super contributions via salary sacrifice.	22%
High	*Scenario 3:* Make minimum mortgage repayments, maximise super contributions via salary sacrifice and commence an investment gearing plan.	44%
Very High	*Scenario 4:* As with Scenario 3, but constantly increase level of investment gearing through debt recycling.	60%

For details on Debt Recycling, please speak to us.

Assumptions include: Client 1 earning $120,000 pa, Client 2 earning $50,000, Living expenses excluding mortgage $70,000, Salaries and expenses increase at 3%, Mortgage = $500,000 with 25 years remaining, Original investment = $200,000 Interest rate = 5.5% Dividend Income = 3% 50% franked Growth = 4.5%, Superannuation return 6.9%.

> The concept behind cashflow gearing is the treatment of the investment as a BUSINESS and not a speculative BET.

Small Steps

If the idea of gearing appeals but you are uncomfortable with or can't borrow additional funds, you can invest in internally geared funds. Here the fund manager borrows and invests on your behalf.

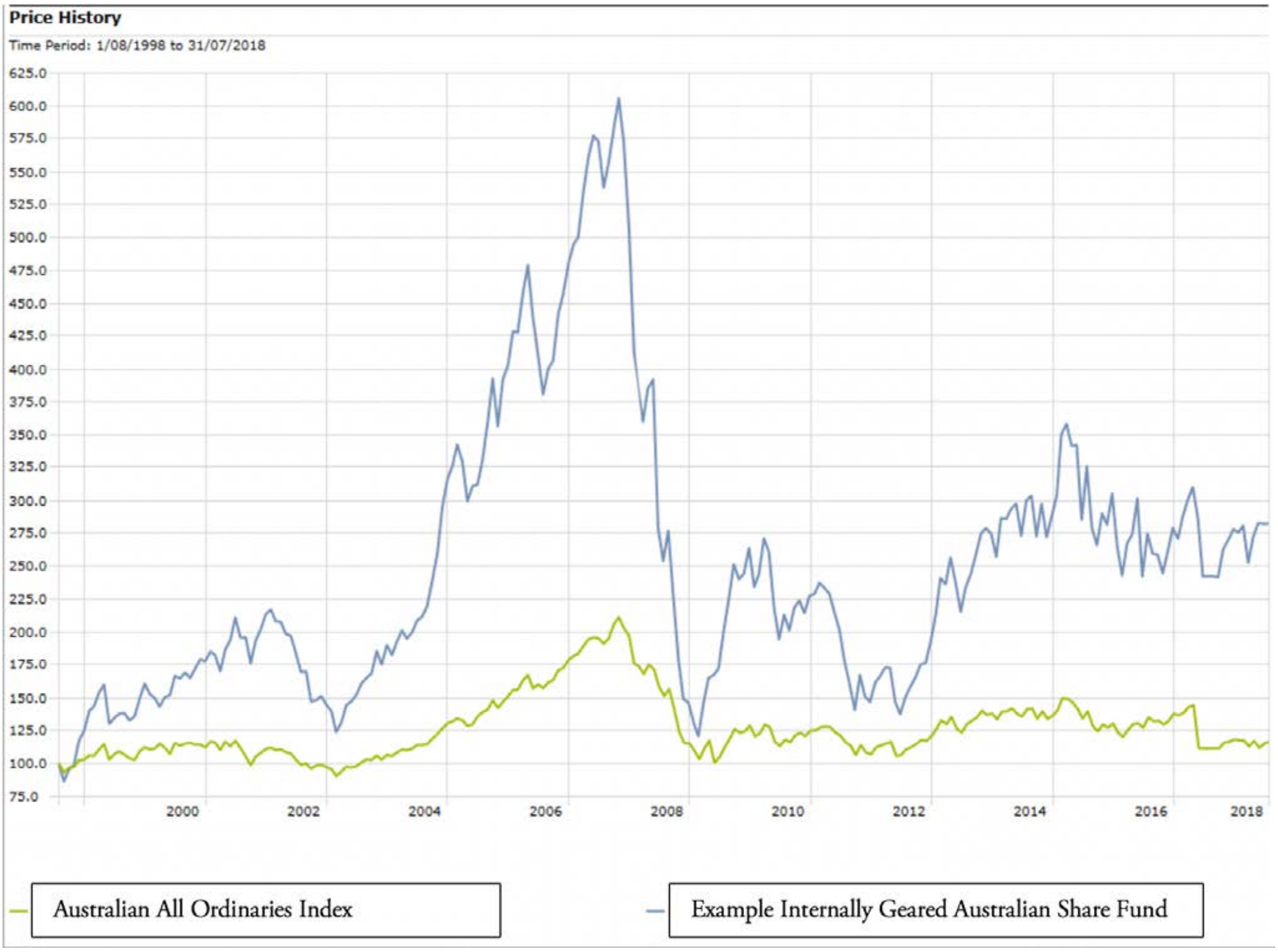
The advantages of this are:

- Simple and easy.
- Potential additional return.
- Only your capital is at risk (you are not liable for the borrowed money should share markets crash as would be the case if you invested directly)
- The fund manager can borrow at lower wholesale rates potentially leading to better returns

The disadvantages are:

- No control over how much money is borrowed – the level of gearing
- Higher fees
- Low diversification (generally they only invest in one or two managers)
- Increased volatility – the chart on page 5 shows the growth and volatility of one of the internally geared investment managers that Kabel recommends compared to the Australian All Ordinaries Index.

Growth and volatility of a Kabel recommended geared investment manager vs. the Australian All Ordinaries Index.



Sourced from Morningstar Direct.

Conclusion

In summary, gearing can be a useful strategy to help achieve your financial goals. Serious consideration needs to be given to whether the additional risk is necessary but once implemented correctly, it doesn't need to give significant short-term savings pain in order to provide a long term reward, which can be as high as 20% to 30%[1] in your financial position at retirement.

[1]The level of improvement will depend on many variables including: level of gearing, level of other retirement resources, time-frames, use of investment funds at retirement etc.

It is a question of how ACTIVE you want to be with your financial strategies.

Changing of the Guard at Kabel

We are a group of dedicated advisers, working as one team to form Kabel Financial Services.

Welcome Jeremy

An introduction and welcome to Jeremy Rankin, who is an experienced Financial Adviser and has joined the Kabel team from Regional Financial Solutions Pty Ltd. He will complement and be an asset to our team, with Irene and Jossel winding down their hours.

Jeremy is married with 2 children and is a running enthusiast, having recently completed the 100 km run in the Blue Mountains.

He will be sharing some of his stories in our next Newsletter.

Farewell Marion

It's farewell to Marion. After 5 years with Kabel, Marion has decided to retire from her job sharing role in Reception.

She has done a great job over the last few years, one of her many achievements being to keep all the office plants alive and well!

Marion's time is already fully taken up with her many hobbies, which include walking, gardening and creating beautiful quilts.

Jump on board Jasmin

We welcome Jasmin Buchanan who joined us in May of this year to take over the job-share role with Kathy in Reception.

Jasmin worked as a Legal Secretary prior to having 3 children. She returns to the workforce after a 13 year hiatus.

She enjoys family time and loves to play tennis as often as she can.