Debt recycling

The secret to building wealth

The great Australian dream is to own a home but really it should be to own a home and have no mortgage. SARAH ROGERS looks at a simple strategy called debt recycling designed to help you pay off your home faster whilst building your personal asset base.

Whatever stage of life you are at or whatever your unique situation, if you have a mortgage the number one goal is to pay off that mortgage.

If you have owned a home for a few years now and have diligently been making repayments, chances are you have built up some equity, which is the difference between the value of your house and how much you owe on it. The money that is paid off your mortgage can be working harder for you, without increasing your monthly expenses. This can be done by releasing some of this equity, for example, using the equity as a deposit to purchase an investment property and then borrowing the difference. Effectively this means you could buy another property without being out of pocket.

The property type you will be looking to purchase with this strategy is a positively geared property. A positively geared property is when the rent you receive from the property covers all of the expenses related to the property such as the mortgage, insurance and rates. Then after the expenses are paid, ideally you will have a surplus left over which you can use to pay off the home that you live in.

There will be a loan for the cost of the house and the costs involved in purchasing that property, which should be set up as an interest only loan.

The aim of this is to keep the loan for the investment property as high as possible, while paying any extra off the house you are living in, to reduce your non-tax deductible debt.

The debt-recycling strategy can be accelerated the more you pay off your home. This is because you are building more equity, which in turn may give you the ability to repeat the process by purchasing another investment property. However, your ability to purchase investment properties doesn't rely only on the equity you have available, it also relies on your ability to repay the loan; this is called serviceability.

Serviceability is determined by your income and expenses, and the more equity you have the more properties you are able to purchase. This should increase the amount of surplus cash you have from the properties thus increasing the amount of extra repayments you can pay off your home, leaving you debt free faster. Plus there is an extra benefit – any of the costs associated with the investment property, including interest costs, maintenance costs, insurance costs, are tax deductible.

This strategy also gives you the ability to increase your wealth. From investing in residential properties, you receive two forms of return: the yield or income which is the rent you receive from the property, and also the growth of the property. This is when the value of your property increases over time.

This means, rather than having one asset which is growing in value, for example, the family home, you may have two, three or even four properties that are growing in value. Although you are not paying down the loan on the investment properties because you are using the surplus to pay your home off faster, in principle these properties will be rising in value.

This can leave you with a substantial portfolio in the long run and once your home is paid off you can begin paying down the loans on the investment properties with the income they are producing through rent. This rental income is generated with no real effort of your own and is what is known as residual or passive income, which can set you on the path to becoming financially free. ■

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