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Q 1: I have a small share holding valued at around $3,000. Should I add to these shares and build a share portfolio or should I sell these shares and put the money onto my mortgage?

J.N., DUFFY

A 1: Many people own parcels of shares due to company floats or demutualisations in the past 20 or so years including Woolworths, Commonwealth Bank, AMP, Telstra, NRMA to name a few, and what to do with these shares is a common consideration.

If you did sell your shares and apply the proceeds to reducing your mortgage then you would be guaranteeing yourself an investment “return” on these proceeds equivalent to your mortgage interest rate, say, 6%. Further, this interest return will not be subject to tax thus creating an after tax return.

While we expect a long term average return from share based investments of some 10% pa after all taxes - which is higher than the effective return when placing proceeds on your mortgage - there is a risk associated with achieving share returns. While the sharemarket as a whole should produce long term returns of some 10% pa, we never know how individual companies will do. The company of your particular shareholding may do better than this, or, at the other end of the scale, the company could collapse leaving you with very little.

You could decide to sell your shares and apply the proceeds to your mortgage. Then you could continue to apply any future cashflow surpluses and savings to paying down your mortgage aswell. Once your mortgage is paid off in full then you could start directing your savings to building an investment portfolio in a more diversified way by investing in managed funds. The downside of this strategy is that it could take many years to pay off a mortgage, decades in fact.

A strategy to allow you to take advantage of time is to borrow funds to invest now. While your cashflow would reduce due to the fact that you are paying interest on a new loan, and the result would be that your mortgage would be paid off slower, the upside is that you have used leverage and time to gain exposure to an investment that should grow even more over time than the cost of the loan.

For example, if you took a loan for $100,000 to invest in a ‘high growth’ managed fund expected to return some 10% pa, and your loan interest was 6% pa, then it would cost you around $6,000 pa in cashflow to hold this loan for 1 year. During this time your portfolio would be expected to increase by some $10,000. After allowing for taxes you should be a few thousand dollars ahead. While this does not sound like a lot, the real benefit comes from the compounding benefits that come over time.

So, the idea of borrowing money to invest in a share based portfolio is fine, so long as you are prepared to hold the portfolio for the long term, ideally 10 years or more. This long term

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timeframe is critical to allow you to benefit from the compounding effects for your returns, and also to allow you to be able to hold the portfolio long enough to 'ride through' any downturn in investment markets.

Phil Thompson is a certified financial planner and authorized representative of Rise Financial Pty Ltd (ABN 86350987645), AFSL 311718, an Approved Financial Planning Association Professional Practice. Answers should be used as a general guide only and professional advice should be sought before making investment decisions.

Send your financial questions to phil@risefinancial.com.au

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