



Royston Capital

Technical and Strategy Update

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Offset Account or Investment Portfolio

Introduction

Debt can be a powerful tool in achieving your financial and lifestyle goals, but its effectiveness depends on how it is structured and managed. Certain types of debt, such as those used to acquire income-generating assets, can be more advantageous, often allowing for tax-deductible interest costs and potential capital appreciation. In contrast, debt incurred for non-income-producing assets—such as a home or a car—typically offers no tax benefits and can hinder long-term wealth accumulation if not carefully managed. An offset mortgage bank account provides a strategic solution by enabling borrowers to use surplus funds to reduce interest costs while maintaining access to liquidity. By optimising cash flow and maximising loan repayments, individuals can minimise inefficient debt and enhance their overall financial position.

When managing a mortgage, homeowners are often presented with the decision of how best to utilise the funds available in their offset mortgage loan account. One of the key benefits of an offset account is its ability to reduce the interest costs on a loan. However, borrowers also face the opportunity to use the cash for other purposes, including investing. Deciding between leaving the funds in the offset account to minimise interest payments or utilising them for investment purposes requires a careful analysis of personal financial goals, risk tolerance, and the potential returns from investing.

Understanding the Offset Mortgage Loan Account

An offset mortgage loan account is a type of transaction account linked to a mortgage loan. The balance of the offset account is subtracted from the outstanding loan amount when calculating the interest charged. For example, if you have a mortgage balance of \$500,000 and \$50,000 in your offset account, the interest will only be calculated on \$450,000. This can lead to significant savings in interest over time, as the money in the offset account directly reduces the amount of principal on which interest is paid.

An interest rate of 6.25% may require an individual to achieve investment returns of more than 11% just to breakeven.

The major advantage of this arrangement is that it offers a flexible way to reduce the interest cost of the loan without the need to make extra payments toward the principal. The funds in the offset account are typically accessible, meaning you can withdraw or transfer them if needed. This flexibility makes it an attractive option for many homeowners.

The Case for Leaving Cash in the Offset Account

Leaving the cash in the offset account and using it to reduce the interest on the loan is a conservative strategy that minimises financial risk. The primary benefit of this approach is the immediate reduction in the amount of interest paid on the mortgage, which can lead to substantial long-term savings and early repayment of a home loan. Given that mortgages often have relatively high interest rates, the interest savings can far exceed the returns from many low-risk investments.

For example, if a homeowner has a mortgage interest rate of 6.25% and \$50,000 in their offset account, they are effectively saving 6.25% annually on that \$50,000. In comparison, low-risk investments such as term deposits or government bonds often offer returns in the range of 3%-4% per year. In this scenario, the homeowner would be better off keeping the money in the offset account rather than seeking investments with lower returns.



The Case for Using Cash for Investment

On the other hand, using the funds in the offset account for investment purposes could provide higher returns than the interest saved on the mortgage. This approach is particularly attractive if the homeowner is seeking to build wealth over the long term and is comfortable with taking on more risk.

Investing in assets such as stocks, managed funds, real estate, or even starting a business could offer returns significantly higher than the interest saved on the mortgage. For example, the average return on a diversified portfolio of stocks has historically outpaced the returns from reducing mortgage interest. However, investing also comes with risks, as the value of assets can fluctuate. Therefore, homeowners must weigh the potential rewards against the risks involved.

Additionally, investments typically come with time horizons and liquidity constraints, meaning that money tied up in investments may not be easily accessible if urgent financial needs arise. Homeowners who choose this path should carefully consider their financial goals and risk tolerance before diverting funds from the offset account to investments.

Making the Decision

Ultimately, the decision to leave cash in the offset account or use it for investment purposes depends on individual circumstances. Homeowners who value financial security, want to minimise debt, and prefer a conservative approach may find it more beneficial to use the funds to reduce their mortgage interest costs. Conversely, homeowners who are comfortable with risk and are focused on long-term wealth accumulation may choose to invest the funds, provided they are confident that the returns will exceed the mortgage interest rate, after tax.

Before deciding, it's essential to consider factors like your mortgage interest rate, cash flow needs, tax implications, and financial time horizon. Understanding these key points can help you make an informed choice to maximise your financial benefits and achieve your goals.

Potential benefits of maintaining funds in your offset account

An offset account offers several compelling benefits for managing your finances. Every dollar in the account directly reduces the interest charged on your mortgage, effectively providing a guaranteed return equal to your home loan's interest rate; for instance, a 6.25% mortgage rate translates to a 6.25% return on your offset balance. Unlike investments, which are subject to market fluctuations, this approach carries zero risk, ensuring consistent savings and peace of mind. The funds in an offset account remain highly accessible, allowing you to withdraw money for emergencies without penalties or delays. The following illustrates the interest saved when leaving cash inside the offset account:

	Offset Account Example 1	Offset Account Example 2
Mortgage Balance	\$1,000,000	\$1,000,000
Offset Bank Balance	\$0	\$300,000
<i>Effective Mortgage Balance</i>	\$1,000,000	\$700,000
Interest Cost (6.25%)	\$62,500	\$43,750
Interest Saved per annum	\$18,750	

Benefits of Investing Instead

Using cash from a mortgage offset account to invest in a share portfolio offers the potential for higher returns compared to the guaranteed savings on mortgage interest. While the offset account provides a risk-free return equivalent to your home loan's interest rate, investing in shares has historically delivered average annual returns of 10%+ over the long term. This return potential is driven by capital growth and dividend income from equities, which can compound over time. However, unlike the certainty of interest savings, share market returns come with risks, including market volatility and the possibility of loss. For those with a long-term investment horizon, a well-diversified share portfolio can provide significant growth opportunities, potentially outpacing the benefits of keeping funds in an offset account.

When deciding between keeping money in an offset account or investing, several factors should be considered. Tax implications play a critical role, as investment returns will be subject to income and/or capital gains tax, whereas savings from an offset account are tax-free.



Required Investment Returns

Let's say you earn a salary of \$150,000 per annum and you have a mortgage on your primary residence with an interest rate of 6.25%. If you were to redirect your offset funds into investments, you would need an investment return of 9.19% per year just to break even, after paying tax.

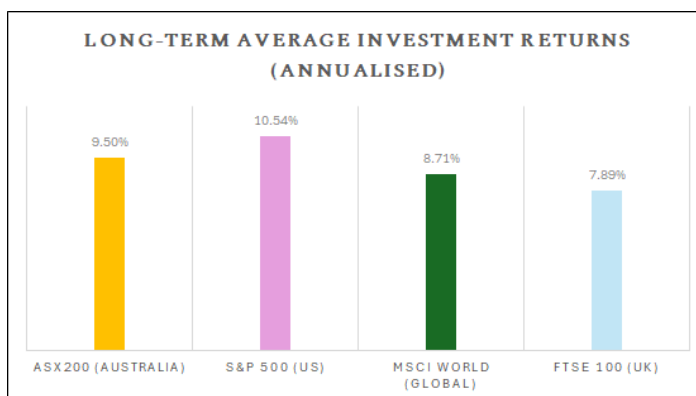
Income	Tax Rate	Investment Returns Required
\$20,000	16%	7.44%
\$50,000	32%	9.19%
\$100,000	32%	9.19%
\$150,000	39%	10.25%
\$190,000+	47%	11.79%

For individuals with an assessable income exceeding \$190,000, this breakeven requirement climbs beyond 11%. This is based on a 1-year simple interest calculation and doesn't include the impact of compounding which can reduce the hurdle rate.

Long-Term Investment Returns

To achieve annual investment returns exceeding 10%, investors typically need to allocate a significant portion (or all) of their portfolio to growth-oriented assets like equities. While these assets offer the potential for high returns, they are often subject to short-term volatility.

The graph summarizes the average annual returns of major market indices over the past 20 years, with the U.S. S&P 500 leading at an annualized return of 10.54%.



The graph identifies that when interest rates are high, even when investing in shares through an index-based approach, it may not provide sufficient returns to achieve a positive outcome. Careful investment planning and advice should be considered.

What Happens When Interest Rates are Reduced?

In a high-interest rate environment, achieving significant returns becomes challenging due to the increased cost of borrowing and the reduced attractiveness of riskier investments. However, the landscape could shift with the prospect of interest rate cuts anticipated during 2025. Lower interest rates generally reduce borrowing costs and thus mortgage interest payments. This can lead to lower investment return hurdles to achieve profitability.

Investment Strategy

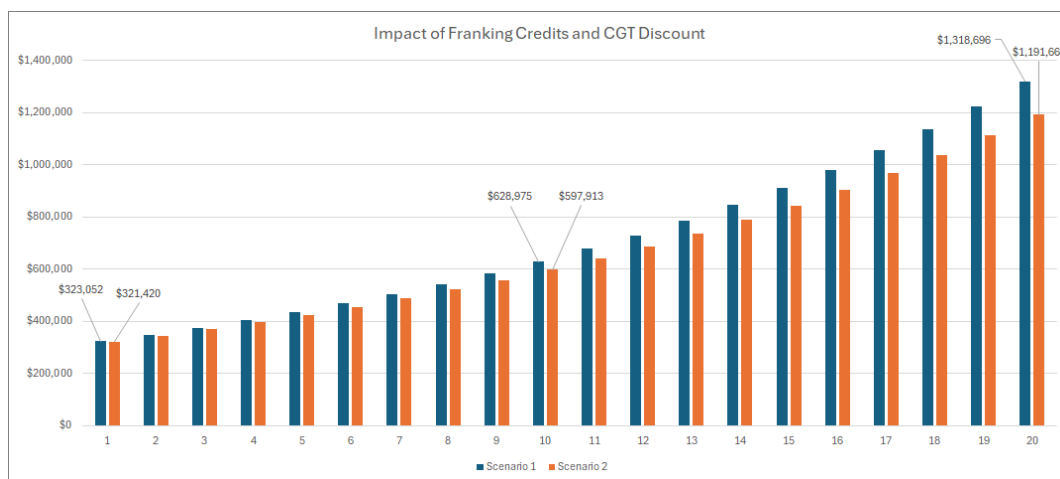
Having the right mix of investments in the investment portfolio can have a material impact on overall performance. Including assets that provide franking credit and qualify for the Capital Gains Tax (CGT) 50% discount (when holding assets for more than 12 months) will positively impact on the investment returns.

We consider the following scenarios of 2 portfolios; both returning 10.50% per annum. In the first scenario, the portfolio benefits from 100% franking credits, and all investments qualify for the 50% capital gains tax (CGT) discount. In contrast, the second portfolio has no franking credits and does not receive the CGT discount.

	Scenario 1	Scenario 2
Investment Portfolio	\$300,000	\$300,000
Tax Rate	32%	32%
Dividends	3.50%	4.50%
Capital Gains	4.90%	6.00%
Total	10.50%	10.50%
Franking	100%	0%
Capital Gains Discount	Yes	No



Over a 20-year period, the difference in portfolio performance has compounded to approximately \$125,000, highlighting the significant impact of tax-efficient investing. The different investment strategy has resulted in reducing tax and allowing more capital to remain invested and grow. The power of compounding amplifies these benefits over time, demonstrating how strategic portfolio construction can lead to substantially higher wealth accumulation in the long run.



Conclusion

Using cash in the offset mortgage loan account for investment or leaving it to reduce the interest cost is a decision that requires careful consideration of the potential benefits, risks and economic landscape. By evaluating individual financial goals, risk tolerance, and the expected return on investments, homeowners can make the most effective choice for their financial future.

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