Managing Your Personal Liabilities

NEVENKA VRDOLJAK, Director, Investment Analytics
DAVID LASTER, Director, Investment Analytics
ANIL SURI, CIO, Multi-Asset Class Modeled Solutions

Credit is a basic part of financial life. Nearly three in four affluent families hold a mortgage, and one in three carries credit card debt (Exhibit 1). Yet people often devote far less thought to their debt than to their investments. Many use credit inconsistently or, worse, reactively.

Though credit is ubiquitous, professional guidance on how best to manage it is scarce. To help fill this void, this paper presents issues to consider in managing your personal liabilities in the context of your “personal balance sheet” (Exhibit 2). As such, it is part of Merrill Lynch’s disciplined Goals-Based Wealth Management approach to achieving your financial goals.

Exhibit 1: Liabilities of Affluent Americans

Exhibit 2: Personal Balance Sheet: Categories and Examples

KEY IMPLICATIONS

Managing liabilities
This paper presents issues to consider in managing your personal liabilities to achieve financial goals.

Disciplined process
Guided by Merrill Lynch’s Goals-Based Wealth Management process, your Financial Advisor can help you evaluate your options and understand how the choices you make regarding your liabilities may impact your ability to achieve your broader financial objectives.

Sound liability management
Judicious use of credit solutions can enable you to fund goals and establish a source of liquidity for future use by using your borrowing power rather than by liquidating assets.

Risk considerations
Credit solutions amplify the risks as well as the potential rewards of a wealth management strategy.

Merrill Lynch Wealth Management makes available products and services offered by Merrill Lynch, Pierce, Fenner & Smith Incorporated (MLPF&S) and other subsidiaries of Bank of America Corporation. Investment products:

Are Not FDIC Insured
Are Not Bank Guaranteed
May Lose Value

MLPF&S is a registered broker-dealer, Member SIPC and a wholly owned subsidiary of Bank of America Corporation.
Your use of credit will depend on your age, net worth, income and risk tolerance. Used judiciously, credit can help you:

- Fund unexpected expenses without having to liquidate assets
- Stabilize your cash flows
- Consider the tax consequences of asset sales
- Build wealth and potentially meet financial goals

This paper examines ways to manage your personal liabilities like CFOs manage corporate liabilities. It explains how goals-based wealth management (GBWM) provides a balance sheet perspective that may help you to identify the extent to which your goals may be attainable. The paper illustrates the GBWM process and the potential impact of credit through case studies. It also reviews the features and risks of various credit solutions.

GOALS-BASED WEALTH MANAGEMENT PROCESS

To help clients manage their wealth and achieve their financial goals, Merrill Lynch Wealth Management has developed a five-step Goals-Based Wealth Management (GBWM) process (Exhibit 3), which can include liability management considerations.

**Step 1: Assess situation**

The first step is to assess your financial situation and your behavioral propensities about investments. Understanding your investment personality allows you to align your financial decision-making with its favorable aspects, while potentially safeguarding against its downsides. Financial assessment includes a review of your assets and liabilities. For most people, debt means a mortgage, car loan or credit card balance. But many affluent individuals use debt more strategically to help build wealth.

**Step 2: Articulate needs and goals**

Clearly defining and structuring your goals is an important first step. Articulating your goals enables you and your Financial Advisor to plan ahead, helping to ensure that your cash flow needs are met as you work to achieve financial goals.

**Step 3: Define and refine approach**

You and your Financial Advisor together develop a wealth management strategy. Continuing to review your plans and goals helps to clarify the potential trade-offs among your financial goals.

**Step 4: Implement goals-based solutions**

Next, to help meet your financial goals, you and your Financial Advisor implement a balance-sheet approach using financial products spanning the full spectrum of investment and credit solutions.

**Step 5: Review progress to goals**

In the final, ongoing stage, you and your Financial Advisor regularly review progress to goals. A material change to your personal situation or goals, or if there is a significant market move, you should contact your Financial Advisor for a review. Tracking progress to goals is critical to your success.

PRACTICAL CONSIDERATIONS

**Risk**

Credit, used judiciously, can help you to strategize towards financial goals. But credit can increase the risks as well as the potential rewards of a wealth management strategy. For example, the strategic use of credit has helped some real estate investors amass fortunes, but has magnified the losses of others. In deciding whether to use credit and, if so, how much, the key is to understand both its risks and potential advantages.
Many forms of credit entail interest rate risk, the risk that a change in rates can adversely affect the terms of the arrangement. Corporations dedicate ample resources to managing interest rate risk. Individuals, though lacking the means and expertise of corporations, can take steps to help manage their interest rate risk. You can, for instance, calculate the maximum interest rate you might need to pay on your loan, to verify that you would be able to make the resulting payments. You might also look into ways of hedging interest rate risk.

**Key features**

In considering the use of credit strategies to help meet your financial goals, you should be aware of their distinctive features (Exhibit 4).

**Secured or unsecured:** The credit strategy can potentially be tied to an asset. Secured strategies are generally used for larger purchases or expenses, whereas unsecured strategies may be more appropriate for meeting smaller or shorter-term liquidity needs.

**Rate differences:** Loan rates can differ widely (Exhibit 5). Your Financial Advisor can explore access to various ways you might gain efficiencies with the type of debt you currently hold.

**Short- or long-term:** The time period over which you pay principal and interest can vary.

**Amortizing or balloon:** An amortizing loan requires periodic payments. A balloon loan offers more flexibility because principal is due at the end of the term. At the end of the term there may be a desire to refinance the loan. In this case, the borrower is subject to refinancing risk.

**Fixed or revolving:** You can access credit for a fixed term or on an ongoing, revolving basis. Rates may change periodically or be fixed for a certain duration.

**Flexibility:** There may be limitations on using a credit facility, such as on the number of times a line of credit may be accessed.

**Qualification requirements:** The availability of a loan may be subject to net worth, income, debt service or other qualifications.

**Taxes:** Some loans may receive preferential tax treatment.
STRATEGIC USE OF CREDIT TO FUND A LONG-TERM GOAL

Step 1: Assess situation
John and Jane are 50 and 45 years old, respectively, and both work. Their total net worth is $1.5 million, including a home valued at $1 million, which they own outright. Both consider themselves experienced investors, confidently navigating and investing in markets.

Step 2: Articulate needs and goals
The couple’s long-term goal is to build a portfolio of real estate investments. In today’s low-property-value, low-interest-rate environment, they seek an attractive investment opportunity. After a year of evaluating various properties, they find a small apartment complex that they wish to purchase for $700,000.

Steps 3 and 4: Define approach and implement goals-based solutions
John and Jane’s Financial Advisor suggests establishing a Home Equity Line of Credit (HELOC) approximately 12 months in advance of their intended real estate investment. A HELOC, or simply “home equity line,” is a loan for a predetermined amount on which they may draw as needed. This form of lending may not be used to purchase, carry or trade securities or to repay debt incurred for those purposes. They expect to use their rental income from the apartment complex to repay the line of credit within five years.

Other potential alternatives to consider:
- Divesting $140,000 in assets for a down payment to achieve an 80% loan to value ratio and applying for a mortgage against their target property
- Obtain a securities-based line of credit using their investment assets as collateral for the $140,000 payment along with a mortgage against the target property for a no cash out of pocket transaction

Step 5: Review progress to goals
The couple meets regularly with their Financial Advisor to review progress toward goals. In addition, following a material change in their personal situation or goals or a significant market move, a review can be scheduled.

A closer look
Many people evaluate their credit options to plan for a significant purchase, to fund education goals or to diversify their portfolios. Credit solutions fall along a spectrum with respect to the ease of access to funds they provide (Exhibit 6). Next we highlight key features, risks and uses of select solutions.

Unsecured Lending
Unsecured loans — such as credit cards, deferred debit and overdraft arrangements — are a form of uncollateralized revolving debt. These loans, which tend to have higher interest rates than secured loans, are most appropriate for meeting small or short-term liquidity needs.

Exhibit 6: Spectrum of credit solutions

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Unsecured Lending</th>
<th>Securities-Based Lending (SBL)</th>
<th>Customized Lending Solutions</th>
<th>Home Equity Line of Credit (HELOC)</th>
<th>Mortgages</th>
</tr>
</thead>
</table>

Source: Merrill Lynch Wealth Management
Securities-Based Lending

A securities-based loan (SBL) is a line of credit secured by marketable securities or similar investments. Borrowing against securities instead of selling them enables you to keep your strategic asset allocation intact while potentially reducing borrowing costs. An SBL can usually be established before the need arises, providing availability as needed. SBLs may not be suitable for you, and your Financial Advisor will only recommend an SBL if it is suitable for you. Borrowing against securities entails special risks. Market conditions can amplify losses. If, for example, the pledged securities decrease in value, you may be required to deposit more securities or cash into your account.

Customized Lending Solutions

Customized lending solutions are designed to meet the lending needs of high net worth and ultra-high net worth individuals. These can include financing for specialty purchases such as aircraft and commercial real estate. By employing non-traditional assets, custom financing solutions can help clients achieve personal goals without disturbing their investment strategies. Of course, asset-based and securities-based financing carries additional risks, including depreciation of collateral, and may not be suitable for you.

Home Equity Line of Credit

A Home Equity Line of Credit (HELOC) establishes the availability of mortgage credit on which you may draw as needed, up to a predetermined amount. This form of lending may not be used to purchase, carry or trade securities or to repay debt incurred for those purposes. By accessing your home equity rather than liquidating your investments, a HELOC can allow you to keep your investment strategy intact. Interest expense may be deductible for some taxpayers. A HELOC is an adjustable-rate mortgage, which can pose added risk. The line of credit may be reduced or suspended at the lender’s discretion for reasons including (but not limited to) a significant decline in the value of the property or a material change in your financial circumstances.

DEBT CONSOLIDATION AND SIMPLIFICATION

Step 1: Assess situation

Mitch has $1.5 million invested with Merrill Lynch in a balanced equity and fixed income portfolio, and a total net worth of $2.5 million. He considers himself an experienced investor and is 54 years old.

Step 2: Articulate needs and goals

During a discussion with his Financial Advisor, Mitch mentions that he has loans outstanding at various interest rates that he seeks to consolidate. Doing so would simplify Mitch’s finances, reducing his debt carrying costs and possibly enabling him to secure a better interest rate should he need to borrow in the future. Mitch tells his Financial Advisor that he currently has $20,000 in credit card debt at 14%, pays 7% on a $100,000 boat loan, and is paying 4% on a $50,000 auto loan. Additionally, he is starting to think about how to provide elder-care support for his parents.

Steps 3 and 4: Define approach and implement goals-based solutions

Mitch’s Financial Advisor mentions that he can qualify for a securities-based lending (SBL) facility of up to $900,000 and that he can immediately use the funds to pay off all his debt. A suitability analysis was completed. The interest rate on the SBL facility would be around 4% and — importantly — Mitch would not have any required monthly payments. Having refinanced his debt and created options for funding elder-care, Mitch is relieved and pleased with the solution.

Other potential alternatives to consider:

- Divesting $170,000 in assets in order to pay off his debts to free up cash flow for potential elder-care needs
- Consider using a Home Equity Line of Credit (HELOC) if sufficient equity is available
- Refinance the boat and auto loans and transfer the credit card balance to a card with a lower interest rate to achieve lower monthly payments and create cash flow

Step 5: Review progress to goals

Mitch and his Financial Advisor regularly review progress toward goals. In addition, following a material change to his personal situation or goals or a major market move, a review may be scheduled.
Mortgages can be used to fund the purchase of a primary home, a second home or an investment property. Mortgages are typically either fixed-rate or adjustable-rate, though other varieties exist, such as fixed-to-adjustable rate and interest-only. A fixed-rate mortgage gives clients the consistency of unchanging payments for the life of the loan. As such, it may be more appropriate than an adjustable-rate mortgage if you plan to live in your home for a long time or if you are able to lock in a low interest rate. An adjustable-rate mortgage, by contrast, may be advantageous if you expect interest rates to decrease or if you plan to move within the next few years. But each poses risks. A fixed-rate mortgage locks you into a set rate that in retrospect can appear high, although refinancing is often available. An adjustable-rate mortgage exposes you to the risk of rising rates.

CONCLUSIONS
Although many associate credit with excessive risk and therefore shun it, the prudent use of credit can help you achieve your financial goals. Sound liability management can help you manage ongoing cash flows, fund unexpected expenses and limit the tax consequences of asset sales to build wealth.

Guided by a disciplined Goals-Based Wealth Management process, your Financial Advisor can help you evaluate your options and understand how the choices you make regarding your liabilities can affect your ability to achieve your broader financial objectives. Viewing your investments and liabilities together provides a clearer perspective of your finances. With the guidance of your Financial Advisor, careful liability management can help you achieve your financial goals.

Case studies are intended to illustrate products and services offered through Merrill Lynch. They do not necessarily represent the experiences of other clients, nor do they indicate future performance. Results may vary. The strategies may not be appropriate for every investor. They do not take into account the specific investment objectives, financial situation and particular needs of any specific person. Individual clients should review with their Merrill Lynch Financial Advisor the terms, conditions and risks associated with specific products and services.
Nevenka Vrdoljak, Director, Investment Analytics, holds analytical responsibilities in the areas of asset allocation and retirement investing. Nevenka developed Merrill Lynch Wealth Management’s target date asset allocation approach for institutional plan sponsors. She is also responsible for developing long-term capital market assumptions. Previously, Nevenka held analytical roles at Goldman Sachs Asset Management (London) and Deutsche Bank Asset Management (Sydney) in fixed income, currency and derivatives. She holds a bachelor’s and master’s in economics with honors from the University of New South Wales (Sydney). Nevenka graduated from Columbia University with a master’s in mathematics of finance.

David Laster, Director, Investment Analytics, is responsible for developing analytical solutions and thought leadership in the area of retirement investing. His research has appeared in the Financial Analysts Journal, Journal of Investing and Journal of Wealth Management and has been discussed in The Wall Street Journal, Financial Times and Fortune. Before joining Merrill Lynch, David was a senior economist at Swiss Reinsurance Company and a financial economist at the Federal Reserve Bank of New York. David earned a Ph.D. in economics from Columbia University and a B.A. in mathematics from Yale University. He is a CFA charterholder.

Anil Suri, Managing Director, is the CIO of Multi-Asset Class Modeled Solutions and the Head of Investment Analytics at Merrill Lynch Global Wealth Management. He leads the development of solutions for goals-based wealth management, retirement investing, behavioral finance, asset allocation, systematic portfolio management, and performance measurement across traditional, market-linked and alternative investments. Anil has been with Merrill Lynch since 2004, where he was previously Head of Investment Strategy & Analytics in the Alternative Investments area and a Senior Investment Strategist on the Merrill Lynch Research Investment Committee (RIC). Anil’s research has been published in the Journal of Wealth Management and discussed in Barron’s and The Wall Street Journal. His prior experience includes roles as a senior AI strategist at Citigroup, trader at Credit Suisse and management consultant at McKinsey. Anil earned an M.B.A. with honors from the Wharton School of the University of Pennsylvania, an M.S.E. (operations research and financial engineering) from Princeton University and a B. Tech. from the Indian Institute of Technology at Delhi.
The article is provided for information and educational purposes only. The opinions and views expressed do not necessarily reflect the opinions and views of Bank of America or any of its affiliates. Any assumptions, opinions and estimates are as of the date of this material and are subject to change without notice. Performance does not guarantee future results. The information contained in this material does not constitute advice on the tax consequences of making any particular investment decision. The material does not take into account a client’s particular investment objectives, financial situations or needs and is not intended as a recommendation, offer or solicitation for the purchase or sale of any security, financial instrument, or investment strategy. Before acting on any recommendation, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice.

GWM Investment Management & Guidance (IMG) provides industry-leading investment solutions, portfolio construction advice and wealth management guidance. Diversification and dollar cost averaging do not guarantee a profit or protect against a loss in declining markets. Since such an investment plan involves continual investment in securities regardless of fluctuating price levels, you must consider your willingness to continue purchasing during periods of high or low price levels.

This information should not be construed as investment advice. It is presented for information purposes only and is not intended to be either a specific offer by any Merrill Lynch entity to sell or provide, or a specific invitation for a consumer to apply for, any particular retail financial product or service that may be available through the Merrill Lynch family of companies.

Any information presented about tax considerations affecting client financial transactions or arrangements is not intended as tax advice and should not be relied upon for the purpose of avoiding any tax penalties. Neither Merrill Lynch nor its Financial Advisors provide tax, accounting or legal advice. Clients should review any planned financial transactions or arrangements that may have tax, accounting or legal implications with their personal, professional advisors.

To set asset class assumptions, Merrill Lynch’s investment professionals, which represent Merrill Lynch’s Global Wealth Management (GWM) Investment Management & Guidance group and both Merrill Lynch Global Research group, follow a rigorous review process and consider a number of factors and analyses, including a close examination of asset class performance over several economic cycles. Special events or circumstances are also considered, but with the appreciation that future performance may not necessarily follow patterns established in the past. As these characteristics do not remain constant, Merrill Lynch reviews and revises them at least annually.

Merrill Lynch Home LoansTM residential mortgage programs are offered and funded by Bank of America, N.A., 4804 Deer Lake Drive East, Jacksonville, FL, 32246-6484; toll-free telephone: 800-854-7154.

Merrill Lynch, Pierce, Fenner & Smith Incorporated, 4 World Financial Center, New York, NY 10080, toll-free telephone: 800-338-2814, Member, Securities Investor Protection Corporation (SIPC), does not make commitments for or fund loans.

Residential mortgage programs, options, and property types are not available in all states and jurisdictions and are subject to change without notice. Loans are offered on properties in all 50 states, the District of Columbia, the U.S. Virgin Islands, and Puerto Rico. Additional terms, conditions, restrictions, and costs may apply. Bank of America Corporation, its subsidiaries, and their employees may receive compensation for its products and services.

Merrill Lynch Wealth Management, Merrill Lynch Home Loans, and the Bull symbol are trademarks owned by Bank of America Corporation. Equity Access is a registered trademark of Bank of America Corporation.

The Loan Management Account® (LMA® account) is provided by Bank of America, N.A., Member FDIC. Equal Opportunity Lender. The LMA account requires a brokerage account at Merrill Lynch, Pierce, Fenner & Smith Incorporated and sufficient eligible collateral to support a minimum credit facility size of $100,000. A complete description of the loan terms can be found within the LMA agreement. Clients should consult their own independent tax and legal advisors. Any assumptions, opinions and estimates are as of the date of this material and are subject to change without notice. Past performance does not guarantee future results. The information contained in this material does not constitute advice on the tax consequences of making any particular investment decision. The material does not take into account a client’s particular investment objectives, financial situations or needs and is not intended as a recommendation, offer or solicitation for the purchase or sale of any security, financial instrument, or investment strategy. Before acting on any recommendation, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice.

Credit facilities may be provided by Bank of America, N.A., Member FDIC, or one of its subsidiaries, each an Equal Opportunity Lender. All loans and collateral are subject to credit approval and may require the filing of financing statements or other lien notices in public records. Asset-based and securities-based financing involves special risks and is not for everyone. When considering an asset-based loan, consideration should be given to individual requirements, collateral composition and risk tolerance, as well as capital gains, portfolio performance expectations and investment time horizon. The securities or other assets in any collateral account may be sold to meet a collateral call without notice to the client, the client is not entitled to an extension of time on the collateral call, and the client is not entitled to choose which securities or other assets will be sold. The client can lose more funds than the amount in such collateral account. A complete description of the loan terms can be found within the LMA agreement. Clients should consult their own independent tax and legal advisors. Some restrictions may apply to purpose loans, and not all managed accounts are eligible as collateral. All applications for LMA accounts are subject to approval by Bank of America, N.A. For fixed rate and term advances, principle payments made prior to the due date will be subject to a breakage fee.

Credit facilities may be provided by Bank of America, N.A., Member FDIC, or one of its subsidiaries, each an Equal Opportunity Lender. All loans and collateral are subject to credit approval and may require the filing of financing statements or other lien notices in public records. Asset-based and securities-based financing involves special risks and is not for everyone. When considering an asset-based and/or securities-based loan, consideration should be given to individual requirements, asset portfolio composition and risk tolerance, as well as capital gains, portfolio performance expectations and investment time horizon. The security or other assets in any collateral account may be sold to meet collateral call as provided in the definitive loan documents and the client is not entitled to choose which securities or other assets will be sold. A complete description of the loan terms will be found in the individual credit facility documentation and agreements. Clients should consult with their own independent tax and legal advisors. The Merrill® Visa Signature Card and Merrill Accolades American Express Card programs are offered by Merrill Lynch, Pierce, Fenner & Smith Incorporated and administered by FIA Card Services, N.A.

Merrill Lynch Wealth Management makes available products and services offered by Merrill Lynch, Pierce, Fenner & Smith Incorporated and other subsidiaries of Bank of America Corporation.

Investment products:

<table>
<thead>
<tr>
<th>Are Not FDIC Insured</th>
<th>Are Not Bank Guaranteed</th>
<th>May Lose Value</th>
</tr>
</thead>
</table>

MLPF&S is a registered broker-dealer, Member SIPC and a wholly owned subsidiary of Bank of America Corporation.

© 2013 Bank of America Corporation

AREA88CA