

# Managing Your Personal Liabilities



## WEALTH MANAGEMENT INSTITUTE WHITEPAPER

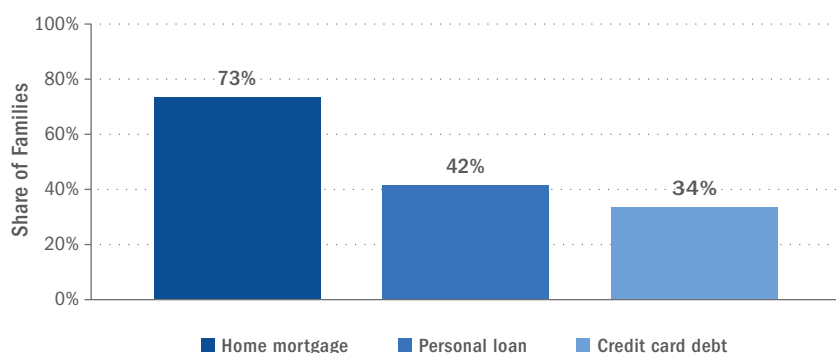
NEVENKA VRDOLJAK, Director, Investment Analytics

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.

**Exhibit 1: Liabilities of Affluent Americans**

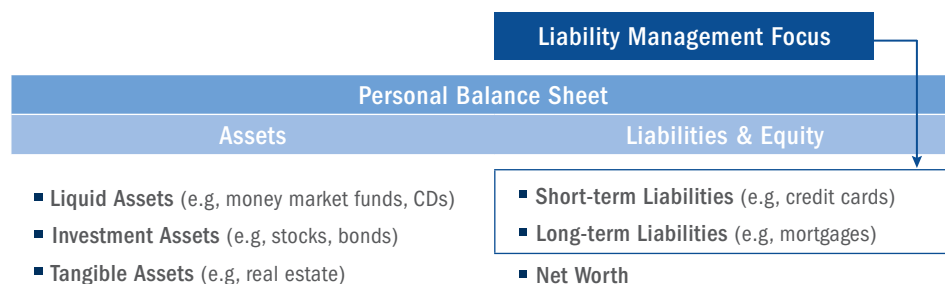


Note: Data are for households whose income is in the top decile.

Source: Federal Reserve Bulletin, June 2012, "2010 Survey of Consumer Finances."

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 2: Personal Balance Sheet: Categories and Examples**



Source: Merrill Lynch Wealth Management

## 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.

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Your use of credit will depend on your age, net worth, income and risk tolerance.<sup>1</sup> 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.<sup>2</sup> 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

**Exhibit 3: Goals-Based Wealth Management Process**



Source: Merrill Lynch Wealth Management

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.

<sup>1</sup> For more details, see David Laster, Anil Suri and Nevenka Vrdoljak, "Liquidity Management for Individual Investors," Merrill Lynch Wealth Management, Fall 2011.

<sup>2</sup> See Michael Liersch and Anil Suri, "Innovations in Behavioral Finance: How to Assess Your Investment Personality," Merrill Lynch Wealth Management Institute, Spring 2012.

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).

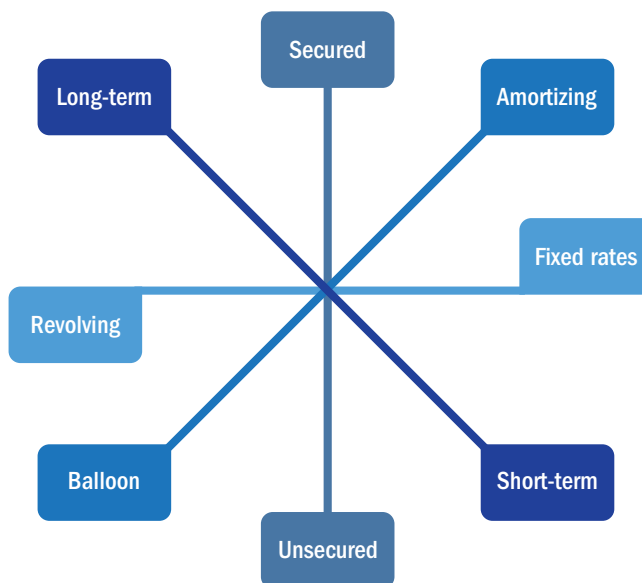
**Secured or unsecured:** The credit strategy can potentially be tied to an asset. Secured strategies are generally used for larger purchases or expenses, whereas unsecured strategies may be more appropriate for meeting smaller or shorter-term liquidity needs.

**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.

Exhibit 4: Key features of credit solutions



Source: Merrill Lynch Wealth Management

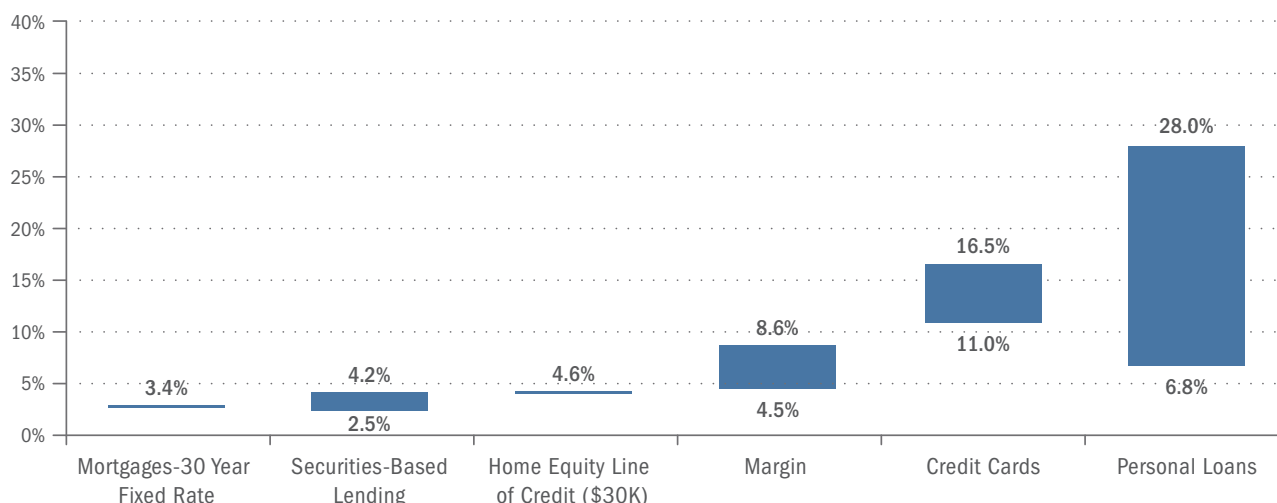
**Fixed or revolving:** You can access credit for a fixed term or on an ongoing, revolving basis. Rates may change periodically or be fixed for a certain duration.

**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.

Exhibit 5: Representative range of lending rates



Note: Rates as of 11/19/12.

Source: Mortgages, HELOC and credit cards - Bankrate; Margin and Securities-Based Lending - Merrill Lynch; Personal loans - LendingClub

## 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.

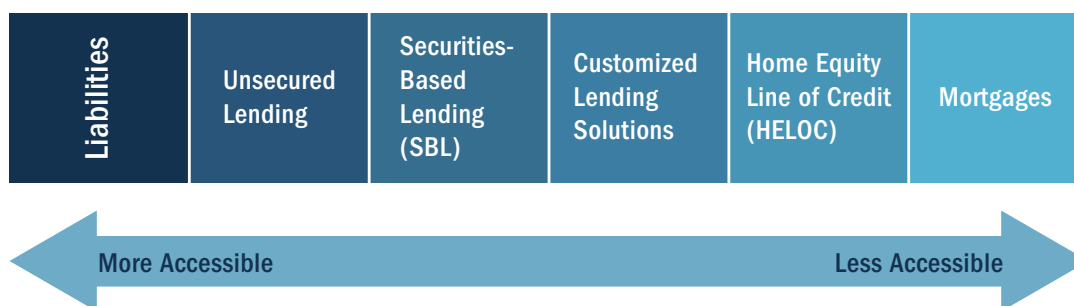
### A closer look

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



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.*

## OPPORTUNISTIC USE OF CREDIT TO FUND A LIFESTYLE GOAL

### **Step 1: Assess situation**

Bob and Linda, both self-employed and 42 years old, have \$25 million in financial assets, as well as a 30-meter yacht worth approximately \$10 million. They consider themselves confident investors.

### **Step 2: Articulate needs and goals**

While staying with friends in Aspen they come across a beautiful condo for sale at a distressed price of \$1.2 million, which they would love to own.

### **Steps 3 and 4: Define approach and implement goals-based portfolios**

They speak to their Financial Advisor about their options for purchasing the condo without jeopardizing the rest of their goals. She suggests obtaining a structured lending line of credit, using their yacht and marketable securities as collateral. With structured lending, the bank underwrites the couple rather than their property. Bob and Linda are able to obtain a \$3 million line of credit that will cover the cost of the condo as well as new furnishings for it. They expect to repay the line of credit within three years.

### **Other potential alternatives to consider:**

- Seek a mortgage loan to finance the property
- Use a securities-based line of credit against their financial assets to obtain the needed cash

### **Step 5: Review progress to goals**

Bob and Linda and their Financial Advisor regularly review progress toward goals. If the couple's personal situation or goals change materially or the market moves significantly, a review can be scheduled.

## **Mortgages**

Mortgages can be used to fund the purchase of a primary home, a second home or an investment property. Mortgages are typically either fixed - 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.

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**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.

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Summer	2012	How Immediate Annuities Can Help Meet Retirement Goals	Laster/Suri
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Spring	2012	Innovations in Behavioral Finance: How to Assess Your Investment Personality	Liersch/Suri
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