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STRATEGY PAPER

How to access the funding you need without disrupting your investment strategy

Your priorities and plans for the future are as individual as you are. So is the long-term investment strategy you employ to pursue those goals. But your life also involves shorter-term demands for funds.

Some of those needs are pleasant, such as paying for a child's wedding or putting a down payment on a vacation home. Others are less so, such as a medical bill or major home repairs. Or you may wish to take advantage of an investment opportunity by buying into a business or expanding your own business.

How do you plan to generate liquidity when a need arises?

Successful investors ensure that they have access to cash before they need it. They know that preparing proactively to meet spending needs can help them stay on track to pursue their long-term goals and short-term needs.

The appropriate funding strategy for a given expense is dictated by factors such as your goals, risk tolerance, investment objectives, time horizon and market views. Depending on the need, your strategy may involve:

- Selling investments or other assets to generate funds
- Using cash on hand
- Borrowing the funds you need

Let's explore the pros and cons of each approach and situations in which each may be preferred.

Selling investments to generate funds

Certain investment goals have a specific time frame and may be funded with a preplanned sale of assets. For example, if you're saving for your children's college education in a 529 plan, you presumably will sell those assets as the tuition bills come due. Similarly, you may intend to draw down your retirement accounts to provide income when you're no longer working.

When you need to pay for something important, you may also decide to sell an asset that has declined in value. Such a strategic sale may generate the money you need and also produce a capital loss that can be used to offset other gains for tax purposes. You should consult your legal and/or tax advisors before making any financial decisions such as these.

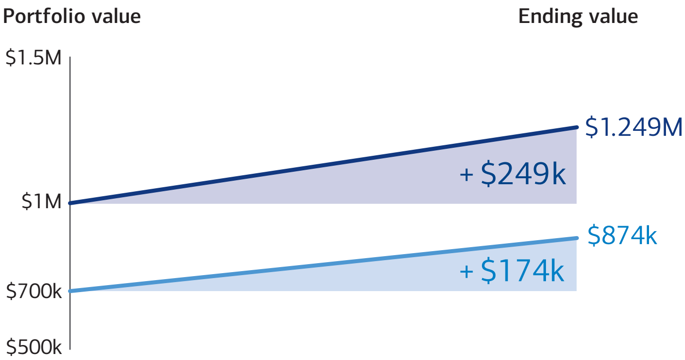
Problems can arise when you have to sell under pressure. A forced sale of long-term investments can generate several unintended consequences.

When you liquidate an investment position, you may miss out on any future market gains and potential income from that security. Similarly, selling at a loss eliminates the possibility of a future price recovery in your portfolio.

On the other hand, selling securities that have risen in value can result in a taxable event. Depending on the size of the position and the length of time you've held it, you could face a sizable capital gains tax bill. You also may need to consider transaction costs, as well as the impact that removing the assets under consideration from your portfolio may have on your other investment goals. In addition, you may then need to rebalance the portfolio, possibly incurring additional transaction costs and tax consequences.

In the hypothetical example below, an investor has a portfolio worth $1 million. She needs $300,000 for the down payment on a second home. If she sells assets to fund that payment, she will miss out on potential growth in her portfolio.

Impact selling assets has on net worth in three years



This example is intended for hypothetical illustration only, and is not intended to be representative of the past or future performance of any particular investment. Actual results will vary.

Assuming an annual return of 7.7% on the investments, annual interest on the loan of 4.67% and a long-term capital gains tax rate of 20%, the investor comes out ahead when she borrows for the down payment rather than selling. The returns of the intact portfolio outpace the returns of the divested portfolio, even after accounting for interest payments. After three years, the intact portfolio is worth $374,773 more than the portfolio from which the down payment was subtracted.

Liquidating your long-term investments to meet a short-term funding need can negatively affect your ability to pursue your goals. But other methods can help you free up cash without disrupting your well-thought-out investment strategy.

Using the cash you have

One way to meet short-term obligations without disrupting an investment plan is to set aside cash proactively for specific life events. This approach can provide an efficient way to meet specific expenses. It allows the saver to fund the need without selling securities, and to earn modest interest rather than borrow and pay interest.

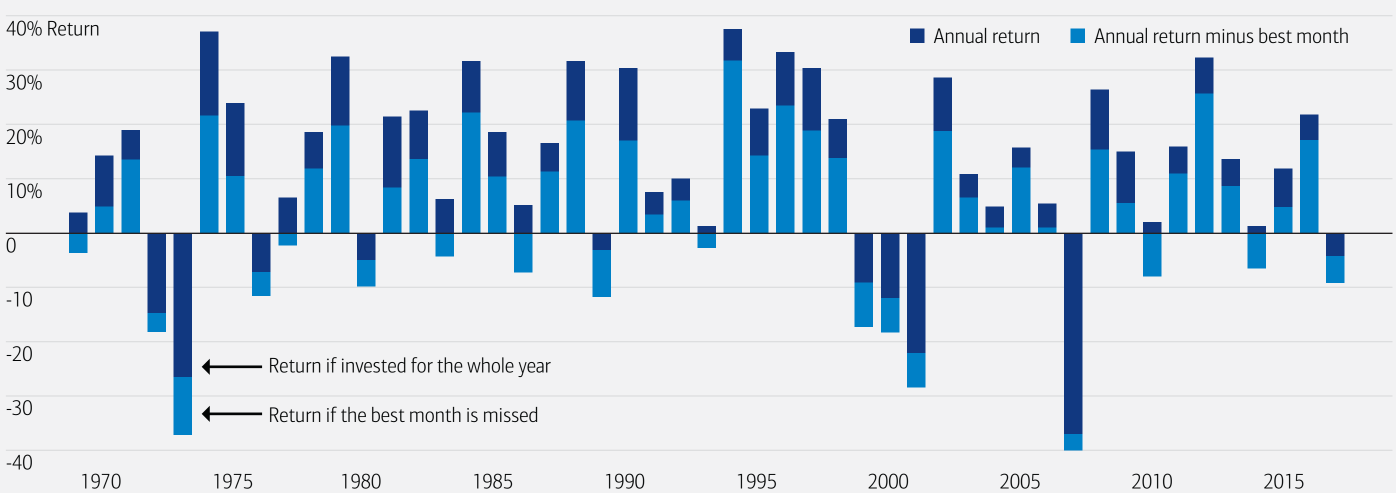
Another benefit of money in the bank is the stability it can offer during volatile markets. Knowing you can meet your needs without selling at a loss may help you weather a decline.

That said, cash savings must work as part of a larger financial strategy that effectively anticipates life events and the costs associated with them. The strategy also must account for expenses that cannot be anticipated, as well as the opportunity cost of holding cash or cash equivalent investments rather than assets with greater potential returns.

It is especially important to use cash savings strategically rather than simply let them build due to risk avoidance or inertia. In times of economic or market stress, people tend to trim back their riskier holdings and take larger positions in cash. But the chart at the bottom of the page illustrates the steep price that could be paid for sitting on the sidelines.

Cash and cash equivalent investments typically cannot keep up with the rate of inflation, which causes their purchasing power to decline each year. In addition, holdings such as certificates of deposit and money market funds have historically been incapable of providing the growth most people need to pursue their longer-term goals. The chart on the next page illustrates the steep opportunity cost that may be paid by those who hold too much in cash or cash equivalent assets.

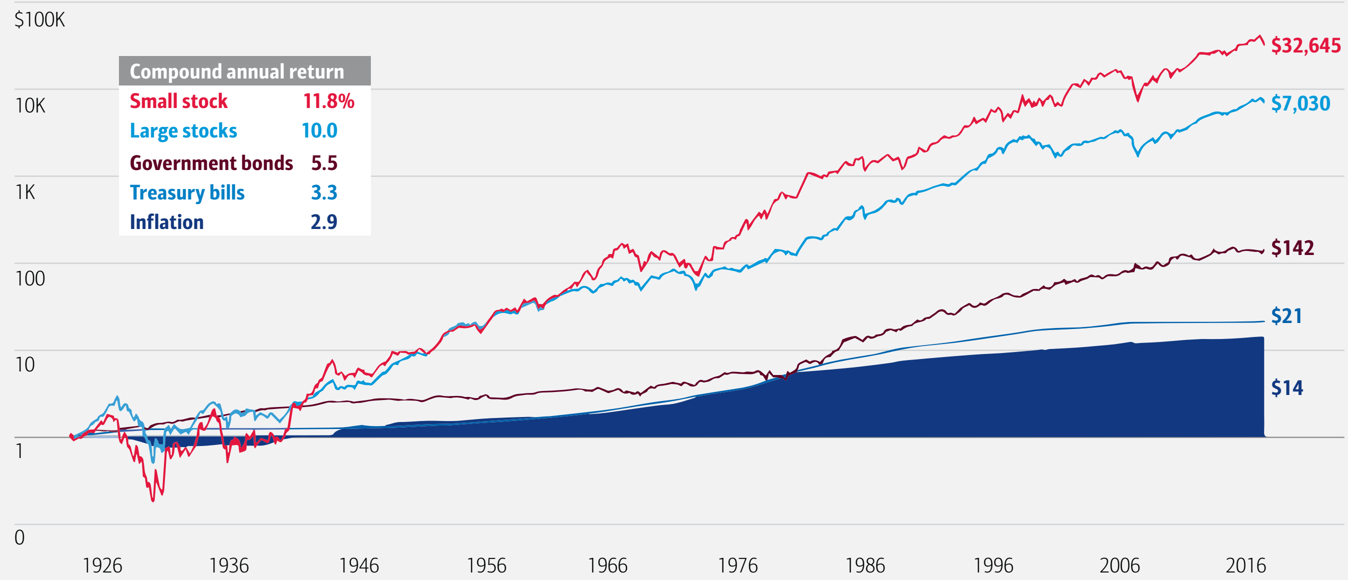
Market-Timing Risk: The effects of missing the best month of annual returns 1970–2018



Source: Morningstar 2019

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Stocks are represented by the Ibbotson® Large Company Stock Index. The data assumes reinvestment of income and does not account for taxes or transaction costs.

Long-term growth of various asset classes



Source: 2019 Ibbotson® SBBI®

About the data: **Past performance is no guarantee of future results.** Small stocks in this example are represented by the Ibbotson® Small Company Stock Index. Large stocks are represented by the Ibbotson® Large Company Stock Index. Government bonds are represented by the 20-year U.S. government bond, Treasury bills by the 30-day U.S. Treasury bill, and inflation by the Consumer Price Index. Underlying data are from the Stocks, Bonds, Bills, and Inflation® (SBBI®) Yearbook, updated annually. An investment cannot be made directly in an index. Hypothetical value of $1 invested at the beginning of 1926. Assumes reinvestment of income and no transaction costs or taxes.

When a large expense is anticipated, it often makes sense to set aside the funds in advance. But even if you have the cash to pay for something, it's a good idea to talk to your advisor before spending it.

Borrowing the funds you need

There is a third option for accessing the funds you need: asset-based lending. This approach offers you a line of credit or loan based on the value of an asset such as your investment portfolio or your home.

The interest rates associated with secured loans tend to be lower than those charged for unsecured debt such as credit cards. As a result, borrowing against your assets may be a cost-effective way to meet your financial obligations or act quickly to pursue new opportunities. The capital appreciation potential of your home or investment portfolio may outpace the typical interest rates on secured lines of credit, based on historical performance. Even if it doesn't, this course of action may be prudent as long as you understand and carefully consider the risks.

Borrowing against your portfolio or your home allows you to leave your investment strategy intact and focus on your longer-term goals. Accessing credit without selling securities may help you delay or avoid realizing taxable gains from a sale.

The chart below shows the effect of a hypothetical asset sale to generate funds. As you can see, in this scenario the tax impact and lost growth potential related to the asset sale make it the less appealing option.

The opportunity cost of selling assets

	Sell assets	Borrow against assets
Current portfolio	$5,000,000	$5,000,000
Cash needed	$500,000	$500,000
Financed amount	$0	$500,000
Capital gains taxes[1]	$100,000	$0
Portfolio value after sale	$4,400,000	$5,000,000
Portfolio value in five years[2]	$6,375,749	$7,245,169
Interest paid[3]	$0	$116,750
Change	**$1,975,749**	**$2,128,419**

[1] Assumes long-term capital gains tax rate of 20%. [2] Assumes an annual growth rate of 7.7%. [3] Annual interest rate on loan is 4.67%.

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Your specific situation and suitability are important considerations for asset-backed loans. You'll want to be sure your future cash flows will support the interest payments on your loan or line of credit and that you have carefully considered the special risks of securities-based and home equity financing. Consult with your own independent tax and legal advisors.

Securities-based lending

Securities-based lending creates exposure to market risk and the possibility of a collateral call.

- You may have to provide additional funds or securities if your securities decline in value. If you fail to meet a collateral call, the bank may sell any assets in the collateral account at its discretion.
- You can lose more funds than you hold in the collateral account.
- If you are forced to liquidate due to a collateral call, you will incur the disadvantages (such as loss of market appreciation, tax consequences) that you sought to avoid by borrowing rather than liquidating.

Borrowing against home equity

- Your home serves as collateral for the line of credit, so it may be at risk if you do not meet minimum payments.
- The bank may freeze your line of credit if the housing market declines.

A broad range of potential solutions

Preferred Deposit. This bank deposit account is linked to your Merrill brokerage account, giving you the flexibility to direct your cash where you need it — whether to meet expenses or to capture investment opportunities. It offers a competitive yield and the security of FDIC insurance, up to applicable limits.

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 but has risks that need to be considered. An SBL can usually be established before the need arises, providing availability as needed.

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 nontraditional assets, custom financing solutions can help clients pursue personal goals without disturbing their investment strategies.

Home equity line of credit (HELOC). A HELOC is a secured credit line on which you may draw as needed up to your available credit limit during the borrowing period of your loan. By accessing a portion of the available equity in your home rather than liquidating your investments, a HELOC can allow you to keep your investment strategy intact. In addition, interest expense may be deductible.[1] Note that you must have sufficient equity and must be comfortable leveraging your home.

As a Merrill client, you have access to banking and financing solutions through Bank of America. You can consider which lending product or financing solution is appropriate for your situation, including a loan based on your portfolio or the value of your home.

Setting aside cash may be the best way to meet the cost of some life events, but it may not always be the optimal strategy. Also consider borrowing against your assets to fund major purchases, emergencies, home purchases or pursue other financial opportunities for you or your children. Judicious use of credit can help you enhance your net worth and maximize both sides of your personal balance sheet.

Maximize your borrowing power

Contact your Merrill advisor to learn more about the financing options including the terms, conditions and risks associated with the specific products and services available to you. Creating a source of cash before you need one can help you meet short-term needs without sacrificing your long-term priorities.

[1] Please consult your tax advisor regarding interest deductibility.

Bank of America, N.A., reserves the right to reduce or suspend your HELOC credit limit in the future for reasons set forth in your loan agreement, including but not limited to a significant decline in the value of your property or a material change in your financial circumstances.

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