Leveraging Both Sides of the Balance Sheet to Help Build Wealth

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Introduction

When it comes to building wealth, managing what you owe can be as important as managing what you own. Integrated financial technology and the ever-increasing availability of detailed account data has created an opportunity to borrow – strategically or tactically – to accomplish financial goals. When both an advisor and client have the knowledge and ability to identify when credit opportunities are appropriate and how to use leverage wisely, it unlocks options that may allow for optimal handling of short- and long-term cash flow needs without sacrificing broader financial goals.

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Credit opportunities are in demand. A Spectrum study completed in 2022 asked clients what they wanted from their financial advisor – 84% wanted lending advice/service. However, the study found only 4% were getting it.[1] Digital platforms are increasingly working to fill this gap, giving an advisor the flexibility to drive opportunities with each client and incorporate credit into a holistic financial plan.

This brief paper will detail when borrowing may be advantageous compared to liquidating portions of a portfolio and altering a holistic wealth management plan. It will also discuss three common lending services that may be suitable for new and current clients in need of short- or long-term cash flow. The effective use of credit, and management of both sides of a client's balance sheet, will be showcased through case studies and a review of the content on this topic.

[1]Spectrum, Market Insights 2022.

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Potential Advantages of Strategic Borrowing

Maintain Long-Term Financial Strategy

Tapping into credit rather than liquidating securities to meet cash flow needs allows a client to keep their overall financial strategy intact. Studies have shown that over 90% of a portfolio's variance of investment return can be attributed to how assets are allocated across different asset classes.[2] A properly balanced asset allocation assists investors with achieving a level of growth needed to meet their financial goals. The inclusion of credit leverages existing assets and may eliminate the need to liquidate investments which could upset that balance.

The interest rate environment and access to credit may also help investors avoid the opportunity cost of selling assets to meet a liquidity need. If the rate paid on the borrowed funds is less than the return other assets earn over the same period, the investor earns that return on a larger pool of assets while also meeting the liquidity need. By utilizing tactical borrowing to capitalize on opportunities without undermining portfolio principal, additional wealth could be earned over what would have been generated had assets been sold to fund a liquidity need.

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Enhanced service capabilities for new and current clients

Wise usage of credit as a potential solution for cash flow needs is a unique service advisors can offer to both new and current clients and address investors' financial situations in a more holistic fashion. Whether it's a new client wanting to immediately invest funds and strategically borrow later, or a current client who is interested in cash flow for a second home or unexpected expenses, better tools can result in greater satisfaction and a heightened level of service.

Cost Advantages

Using credit to avoid the sale of securities also avoids the transaction costs clients would incur upon their sale, to say nothing of the forced loss they would take if cash flow needs crop up in an untimely down market environment. Clients also avoid current tax consequences, whether that be capital gains on long term holdings, which can be taxed up to 20%, or worse, short-term capital gains which are taxed at higher rates, up to 37% depending on the client's tax bracket.

[2] Gary P. Brinson, Brian D. Singer, and Gilbert L. Beebower, "Determinants of Portfolio Performance II: An Update," Financial Analysts Journal, May-June 1991, pp. 40-48.

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Lending Possibilities

Securities-Based Line of Credit (SBLOC) – This refers to accessing credit using stocks, mutual funds, exchange traded funds, bonds, etc. as collateral. Securities-based lending provides ready access to capital that can be used for almost any purpose, such as buying real estate, purchasing property like a car or boat, or investing in a business. However, one restriction of a SBLOC to be aware of is that proceeds may not be used to purchase additional securities.

It is important for investors to understand the capital accessible via a SBLOC is largely dependent on the underlying risk of the holdings in the associated portfolio. Portfolios with less expected volatility, like a conservative fixed income portfolio, have the potential to qualify for a greater level of borrowing power. Conversely, a portfolio composed of more volatile securities, such as equities, may be limited in terms of borrowing power.

Borrowers may benefit from convenient access to capital, lower interest rates compared to unsecured loans, and greater repayment flexibility.

Consumer Real Estate Loan – Real estate loans are secured loans with the property listed as collateral, which tends to result in lower interest expenses than other forms of lending. Real estate loans offer a financing option that allows investors to tap into a property's equity to fill liquidity needs.

With many housing markets experiencing unprecedented appreciation in value in recent years, unlocking equity in a home, either through a cash-out refinance or home equity line of credit (HELOC), could serve as a suitable option for a client in need of credit.

Consumer Unsecured Loan – This loan type is not backed by any collateral, but rather based on a borrower's creditworthiness. In certain circumstances, it may be beneficial for the borrower to use an unsecured loan instead of security sales. While unsecured loans typically carry higher interest expense, they are generally available at minimums below other forms of lending. Additionally, the proceeds can be used for anything from home improvements, luxury purchases, or paying off high interest debt, like credit cards.

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Credit Risks

While a SBLOC can be a powerful tool, allowing leverage for the borrower, an investor must be aware of the risks. A securities-backed line of credit is most attractive when the market is producing strong returns. When the market experiences volatile price changes, investors risk amplifying their losses. In the event of a maintenance call, investors might be required to post additional collateral, repay the loan, or risk liquidation of securities. While individual circumstances will vary, there are a few considerations if a maintenance call were to occur:

- The investor may end up paying more in interest costs for the SBLOC than they are earning on the portfolio, resulting in a net loss. However, the interest costs should be weighed against other financing options, the tax implications of selling assets and the return on the use of the loan proceeds.
- If underlying investments lose value, the lender may liquidate securities to get their interest payment, which could result in a net loss for an investor and potential negative tax consequences.

The use of credit can include terms with adjustable rates that can increase or decrease based on a designated reference rate. In a market environment where rates are forecasted to rise, the interest costs of a loan may materially increase compared to when the loan was originated. The opposite can also happen in a falling rate environment up to a certain point. In order to hedge the interest rate risk, some lenders have fixed rate options with different terms to “match fund” to the use of proceeds.

When utilizing a securities-based line of credit (SBLOC), pledged assets may become restricted from trading into other asset classes and option activity. If pledged assets are currently administered by a third-party manager, an account could see significant allocation and performance deviations relative to the manager’s target model and the client’s own financial plan over the long-term. It is also important to consider if portfolio dividends will be used in the repayment of an SBLOC, which has the potential to disrupt expected cash flow. In the case of option activity, the reduced income available from covered call or spread writing could also be restrictive to cash flow needs.

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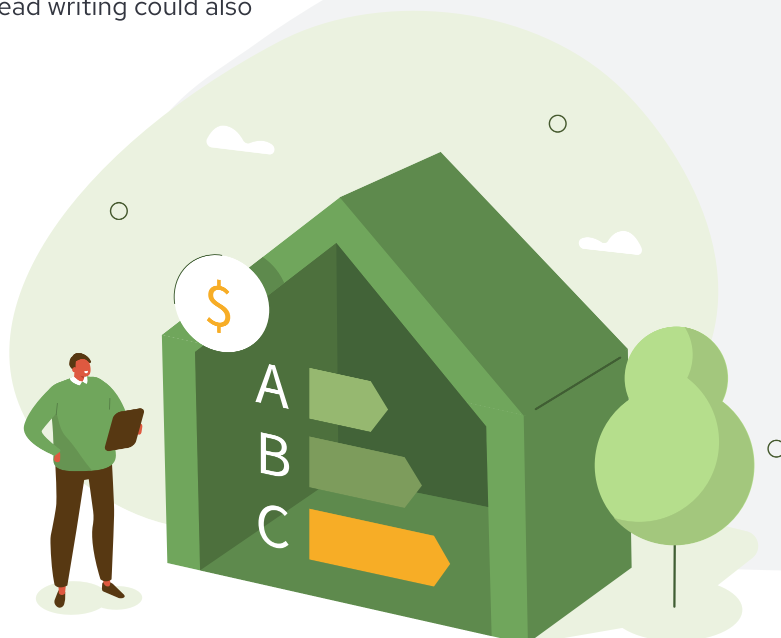

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Things to Consider Prior to Using Credit

- ❐ What is the client's timeline? Is there an immediate need for liquid funds and are they currently available?
- ❐ What is the client's overall risk tolerance and are adjustable rate opportunities appropriate?
- ❐ Is there the ability to repay the loan under the stated terms and timeframe? Are financial circumstances expected to significantly change in the near term?
- ❐ What is the current tax situation and would the deferring of capital gains help maintain long-term investing goals? Is the client's tax situation expected to change during the term of the loan?
- ❐ What would be an appropriate payback period when utilizing a loan? Is there a preference for a set term or greater need for flexibility to pay back the loan when funds come available?

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Tax Savings Case Study

The following hypothetical scenario showcases how the use of lending can help an investor avoid a tax consequence of liquidating securities to meet a cash flow need.

Scenario A is the conventional option of liquidating assets in a portfolio to meet a cash flow need. In this example, the client is liquidating $750,000 worth of securities with a cost basis of $200,000, representing a sizeable capital gain. With a 20% marginal tax rate, the client can expect a tax bill of $110,000 as a result of the liquidation.

Now consider scenario B, where the client utilizes a securities-based loan to fund their $750,000 cash flow need. The 4.15% annualized percentage rate on the loan leads to a one-year loan cost of $31,125, but the client does not incur the significant tax consequences of liquidating securities, and keeps the assets invested, potentially allowing for further market appreciation.

	Scenario A	**Scenario B**
Portfolio	$ 5,000,000	$ 5,000,000
Liquidation Request	$ 750,000	$ –
Cost Basis	$ 200,000	
Taxes Paid	$ 110,000	$ –
Remaining Investment	$ 4,250,000	$ 5,000,000
Year-One Loan Cost	$ –	$ 31,125
One-year cost savings (Taxes Deferred Minus Interest Paid)		$ 78,875
20% Marginal Tax Rate		
4.15% APR		

Opportunity Cost Case Study

Consider the following hypothetical scenario in which a client must choose between liquidating securities and taking out a securities-based loan to meet a cash flow need. We'll assume this is a tax-free withdrawal to draw the focus to opportunity cost.

In scenario A, the client sells $750,000 worth of securities, while the rest of the portfolio continues to earn a 6% return.

In scenario B, the client uses a securities-based loan to fund the $750,000 need, while the full $5,000,000 continues to appreciate. Despite having to pay interest on the loan, scenario B leads to a net benefit of $28,875 compared to scenario A.

	Scenario A	**Scenario B**
Portfolio	$ 5,000,000	$ 5,000,000
Liquidation Request	$ 750,000	$ –
Remaining Investment	$ 4,250,000	$ 5,000,000
Total Portfolio Return	$ 255,000	$ 300,000
Year-One Loan Cost	$ –	$ 31,125
Net Return	$ 255,000	$ 268,875
Value Gained Using Credit		$ 13,875
6% return		
4.15% APR		

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Liquidation vs. SBLOC vs. Consumer Unsecured Case Study

Utilizing credit for smaller liquidity needs may prove more effective versus liquidating securities. As seen in the hypothetical scenario below, a relatively small securities-based line of credit (SBLOC) or a consumer unsecured loan of $100,000 can prove beneficial for deferring capital gains and avoiding the immediate tax consequences of security sales. With either the SBLOC or the consumer unsecured loan, a portfolio remains fully intact and participatory in the market.

	Liquidation	SBLOC	Consumer Unsecured
Portfolio	$ 5,000,000	$ 5,000,000	$ 5,000,000
Liquidation Request	$ 100,000		
Cost Basis	$ 40,000		
Remaining Investment	$ 4,900,000	$ 5,000,000	$ 5,000,000
Total Portfolio Return	$ 294,000	$ 300,000	$ 300,000
Year-One Loan Cost	$ –	$ 4,150	$ 6,990
Taxes Paid	$ 12,000	$ –	$ –
After Tax Net Return	$ 282,000	$ 295,850	$ 293,010
Value Gained Using Credit		$ 13,850	$ 11,010
6% Market Return			
4.15% SBLOC APR			
6.99% Consumer Unsecured APR			
20% Marginal Tax Rate			

Potential Credit Scenarios

Personas	Situation Details	Potential Solution
Client looking to purchase first home	Little cash on hand, but has invested securities	SBLOC for down payment plus traditional RE loan
	Significant cash on hand for down payment	Consumer RE Loan
Client looking to make a luxury purchase	High risk tolerance with flexibility to pay back at own pace, substantial portfolio of securities	SBLOC adjustable rate loan
	Low risk tolerance, wants fixed rate and term, unwilling to take on high tracking error from target asset allocation	Consumer Unsecured with fixed rate term loan
Client is looking to purchase a second home	Unable to access or has low first home equity, most assets are invested	SBLOC for down payment plus traditional consumer RE loan
	High first home equity balance	Cash-out refinance
Client needs cash flow for business	Needs cash quickly to fund expenses such as materials and inventory, substantial invested assets	SBLOC
	Need for predictable rate and term, no immediate cash need	Cash out refinance
Client needs emergency funds	Needs cash quickly to fund unforeseen business or personal losses	SBLOC
	Wants to create emergency fund in advance	HELOC
	High first home equity balance	Cash-out refinance

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Conclusion

When it comes to using credit, each client's circumstances are unique and it is important to weigh the costs of borrowing, both from a dollar and opportunity cost standpoint. Nevertheless, an advisor who incorporates thoughtful borrowing into their conversations, and leverages the tools available to them, adds value to their service with a complete view of both sides of a client's balance sheet. This comprehensive approach may be able to provide previously unconsidered solutions, which could satisfy short-term cash flow needs, while preserving progress toward long-term financial goals.

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