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Connecting Clients to Liquidity

By Whit Magruder, Managing Director and Head of *GS Select*

Understand when it makes sense to borrow against an investment portfolio.

Get to know an increasingly popular player in today's wealth management space: the securities-based line of credit. Securities-based lines of credit, or SBLOCs, enable people to borrow against their non-retirement assets rather than cashing out when they need liquidity. SBLOCs have experienced growing popularity in recent years, as more independent advisors incorporate them into their practice.[1] Their increased use highlights the need clients have to access liquidity without selling their investments—and without incurring the real and opportunity costs of selling.

What does it do?

The name is long but the use is simple: SBLOCs offer liquidity for any purpose other than purchasing, carrying or trading margin stock. Borrowers draw against their credit line using eligible stocks, bonds, mutual funds, ETFs and cash-like instruments as collateral for the loan. A big part of the appeal is that the client's market assets stay invested and continue to be managed while also providing liquidity. This allows them to earn market returns on their capital, as well as avoid the tax and transaction costs associated with selling investments. Once opened, a client can borrow and repay the line of credit as needed. All that is required is paying the monthly interest.

Some clients prefer to keep cash on hand to account for any urgent liquidity needs. SBLOCs allow that "dry powder" to be invested in higher-yielding assets, such as public equities which have higher expected returns than cash, while still being prepared for urgent liquidity needs.

SBLOCs not only help your client; they also preserve the size and scope of your relationship with the client. The effort you put in to design and implement their investment plan is not diminished by withdrawals to fund other needs. And when integrated properly into your wealth management plan, it can allow you to deepen and broaden the financial relationship with your client.

For now or later

Some cash needs can be planned. It's fairly easy to anticipate the cash needed for home renovations, tuition or a major purchase. SBLOCs can be useful in these cases, providing cash for the need until future cash flows allow the credit line to be paid down.

But cash needs can also arise at a moment's notice. Think capital calls, funding for a new or fast-growing business or buying that special real estate that suddenly comes on the market. Accessing liquidity under tight timelines often requires significant tradeoffs and rapid management of the process.

In either case, selling out of market positions to access liquidity can result in transaction costs and may incur capital gains taxes. And the opportunity cost of being out of the market could be significant, especially in favorable market environments with

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expectations of rising asset prices. In other words, there's both a potential market return missed when not fully invested in the market as well as hard dollar costs from transaction fees and potential taxes.

Case Study: Retirement

Scenario: A securities-based line of credit enabled a retired couple to borrow funds to build a retirement home before the sale of their existing residence.

Impact to Advisor: The advisor was able to help her clients achieve their goals, keep the investment assets under her management, and increase the potential for positive referrals.

When is it right?

How should your client balance the cost of a line of credit with the benefits of staying invested? An SBLOC generally makes sense when the client's expected investment portfolio returns (market growth + interest and dividends), plus the sum of costs avoided by not selling positions in their portfolio (the expected tax liability and transaction costs), is greater than the cost of borrowing. The key here is to understand the expected market returns of the portfolio. A portfolio of short-term US Government bonds will generally not produce the returns needed to support an SBLOC. The risk/return profile of a diversified investment of equities, mutual funds and ETFs is more likely to produce returns that justify the borrowing cost.

While SBLOCs are not 'permanent' financing (say, the way a typical home mortgage is), they can be used to meet both short-term and medium-term needs—generally anything from a few weeks to a few years. For very short-term needs, where market returns and interest costs are both expected to be small, navigating tax liabilities and transaction costs are the main drivers of the benefit of borrowing. As the length of the expected borrowing increases, expected market returns versus the loan interest becomes increasingly important in assessing the benefit of borrowing. So for both short- and medium-term liquidity needs, SBLOCs may be a good option—and setting one up in advance can help manage you and your client's blood pressure when urgent needs arise.

Enhancing the relationship

Advisors work diligently with their clients to create and maintain customized asset allocations. Yet those same clients' infrequent or one-time needs for cash account for the majority of outflows an advisor sees from his or her practice today, according to

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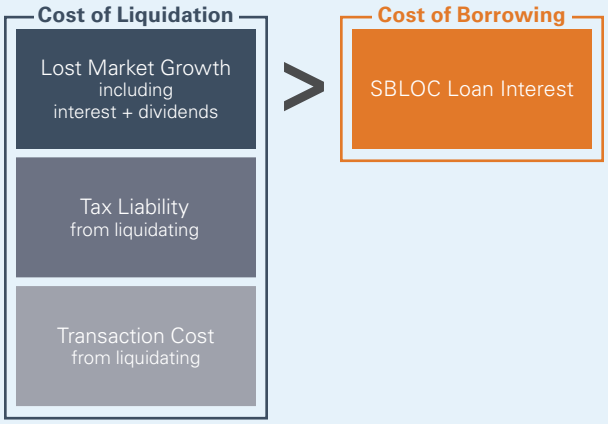
SBLOCs in Practice

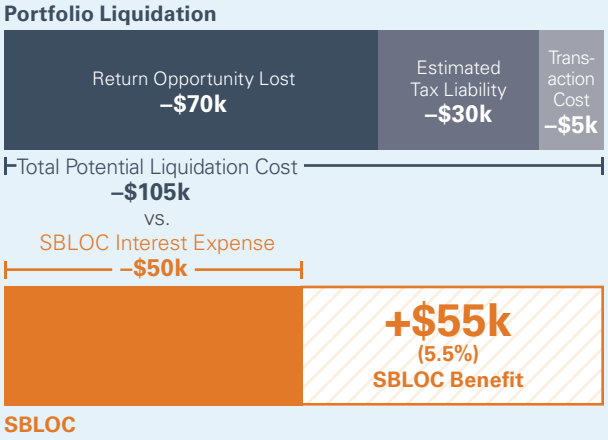
Your client needs $1mn for one year. Should they liquidate an investment portfolio or consider an SBLOC?

You know that SBLOC's can be economically advantageous for clients when the **Cost of Liquidation is greater than the Cost of Borrowing**.



You decide to run a few numbers. You expect the market to return 7.0% You also consider the costs of cashing out, which include incurring capital gains tax on 10.0% of the portfolio sold and transaction costs of 0.5%. The Cost of Borrowing, on the other hand, has been quoted at 1-Month Libor + 2.50%.

Below are the economics for this scenario.



Key Assumptions: Half of capital gains are accounted for as long-term and subject to tax rate of 20%; Short-term capital gains are taxed at 39%; 1-Month Libor at the time of borrowing is approximately 2.50%.

For Illustrative Purposes Only

a recent study from Cerulli Associates.[2] SBLOCs can help preserve the original asset allocation, reducing the advisor's time spent re-balancing portfolios, and allow continued maintenance of the client's assets under management as originally designed.

In a competitive landscape, some advisors may find deeper relationships with clients by working to manage both sides of the balance sheet. While many focus on growing assets, liability management is an important aspect of a client's financial life that also needs to be considered to help drive wealth.

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Case Study: Tax Liability

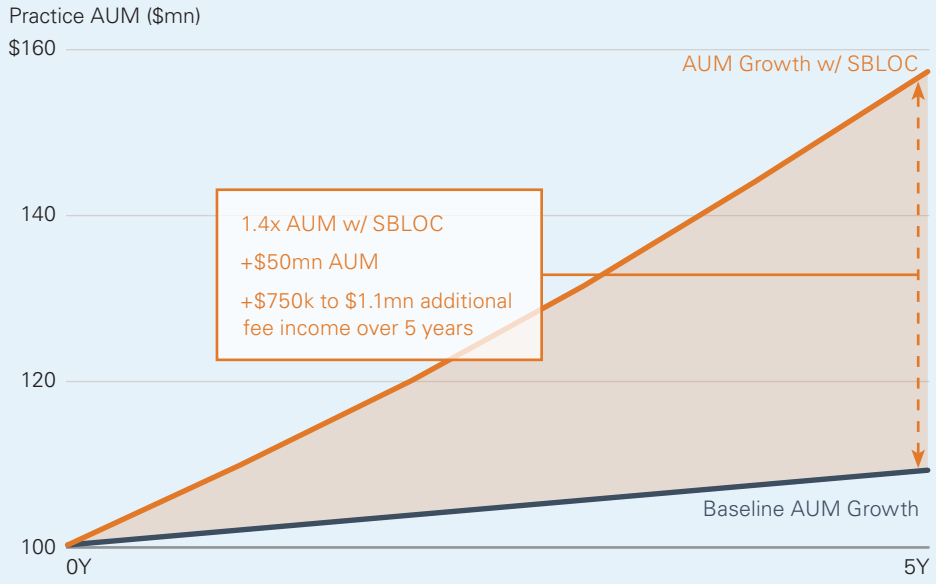
Scenario: A client that recently sold a business for $10mn was planning to reserve a portion of the proceeds to hold in T-bills for the upcoming tax liability. Instead, a securities-based line of credit allowed the client to fund the tax bill and put the amount he was setting aside into risk-assets with a higher return profile.

Impact to Advisor: The securities-based line of credit allowed the advisor to deepen his relationship with the client who remained fully invested in their fee-based program.

Increase your practice AUM by slowing asset attrition

Portfolio liquidation can reach as high as 15% as clients sell assets for liquidity*

Hypothetical Scenario Over 5 Years



SBLOCS may:

Increase fee income from a faster growing asset base

Reduce asset attrition from clients needing liquidity for other uses

Reduce reliance on new client acquisition to grow your asset base

Assumptions: 7% annual market value appreciation; 10% annual gross new asset sales; 15% annual organic asset attrition; SBLOCs can reduce asset attrition up to half; Management fees range from 0.75% to 1.00%

*Organic asset attrition sourced from Cerulli Associates study in 2017, in partnership with the Investments & Wealth Institute (formerly IMCA) and The Financial Planning Association® (FPA®)

Why not use this all the time?

Advisors and their clients must together decide if the product and its risks make sense on a case-by-case basis. Here are some considerations to determine when the product may or may not be a good idea:

1. Securities-based lines of credit generally have adjustable interest rates. This means interest payments can increase if the benchmark rate—usually one month LIBOR—rises.
   Tip: *SBLOCs are best used for short/medium term funding needs, anything from a few weeks to a few years*
2. A market drop could result in a "maintenance call" for partial repayment of the loan or additional collateral or liquidation of assets.
   Tip: *The best way to avoid a maintenance call is to hold more collateral than is required in the account pledged to the bank*
3. A change in the collateral account's holdings could result in a reduced capacity to borrow and a maintenance call.
   Tip: *Understand the lending value of various security types (e.g., cash vs. municipal securities vs. equities) before trading*
4. Required payments are usually interest only, so the borrower has to figure out how and when to repay the loan.
   Tip: *Advisors and their clients should decide in advance of borrowing how the loan will be repaid*
5. Collateral pledged to the bank will not be able to be removed without the bank's permission.
   Tip: *Lenders may pre-authorize release of dividends and interest; and the advisors should plan with the client to maintain sufficient cash outside the account (or draw on the credit line) to meet near term needs*

Interested? Learn More.

GS Select is currently available to tens of thousands of financial advisors working in RIAs and Independent Broker-Dealers across the country. GS Select builds upon the extensive lending expertise of Goldman Sachs' Private Bank and offers digital securities-based lines of credit as a liquidity source. Learn more about the high-tech, high-touch program on LinkedIn, at welcome.gsselect.com or by calling us at (833) 280-1250.

Not yet a part of GS Select?

Give us a call at (833) 280-1250.

1 https://www.wealthmanagement.com/alternative-investments/when-securities-based-lending-right-clients

2 Organic asset attrition sourced from Cerulli Associates study in 2017, in partnership with the Investments & Wealth Institute (formerly IMCA) and The Financial Planning Association® (FPA®)