# Planning for Unforeseen Expenses

## BORROWING VS. SELLING CASE STUDY

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As this year's tax payment and filing deadline draws near, investors are faced with the decision as to how to pay their tax bills: fund with cash, liquidate assets or borrow. While in a perfect world liquidity would be preset for such expenses, this is not always the case. Many will look to their liquid investment portfolios as an immediate funding source, but sometimes investors are not fully aware of the impact that liquidating assets can have.

During distressed moments in the market, liquidating assets can significantly lead to a divergence from one's long-term investment plan. Furthermore, it can compromise current portfolio structures, create unwanted additional tax bills, and potentially miss on opportunities that one would otherwise participate in if the portfolio remained intact.

As an alternative, investors should at least consider other methods to fund their tax obligations before selling assets. NewEdge Wealth has created a simple guide and case study to help clients understand the liquidity resources available to them so decisions can be made confidently. The use of bridge loans through portfolio leverage, either through purpose or non-purpose loans, can make economic sense when thoughtfully implemented.

## What is portfolio leverage?

Portfolio leverage is simply a financing instrument that offers liquidity by borrowing capital against the equity or value in an investor's portfolio. These loans are either constructed as purpose loans where proceeds can be used for marketable security investments, or non-purpose loans where proceeds cannot be used for such investments, but can be used for almost any other purpose including tax payments. Administratively, they also offer ease when put into place and can be structured with fixed or floating (variable) interest rates.

## What are the benefits to using short term financing to fund tax obligations?

**Administrative Ease -** Most security-backed loans require minimal paperwork to open and typically offer flexibility to pay back the loans at any time without penalty.

**Time -** Unforeseen expenses can lead to quick and potentially harmful portfolio decisions. Borrowing can buy time so investors can consider thoughtful funding strategies through their cash flow or balance sheet.

**Low Financing Costs -** Competitive interest rates are often significantly lower than that of a credit card or the potential tax bills associated with selling appreciated assets.

**Rate Arbitrage -** The growth on a portfolio during a bull market or having increased portfolio income can sometimes cover or even outperform the cost of financing.

**Tax Benefits -** Loan interest may be tax deductible. You should consult with your tax advisor to confirm the deductibility of your interest expense.

**Opportunity Cost -** Staying invested rather than selling can allow for one's portfolio to continue participating in bull markets.

**Maintain Portfolio Structure -** Portfolios can take time to properly structure so divesting can further elongate the implementation of a target allocation.

**Wealth Strategy and Long-Term Investment Plans -** Remaining invested allows for one's assets to stay aligned with his or her wealth strategy so he or she can continue to pursue their personal and financial aspirations.

## Case Study

Consider the case study below. A client has a $10M portfolio and an upcoming $1M tax bill due. The options are to 1) sell from the portfolio or 2) borrow $1M against the portfolio to fund the tax obligation. The math exercise below illustrates the added benefit borrowing can have over selling down portfolio assets. Furthermore, the analysis assumes no capital gains are incurred during the initial sale. Such taxes could further reduce an investor's overall growth participation. Assuming the investor pays the interest cost at the onset of the loan creation, we can see the benefit of borrowing versus selling with ~$117K excess growth occurring in the portfolio.

| | Selling | Borrowing |
|---|---|---|
| **Portfolio Value** | $10,000,000 | $10,000,000 |
| **Transactions Costs** | | |
| **Liquidation Amount*** | $1,000,000 | $0 |
| **Borrowed Capital** | $0 | $1,000,000 |
| **Annual Interest Rate** | 0% | 2.50% |
| **Loan Duration** | 0 Years | 2 Years |
| **Loan Interest** | $0 | ($50,000) |
| **Total Transaction Cost** | $0 | ($50,000) |
| **Portfolio Growth** | | |
| **Net Portfolio Value** | $9,000,000 | $9,950,000 |
| **Assumed Growth Rate** | 6% | 6% |
| **Portfolio Tenure (Years)** | 2 | 2 |
| **End Portfolio Value** | $1,112,400 | $1,229,820 |
| **Net Growth (Selling vs. Borrowing)** | **$117,420** | |

*This sale assumes no recognition of capital gains.

## What are the risk factors that should be considered before borrowing capital against a portfolio?

**Margin Call Risk -** Individuals should consider the amount of leverage they use against their assets, or the loan to value (LTV) ratios, before drawing on a line. Market volatility can lead to moments where the collateral pool is incapable of supporting the loan. As a result, forced sales may be implemented.

**Interest Rate Risk -** With floating or variable loans, interest rates that accompany borrowed capital will fluctuate. Secured Overnight Financing Rates (SOFR) or the Effective Federal Funds Rate (EFFR) are typical rates used to determine the total cost of a loan and can change as often as daily.

**Duration Risk -** Related to interest rate risk, re-payment plans should be structured to make sure the cost of repaying the loan does not outweigh future portfolio growth. Loans held for long time periods may become more expensive to an investor if interest rates rise over time.

**Pre-Payment Penalties -** For fixed credit lines, there can be an additional cost to pay back credit lines before the end of a loan term if prevailing rates fall since the loan's inception.

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## When does it make sense to use portfolio assets to fund tax obligations?

**Pre-Planned Funding Strategies -** Debt is not always the answer. To the extent liquidity planning was executed, cash reserves can often suffice as a payment strategy.

**Tax Loss Harvesting -** Selling portfolio assets with unrealized losses can sometimes outweigh the benefits of borrowing capital.

**Aversion to Debt -** Not all people look at debt the same, so it is important to evaluate one's comfort with lines of credit.

## Conclusion

Like many financial instruments, debt can be a useful tool when structured properly. It can also be a burden. Clients should contact their NewEdge Wealth advisor to review the pros and cons of using debt to fund obligations such as tax payments. Overall, the use of such financing methods should be personalized to properly consider an investor's balance sheet, cash flow and comfortability with debt.

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