Portfolio Perspectives

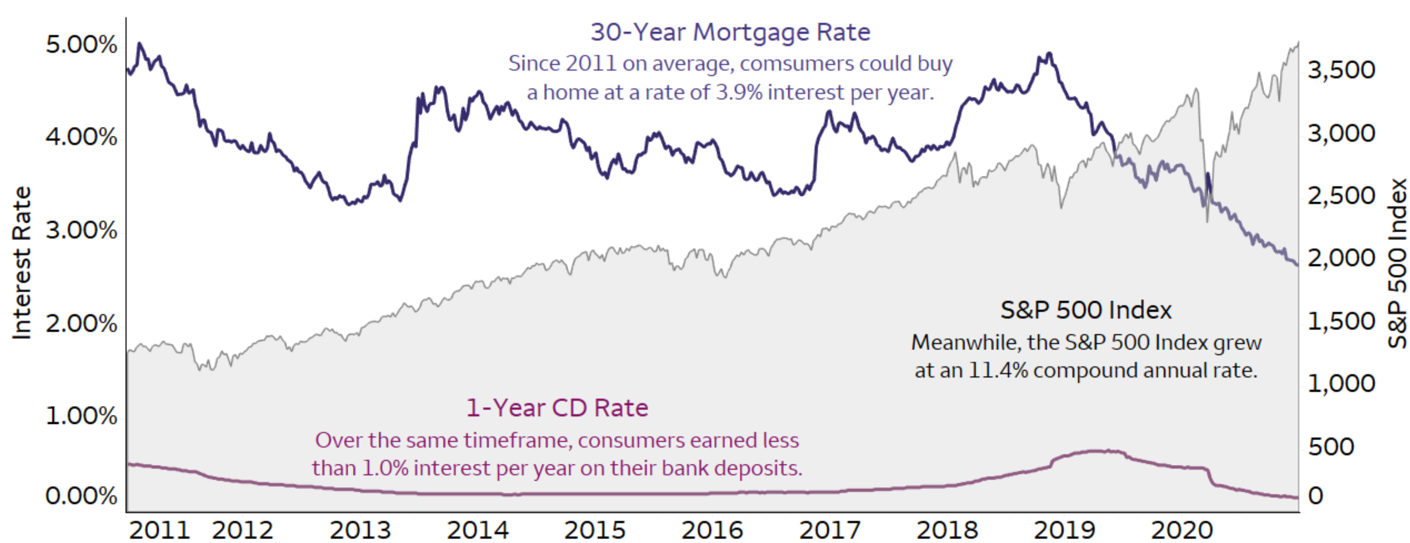
The Funding Conundrum: Save, Sell or Borrow?

Advice & Research

David Furst – Advice Strategy

What is the purpose of investing? Seriously, think about it for a minute… The question may sound trite, but investing is simply a method of funding future consumption. No matter what the ultimate purpose (retirement, a child's education, charitable gift, etc.), it ultimately requires a certain amount of assets at a specific point in time. Many investors think first of aspirational goals: the "bucket list"-type financial achievements they dream of for years. However, life's unexpected curveballs (COVID-19, car or home repairs, medical or tax bills, divorce or a death in the family, etc.) have the potential to delay or even derail financial plans if not properly accounted for. But what happens when the bills come due, the vacation date nears, or living expenses outpace expectations? Investors primarily have three options for funding these events: paying cash, selling investments, or borrowing (or some combination of these). This report will discuss the costs and benefits of each funding option and provide strategies for making your cash go further. As a primer, the chart below illustrates the choice that investors face. When comparing saving, investing, and borrowing, it is helpful to compare the rates at which money will grow (or accumulate interest costs in the case of borrowing).

Consumer Rates and Market Movement

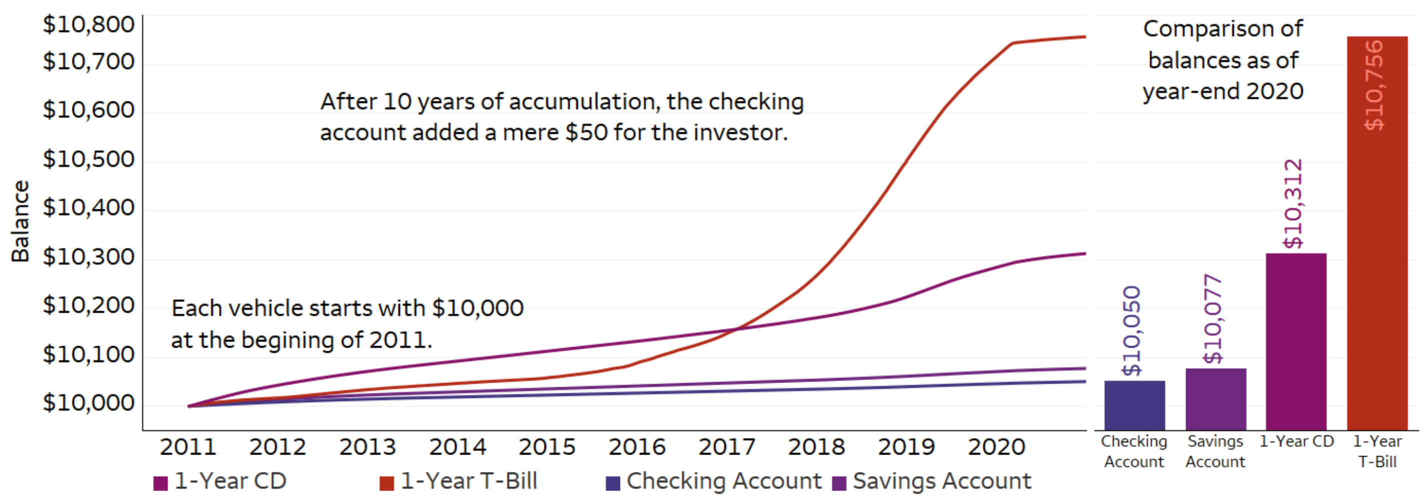


Source: FactSet, Freddie Mac, Federal Deposit Insurance Corporation (FDIC). Data as of 12/31/20. See disclosure section for full data descriptions. Past performance is no guarantee of future results.

Save: Accumulating cash in a bank account to cover liquidity needs

Using cash from short-term savings, or spending from current income is the most common option for funding small and recurring living expenses (gas, groceries, and utility bills). Money stored in a bank account is highly liquid and readily accessible when needed. However, because of the near-zero interest rates paid to depositors on checking account balances by most banks, it may not be advisable to store a significant portion of your overall portfolio in a checking account for long periods of time depending on specific goals. To illustrate why, the chart below shows the differences in interest earned by a hypothetical investor that keeps their cash in: a checking account, a savings account, a 1-year certificate of deposit (CD) from a bank (all three of which are insured by the Federal Deposit Insurance Corporation FDIC), or invests in a 1-year US Treasury security (which are not insured but are considered low-risk investments).

The "Growth" in Savings



Source: Federal Reserve Bank of St. Louis, Federal Deposit Insurance Corporation (FDIC). Data as of 12/31/20. See disclosure section for full data descriptions. Past performance is no guarantee of future results. The 1-Year CD and T-Bill investments are assumed to be reinvested upon annual maturity during the measurement period at the historically correct rate.

With such low rates paid on checking accounts, depositors miss out on interest that could have been earned by storing their cash elsewhere and increase their risk that inflation will eat away at some of the purchasing power their money holds.

This concept is known by economists as *opportunity cost.* It is the result that would have occurred if the next-best alternative were chosen. For example, you are debating between vacation destinations of skiing in Colorado, or lounging on the beach in Florida. The opportunity cost of choosing the ski trip would be missing the sound of the ocean in Florida. Alternatively, the opportunity cost of soaking up the sunshine on the beach, would be missing the refreshing mountain air.

Although large sums of cash in checking accounts is not recommended for the growth in long-term wealth, investors should ensure they keep enough cash on-hand to cover their expected near-term expenses (generally 3-6 months). By maintaining this level of cash, investors are less likely to be pressured into selling investments prematurely (potentially having to take a loss) in order to cover expenses.

Sure, it seems obvious to fund living expenses with your earnings, but what about larger purchases and goals? Should you save cash to fund your family vacations, home renovations, and large purchases? Should you consider alternative sources of funding?

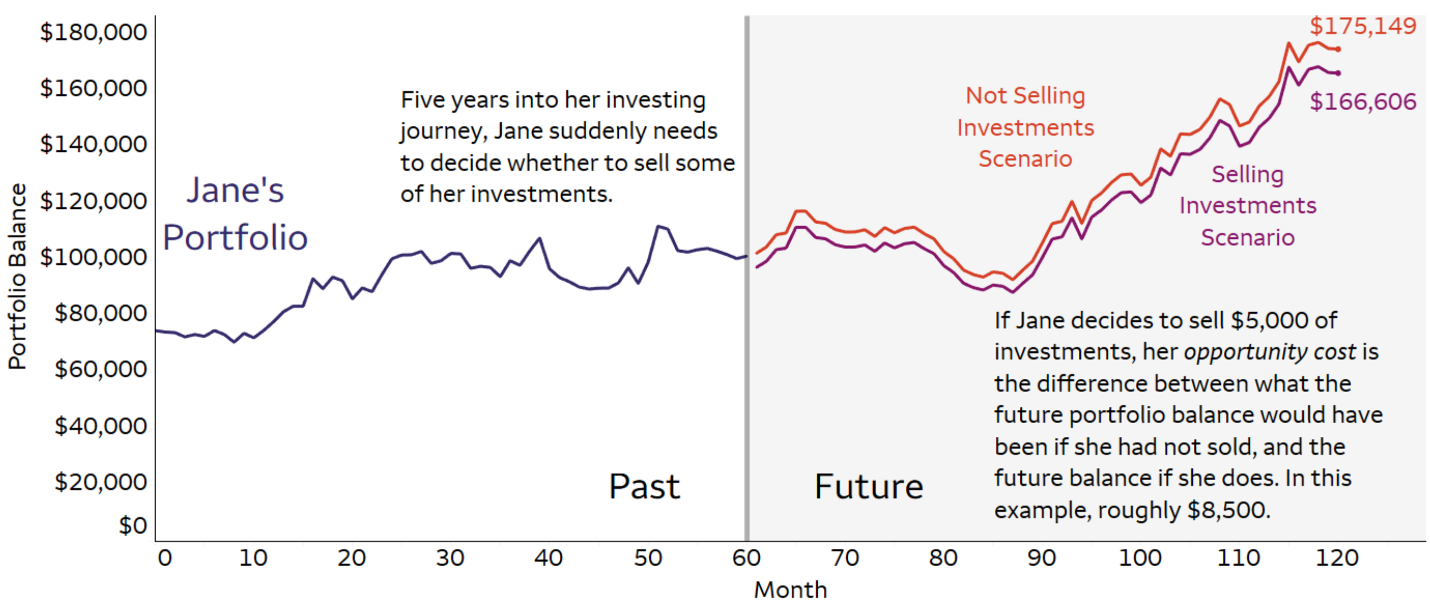
Sell: Selling investments to cover liquidity needs

A robust method for investors to take steps toward achieving their life's larger financial goals is to work with an advisor and create an *Envision*® Plan. Having a plan is one of the best ways investors can proactively save, allocate their investments, and stay focused on their goals until they are funded. But what about a large *current* expense; one where there is no time to save up or invest towards? Is an investor better off covering large current expenses by selling a portion of their portfolio? Maybe…

To determine whether selling investments to fund current cash needs is prudent depends heavily on individual circumstances, personal investing preferences, and expectations for future market returns. If markets rise, and the investor sold out of the investments to fund an expense, they would not experience any potential gains (these potential gains are the investor's *opportunity cost*). Conversely, if markets decline and the investor sold out of their investments, they would not experience any potential losses either. Although there is no way to know for certain what the market will do in the future, consulting with your advisor and referencing the publications from the investment strategists at the Wells Fargo Investment Institute can provide insight into trends and a thoughtful opinion.

To better illustrate this, take investor Jane for example. Jane has accumulated roughly $100,000 in her investment portfolio, but her air conditioning unit failed in the heat of summer and will cost $5,000 to replace. If she pays for the new unit in cash, she would spend most of her emergency savings, leaving little to cover routine expenses. She could instead sell some of her investment portfolio to cover the cost.

Impact of Selling Investments



Source: Wells Fargo Advisors. Chart is for educational/illustrative purposes only and is not intended to represent any particular investment, security, index, or portfolio. Simulation assumes a normal distribution of annual market returns with a mean of 6% and standard deviation of 12%. Simulation results are heavily dependent on the mean and standard deviation assumptions of the distribution and will change if the simulation was repeated.

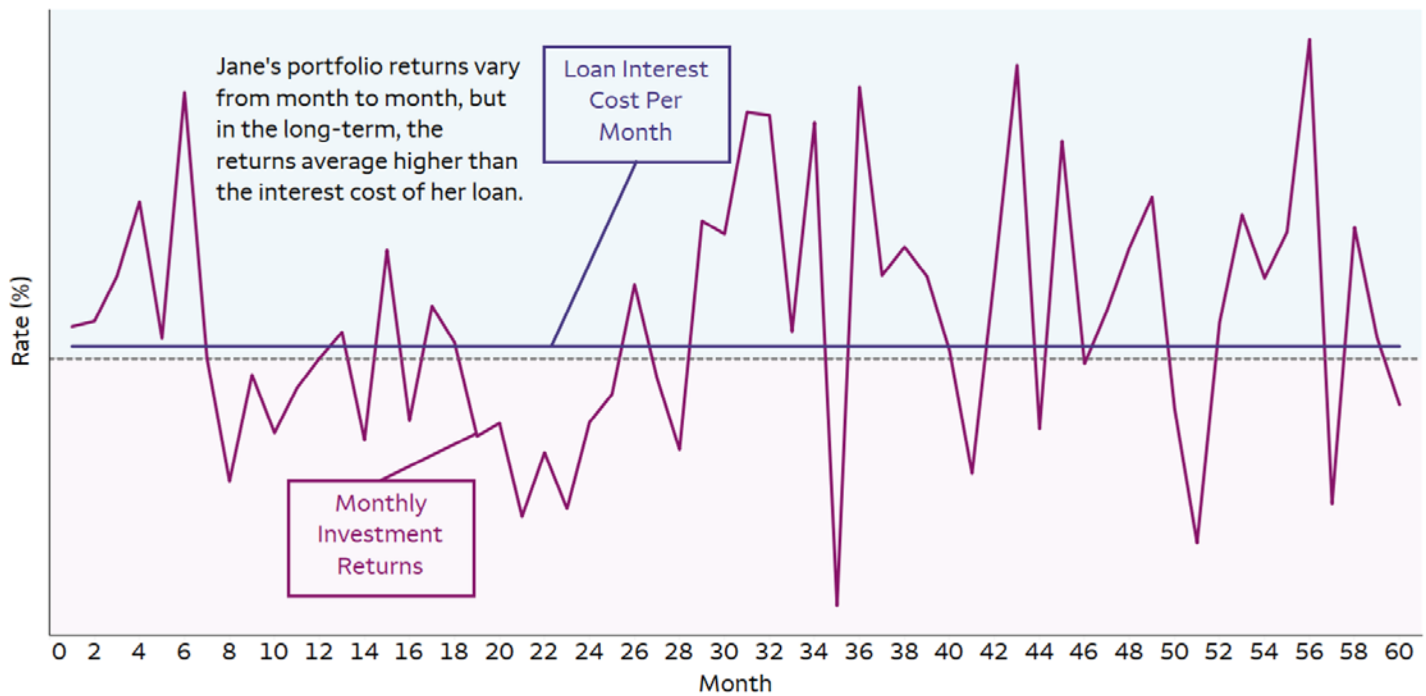
If she sells $5,000 worth of investments and the market subsequently rises, she would miss out on any potential gains on those investments. There are other factors to consider as well; selling investments may have tax consequences for Jane, and may also negatively affect her *Envision*® Plan, hindering her other financial goals.

Your financial advisor can help navigate these complex decisions and help create a strategy to ensure your *Envision*® Plan stays on track in the face of life's unexpected events.

Borrow: Drawing on credit in order to cover liquidity needs
Another source of funding is borrowing. This may take the form of credit cards, personal loans, home equity loans, or even securities-based loans and could be short-term (month-to-month basis as with credit cards) or long-term (30-year mortgage) and anywhere in between. The best way to assess whether borrowing could be a good funding option is to compare the interest rates charged by the lender and the terms of the loan. The interest paid by the borrower can be the best factor in determining how "cheap" or "expensive" the loan is. So how does an investor determine if funding by borrowing is a good option? We return to the concept of opportunity cost discussed above. Essentially, if the interest rate charged by the lender on the borrowed money is lower than the opportunity cost of the money to the borrower, the loan may be an attractive option, depending on the individual needs and circumstances. If the interest rate is higher than the opportunity cost of the money for the borrower, then other funding sources may be better suited.

Revisiting Jane and her need for a new air conditioner: Jane calls her financial advisor to discuss her conundrum. She thinks that paying for the new unit in cash is too much of a risk to covering her routine living expenses. She also has a good credit history and is eligible for a five-year $5,000 loan at 4% interest per year. The loan payments would amount to roughly $100 per month which she is comfortable with covering in her budget. The only other outstanding debt she has is her home mortgage, which is manageable for her. Jane then reviews her investment portfolio and her advisor's guidance for market performance over the next few years. They determine that her diversified portfolio is expected to return 8% per year on average, but she knows that this is just an expectation, (not a guarantee) and her actual results may be different.

Interest Cost vs. Investment Returns



Source: Wells Fargo Advisors. Chart illustrates a hypothetical scenario and is not intended to represent the performance of any particular portfolio, index, or security. The returns on the hypothetical portfolio are assumed to fit a normal distribution with a mean of 8% and standard deviation of 12%.

Because Jane's investment portfolio is expected to return 8% per year (on average, but not guaranteed), it appears to be more attractive to leave the $5,000 invested in her portfolio, and instead borrow the needed funds with the five-year loan at 4% interest per year. Over the five years the loan is outstanding, she would pay a little more than $500 in interest. However, she is expected to earn more than that over the same timeframe if she remains invested because of the compounding effect of her portfolio returns.

Bringing it all together

Jane's situation is unique, but the decision she had to make between funding options is not. Choosing between dipping into savings, selling investments to generate cash, or borrowing money, can present investors with a funding conundrum. However, by following a few rules of thumb and seeking help from a trusted advisor, investors can fund their future cash needs (both planned and unexpected) with confidence:

- **Ensure that cash on hand is sufficient** to cover routine living expenses as well as the occasional curveball that life throws. The exact amount will depend on your situation, but generally three-to-six months' worth of expenses should suffice. However, long-term storage of large amounts of cash in low-interest-paying accounts is not advisable. If your cash reserve is low, refocus on your budget, control spending, and work to build your balance back up to a comfortable level.

- **Maintain your investment discipline** by working with your financial advisor to ensure that your financial goals are up-to-date and properly accounted for in your *Envision*® Plan. Further, keep your investment portfolio aligned to your long-term goals and maintain your focus on the future. By maintaining a well-diversified portfolio and sticking to your plan, your money is more likely to weather the storms of market and geopolitical uncertainty.

- **Remember that debt is a tool** and depending on your financial situation, debt may or may not be the right tool for the job. When investors use debt intelligently, they often can save on long-term interest costs and ensure more of their dollars actually go toward funding their goals.

- **Assess all your available options.** This means taking time to: (1) routinely maintain and evaluate your personal budget to ensure your cash reserve is appropriate. (2) Have a conversation with your advisor about your portfolio and ensure it continues to align to your goals, and (3) educate yourself about lending options and the best possible interest rates.

"Invest in as much of yourself as you can, you are your own biggest asset by far."
– Warren Buffett

INDEX & DATA DEFINITIONS

Index return information is provided for illustrative purposes only. Index returns do not represent investment returns or the results of actual trading nor are they forecasts of expected gains or losses a fund might experience. Index returns reflect general market results, assume the reinvestment of dividends and other distributions, and do not reflect deduction for fees, expenses or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Past performance does not guarantee future results.**

S&P 500: The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

30-Year Fixed Rate Mortgage: Freddie Mac, 30-Year Fixed Rate Mortgage Average in the United States [MORTGAGE30US], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MORTGAGE30US, Weekly data, ending Thursday not seasonally adjusted. Primary Mortgage Market Survey dataset.

1-Year CD Rate: Federal Deposit Insurance Corporation, National Rate on Non-Jumbo Deposits (less than $100,000): 12 Month CD [CD12NRNJ], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CD12NRNJ, Weekly data, ending Monday not seasonally adjusted. Weekly National Rates and Rate Caps dataset.

1-Year Treasury Bill Rate: Board of Governors of the Federal Reserve System (US), 1-Year Treasury Bill: Secondary Market Rate [TB1YR], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/TB1YR, Not seasonally adjusted.

Savings Rate: Federal Deposit Insurance Corporation, National Rate on Non-Jumbo Deposits (less than $100,000): Savings [SAVNRNJ], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SAVNRNJ. The national rate is calculated by the FDIC as a simple average of rates paid (uses annual percentage yield) by all insured depository institutions and branches for which data are available. Data used to calculate the national rates are gathered by RateWatch. Savings and interest checking account rates are based on the $2,500 product tier while money market and certificate of deposit are based on the $10,000 and $100,000 product tiers for non-jumbo and jumbo accounts, respectively. Account types and maturities are those most commonly offered by the banks and branches for which data is available- no fewer than 49,000 locations and as many as 81,000 locations reported. The deposit rates of credit unions are not included in the calculation (http://www.fdic.gov/regulations/resources/rates/).

Checking Rate: Federal Deposit Insurance Corporation, National Rate on Non-Jumbo Deposits (less than $100,000): Interest Checking [ICNRNJ], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/ICNRNJ. The national rate is calculated by the FDIC as a simple average of rates paid (uses annual percentage yield) by all insured depository institutions and branches for which data are available. Data used to calculate the national rates are gathered by RateWatch. Savings and interest checking account rates are based on the $2,500 product tier while money market and certificate of deposit are based on the $10,000 and $100,000 product tiers for non-jumbo and jumbo accounts, respectively. Account types and maturities are those most commonly offered by the banks and branches for which data is available- no fewer than 49,000 locations and as many as 81,000 locations reported. The deposit rates of credit unions are not included in the calculation.(http://www.fdic.gov/regulations/resources/rates/)

DISCLOSURES

All investing involves risk, including loss of principal.

The investment(s) discussed may not be appropriate for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Additional information is available upon request.