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A systematic and thoughtful approach to managing liquidity can be an important part of a wealth management strategy. To help you develop a strategy that is appropriate for various markets and your personal circumstances, GWM Investment Management & Guidance (IMG) has created a liquidity management framework. In this paper, we explain how you can apply the framework. We suggest how to manage your liquidity needs by prioritizing your goals and then proactively considering a range of applicable solutions.

Key Implications

A thoughtful framework for managing liquidity is essential to fund unexpected liquidity needs while limiting the need to sell assets at unfavorable prices and with adverse tax implications.

We help you identify and prioritize your liquidity needs based on your investment objectives, risk tolerance, and financial situation and needs, including lifecycle stage. Next, we propose an approach to help you meet your liquidity and cash flow requirements.

We recognize that meeting liquidity needs also includes the ability to take advantage of investment opportunities as they arise. We suggest balancing the mix of yield, security and convenience features embedded in liquidity solutions to suit your personal circumstances.[†] This approach, with a disciplined use of credit, can help you maintain your long-term investment strategy while retaining access to liquidity.

[†] For more information, please refer to pp. 4-5.

The Importance of a Thoughtful Approach to Managing Liquidity

Liquidity management can be a crucial component of a wealth management strategy to help you meet your cash flow needs in various market conditions and personal circumstances. The importance of managing liquidity was demonstrated during the recent market disruption when, as volatility rose sharply, many investors needed to sell assets at unfavorable prices.

We have developed an approach to help manage liquidity in both stressed and normal market environments. Our framework draws upon the lessons of the past several years, which include:

- Even high-quality assets can become illiquid during heightened market uncertainty;
- Continuous access to liquidity is critical to meet ongoing needs and maintain a long-term investment strategy; and
- Liquidity management is not only defensive; it should allow you to take advantage of investment opportunities in various market environments.

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Our approach to liquidity management is described in two main sections. The first explains how you can identify and then prioritize your liquidity needs, which will depend largely on your personal circumstances. We recognize that you may have multiple wealth management goals and that your liquidity goals are also likely to differ based on their relative size and timing. To help you plan, we propose grouping your liquidity needs into three hierarchical segments: “precautionary,” “basic” and “discretionary.”

The second section discusses how to create a strategy that can help you achieve your cash flow needs. We encourage you to be proactive rather than reactive in managing your liquidity needs by using cash and, where appropriate, credit solutions.

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Liquidity Management & the Personal Balance Sheet

Liquidity needs should be considered in the context of all your assets and liabilities, i.e., your “personal balance sheet.” Exhibit 1 shows a high-level example of such a balance sheet. The section where liquidity management strategies can play a role in your wealth management planning process is highlighted. We recommend managing liquidity by first identifying and prioritizing your liquidity needs. Next, align elements of your personal balance sheet – such as liquid assets, and short- and long-term liabilities – with these needs while remaining consistent with your investment objectives, risk tolerance and financial situation.

Exhibit 1: Liquidity Management and the Personal Balance Sheet

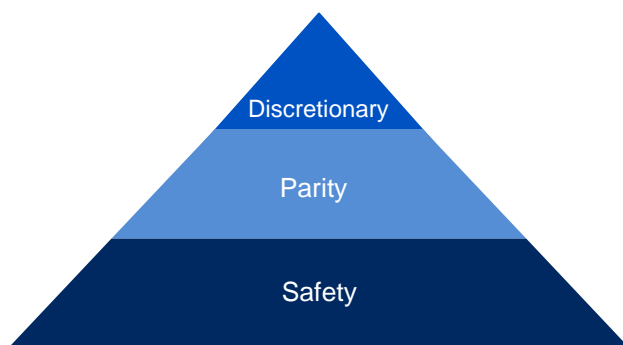
| Personal Balance Sheet | |
|---|--|
| Assets | Liabilities & Equity |
| <ul style="list-style-type: none"> ▪ Liquid Assets ▪ Investment Assets ▪ Tangible Assets | <ul style="list-style-type: none"> ▪ Short-Term Liabilities ▪ Long-Term Liabilities ▪ Net Worth |

1. Prioritizing Your Liquidity Needs

We recognize that you will usually have multiple wealth management goals. To help you plan, we propose grouping these goals into three behaviorally intuitive groups as shown in Exhibit 2 below. A large body of evidence suggests that individuals think in terms of separate “mental” accounts, with each account dedicated to a distinct goal.¹ This contrasts with the traditional balance sheet orientation of analytical finance shown above. The goal categories we suggest are:

- *“Safety” Goals:* to help protect your standard of living from declining below a minimal threshold.
- *“Parity” Goals:* to help maintain your standard of living.
- *“Discretionary” Goals:* to help increase your standard of living and/or maximize your overall well-being through bequest or philanthropy.

Exhibit 2: Hierarchy of Wealth Management Goals



Source: GWM Investment Management & Guidance

1. Seminal Work: Kahneman, Daniel & Amos Tversky. “Prospect Theory: An Analysis of Decision Making Under Risk.” *Econometrica*, Vol. 47, No. 2 (1979), pp. 263-291.

Next, we propose a systematic method of mapping your wealth management goals to your liquidity needs as outlined below:

- *Precautionary Liquidity Needs:* These map to “Safety Goals” and may be triggered by an unanticipated event, such as unexpected medical/healthcare expenses or potential loss of income.
- *Basic Liquidity Needs:* These map to “Parity Goals” and are designed to meet everyday expenses in real terms. Examples include: basic living expenses, travel expenses, and rent/mortgage loan payments.
- *Discretionary Liquidity Needs:* These map to “Discretionary Goals” and go beyond basic lifestyle expenses. Although these liquidity needs are not considered “must-haves,” you should still plan for significant “nice-to-have” events such as real estate acquisitions and improvements.

Your stage in life will likely be a major driver of your liquidity needs.

Our approach to managing liquidity acknowledges that the needs outlined above will vary according to each individual and depend on many factors.

One factor is *lifecycle stage*, which will likely be a major driver of your liquidity needs. For example, younger investors are typically concerned with meeting basic, rather than discretionary liquidity needs. In contrast, older investors are usually more concerned about precautionary and discretionary liquidity needs.

Another factor is *wealth level*. Wealthier investors may have a smaller proportion allocated to basic liquidity needs.

Finally, your *risk tolerance* is an important component. Conservative investors typically view liquidity management primarily in terms of capital preservation and meeting anticipated cash flow needs. Modest and disciplined leverage has the potential to meet investment and liquidity objectives while remaining consistent with your overall risk tolerance.

2. Liquidity Management Strategy

A thoughtful framework for managing liquidity can be essential to limiting the need to sell assets at unfavorable prices or to fund unexpected liquidity needs. We recognize that meeting liquidity needs may also include the potential to take advantage of investments as they arise. We suggest balancing the mix of yield, security and convenience features embedded in liquidity solutions to suit your personal circumstances. This may be tempered with a disciplined use of credit solutions to help you stay with your preferred long-term investment strategy while retaining access to liquidity when needed.

Exhibit 3: Liquidity Needs Determine Appropriate Solutions

| Liquidity Needs | Liquidity Solutions |
|-----------------|--|
| Precautionary | Near Cash &/or Select Credit Solutions |
| Basic | Cash & Near Cash |
| Discretionary | Enhanced Cash &/or Credit Solutions |

Source: GWM Investment Management & Guidance

Near Cash includes: Money Market, Checking Accounts

Enhanced Cash includes: Certificates of Deposit

Select Credit Solutions includes: Credit Cards, Securities-Based Lending

Credit Solutions includes: Customized Credit Solutions, and Home Equity Lines of Credit and Loans. (Note: The proceeds of home-equity lines of credit and mortgage proceeds should not be used for securities purchases.)

An Approach to Managing Liquidity Needs

Once liquidity *needs* have been identified and prioritized into precautionary, basic and discretionary buckets, the next step is to map them to appropriate liquidity *solutions* as outlined below:

- *Precautionary Liquidity Solutions* are designed to fund unexpected expenses while preserving capital, which can be accomplished with cash and, where appropriate, credit solutions. This component should be set up to ensure sufficient funds are available for unexpected liquidity needs, thereby avoiding the sale of assets at potentially unfavorable prices. Examples include: checking accounts, money market accounts, credit cards and securities-based lending.

- *Basic Liquidity Solutions* are designed to fund everyday transactions, preserve capital and offer immediate liquidity. As a result, we believe assets in this category should be held in a traditional cash and money market strategy that is intended to maintain a stable net asset value (NAV). Examples include: checking accounts and money market accounts.
- *Discretionary Liquidity Solutions* are meant to be available to achieve discretionary goals. Goals with unpredictable timing – such as purchases of assets at discounted prices during market dislocations – may require solutions with a credit component and/or enhanced cash strategies. Such solutions may be more appropriate for those with greater risk tolerance, a lower need for immediate liquidity and an opportunistic return-enhancing outlook. Examples can include: Certificates of Deposit, customized credit solutions, home equity lines of credit and secured loans. The proceeds of home-equity lines of credit and mortgage proceeds should not be used for securities purchases.

To read about liquidity management plans applied in practical situations, see the case studies below and on the following pages.

Case Study #1: Liquidity Challenge – Cash and Credit Solution

Judith and David are 55 and 60 years old. They are both working but are considering retiring in five years. Judith had recent health issues and David is in excellent health. They own their own home, valued at \$700,000, and have accumulated savings valued at \$600,000.

They estimate that they require a minimum of \$40,000 on an annual inflation-adjusted basis to maintain their current standard of living. After a review with their Financial Advisor, Judith and David established a liquidity strategy that would account for day-to-day living expenses and the potential for unexpected healthcare expenses. They considered themselves to be risk averse.

Solution

Precautionary: Given Judith’s health condition, a portion of their current savings would be allocated to near cash and, as appropriate, certain credit solutions to meet unexpected liquidity needs. The remaining portion would be allocated to basic liquidity needs as discussed below, and to assets such as equities and fixed income securities in a manner consistent with their risk tolerance.

Basic: In order to meet their day-to-day living expenses, they should work with their Financial Advisor to invest approximately the equivalent of 6 to 12 months of their basic expenses in cash solutions. This would represent approximately \$20,000 to \$40,000. This can include checking accounts and money market accounts, which allow for immediate liquidity to cover day-to-day living expenses to maintain their standard of living.

Cash Solutions

When considering cash solutions, you should be aware of many factors, including:

- **Yield:** Yield may vary across cash solutions based, among other things, on the maturity date of the offering. Deposit solutions allow surplus cash to be readily redeployed into the market or withdrawn as needed, but may offer a lower yield. However, opportunities may occasionally exist to achieve both higher cash yields and obtain FDIC insurance. You should consult with your Financial Advisor for more details.
- **Security:** Security features vary across cash solutions based on issuer and amounts. Various account structures can be used to maximize FDIC insurance and add extra security to clients’ cash holdings. You should consult with your Financial Advisor to understand the security features of liquidity solutions you are considering.

- *Convenience:* Certain liquidity management solutions allow ready access to cash, which may help you to opportunistically take advantage of investments that may arise during market dislocations.

You should consult with your Financial Advisor to understand the security features of liquidity solutions you are considering.

Credit Solutions

You should also be aware of the salient features of credit solutions:

- *Secured or Unsecured:* The credit solution can potentially be tied to an asset. Secured solutions are generally used for larger purchases or expenses, whereas unsecured solutions may be more appropriate for meeting smaller or shorter-term liquidity needs.
- *Amortizing or Balloon:* You may be able to repay the principal throughout the life of the lending solution or only at certain dates later in the term of the loan.
- *Closed-end or Revolving:* You can access credit for a fixed term or on an ongoing, revolving basis.
- *Short- or Long-term:* You may be able to repay principal and interest over a long or a short period of time.
- *Flexibility:* Limitations in using a credit facility, for instance, the number times a line of credit can be accessed.
- *Qualification Requirements:* There may be net worth, income, debt service and other qualifying criteria to consider.
- *Risks:* Credit solutions carry additional risks. You should fully understand and carefully weigh those risks.

Case Study #2: Liquidity Challenge – Cash and Credit Solution

Matthew and Sally are 50 and 45 years old, and are both working. They own their own home valued at \$550,000 and have accumulated savings valued at \$500,000. They estimate their basic annual after-tax expenses to maintain their current standard of living at \$55,000. They are both in excellent health. They have plans to purchase a vacation home. Their risk tolerance is moderate.

Solution

Precautionary: Matthew and Sally should consult their Financial Advisor to dedicate a portion of their portfolio to meet unexpected liquidity needs. This would include near cash solutions and, as appropriate, certain credit solutions.

Basic: In order to meet their day-to-day living expenses, they should work with their Financial Advisor to invest approximately the equivalent of 6 to 12 months of their basic expenses in cash and near cash solutions. This would represent approximately \$27,500 to \$55,000. This can include checking accounts and money market accounts, which allow for immediate liquidity to cover recurring annual expenses to maintain their standard of living.

Discretionary: Given their desire to purchase a second home, their Financial Advisor has recommended setting aside a component of their savings portfolio to meet these needs. Their Financial Advisor suggests establishing a home-equity line of credit (HELOC) approximately 12 months in advance of their intended purchase of a vacation home in case they need to act swiftly. The remaining portion of their savings should be allocated to assets, such as equities and fixed income securities, in a manner consistent with their risk tolerance.

Case Study #3: Liquidity Challenge – Cash and Credit Solution

Jake and Julia are 55 and 50 years old and operate their own business. Their business was recently valued at \$20 million and they own their home, which was valued at \$2 million. They estimate their basic annual after-tax expenses to maintain their current standard of living at \$250,000. They are both in excellent health. They have plans to purchase a vacation home and a private jet. Their risk tolerance is moderately aggressive.

Solution

Precautionary: Jake and Julia should consult their Financial Advisor to allocate a portion of their portfolio to meet unexpected liquidity needs. This would include cash and credit solutions. Examples include: checking accounts, money market accounts and securities-based lending .

Basic: In order to meet their day-to-day living expenses, they should work with their Financial Advisor to invest approximately the equivalent of 6 to 12 months of their basic expenses in cash and enhanced solutions. This can include checking accounts and money market accounts. This allows for immediate liquidity to cover recurring annual expenses to maintain their standard of living.

Discretionary: Given their desire to purchase a vacation home and a private jet, their Financial Advisor has recommended setting aside a component of their savings portfolio to meet these needs. Their Financial Advisor suggests a customized credit solution. The remaining portion of their savings should be allocated to assets in a manner consistent with their risk tolerance. Also, those investment assets can be used as collateral for funding future investments, as well as to meet unexpected costs related to ownership of the plane and second home.

Conclusion

A robust liquidity management strategy should be based on a proactive plan for your future liquidity needs. We recognize that at any stage you may have multiple investment goals, which will likely depend in part on your risk tolerance and financial situation and needs. Your liquidity needs are also likely to differ based on the relative size and timing of those needs. To help you plan, we propose grouping your liquidity needs into three hierarchical segments: “precautionary,” “basic” and “discretionary.”

Once your liquidity needs are appropriately identified and prioritized, we propose an alignment of a range of solutions with your needs by using both cash and, where appropriate, credit solutions. Your Financial Advisor can help you customize such an approach to your personal circumstances.

For More Information

If you are looking for more information related to liquidity, ask your Financial Advisor for *Understanding Money Market Funds*, a client-approved whitepaper from GWM Investment Management & Guidance (IMG).

Case studies are intended to illustrate products and services of Merrill Lynch. It does not necessarily represent the experiences of other clients, nor does it indicate future performance. Results may vary. The investment strategies may not be appropriate for every investor. They do not take into account the specific investment objectives, financial situation and particular needs of any specific person who may receive it. Individual clients should review with their Merrill Lynch Financial Advisor the terms and conditions and risks involved with specific products and services.

Appendix: A Three-Step Process to Developing and Managing a Liquidity Management Strategy

Step 1: Determine Your Liquidity Strategy

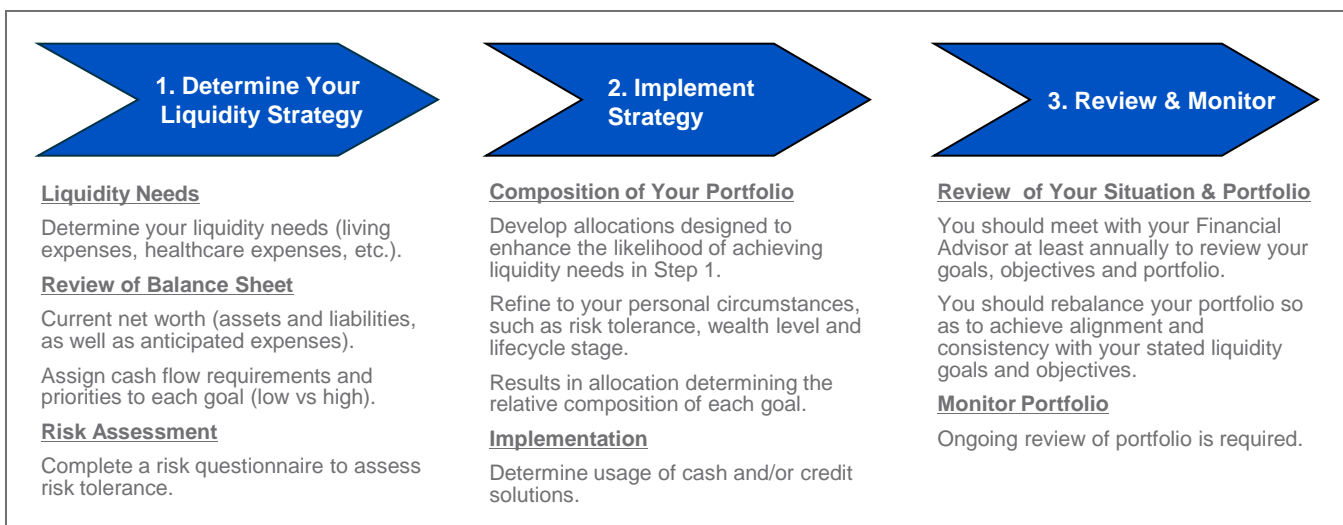
The first step in establishing a liquidity management strategy is identifying all your potential liquidity needs. These needs should be prioritized based on the approach outlined in Section 2 (medical/healthcare expenses, basic living expenses, etc.). Secondly, it is important to complete a thorough review of your balance sheet and anticipated cash flows (assets, liabilities, as well as expenses and sources of income). You should assign cash flow requirements and priorities to each liquidity goal. Thirdly, you should complete a questionnaire to assess your risk tolerance. (For more information about the questionnaire, ask your Financial Advisor.)

Step 2: Implement Strategy

Your portfolio should raise the likelihood of achieving your liquidity needs as identified in Step 1, accounting for, among other things, your lifecycle stage, risk tolerance and wealth level. Determine relative composition of each goal. For implementation purposes determine usage of cash vs. credit solutions.

Step 3: Review & Monitor

To help ensure your liquidity management strategy is appropriate for your situation, it is important for you to meet as needed (at least annually) with your Financial Advisor to review your portfolio or to help determine whether your risk tolerance, situation, liquidity needs, cash flows or goals have changed. You may want to rebalance your portfolio or make other changes to align it with your liquidity needs.



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