DIVORCE AND THE VOLATILE STOCK MARKET

How to Mitigate Risk in Uncertain Financial Times

By Geoff Burroughs, CFP®, CDFA®

Stock market volatility can make the most seasoned professional uneasy. But what about a person whose entire nest egg has been dropped in their lap due to a divorce? Often, they have very little understanding of their financial picture, and making sense of it during stock market fluctuations is a challenge.

It is not uncommon for one person in the relationship to be solely in charge of the family's investments. When that couple then goes through a divorce, one party needs to play catch-up. Not only do they need to quickly come to an understanding of what they have, but they also need to do an assessment of what role their investments play in their new future. Chances are, some of their needs have changed.

What might have been earmarked for retirement is now needed for the down payment or buyout of a house. Maybe a couple that was living within their means finds that dividing everything into two households has left their cash flow a little short, forcing them to lean on investment income to make up the difference. There are numerous scenarios in which, due to a divorce, the function of investments changes.

The biggest issue with these types of adjustments is the dramatic change in time horizon. Investments that were earmarked for use 20 years down the road may now be needed in the next six months. Money that was invested for growth may now need to be invested for income.

Making these types of changes is not a problem in a calm market. But what happens when calm turns volatile? Here are some areas to look out for:

MARGIN OR SECURITIES-BASED LOAN

Both strategies mean that you are using your investments as collateral on a loan. Many times, that loan is used to buy more investments. The problem lies in the value of the underlying investments. If the value of the collateralized investments drops too much, the loan can be called, forcing investments to be sold to pay off the loan. This means selling at a low level and potentially wiping out an account. Typically, this happens when the loan collateralizing the securities in the account becomes 70% of the value of the asset (assuming it is in stocks). This threshold is referred to as margin requirement (in this case, 30%).

Example 1: The client has $100,000 in current value in a stock mutual fund, and takes a loan of $50,000 to buy a car, resulting in $50,000 in equity. *Then the mutual fund value drops 30%.* Now, the client has $70,000 in current value in a stock mutual fund, and the original loan of $50,000 is now adjusted to $20,000 in equity.

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The equity in the account has dropped from $50,000 to $20,000, because the stock mutual fund went down but the loan stayed the same. So the required equity has dropped below the margin requirement of 30%, and a margin call will be made. $20,000 (current equity)/ $70,000 (mutual fund value) = 28.57% (below the 30% requirement). The client will have to deposit $1,000 or sell $3,334 worth of the stock mutual fund (remember that you are reducing equity by selling some of the stock mutual fund).

If the margin loan was used to buy more investments (which is common), a move down will be magnified even if a margin call is not triggered.

Example 2: You own $100,000 worth of Apple stock (typically the margin requirements are higher if you are just using one stock as collateral, but we will ignore that for illustration purposes).

You take a margin loan of $50,000 and buy $50,000 worth of Facebook stock. Now you have $100,000 in Apple, $50,000 in Facebook and debt of $50,000, resulting in $100,000 equity.

If the investments go down by 20%, you have $80,000 worth of Apple, $40,000 worth of Facebook and debt of $50,000, resulting in $70,000 equity. *This is an actual loss of 30%.*

ALTERNATIVE INVESTMENTS

There is a wide variety of alternative investments, but some are less liquid than others. During volatile times,

many of these products (such as hedge funds) have the ability to put up what's called a "gate," which can prevent or limit you from selling your position. The purpose of the "gate" is to prevent a run on the fund and a fire sale of its assets. Although this feature can be helpful to its shareholders, "gates" can be very problematic if people find themselves in a cash crunch.

Other alternative investments, such as non-publicly traded REITs (Real Estate Investment Trusts) or BDCs (Business Development Companies) have severe penalties for an early withdrawal—if they are even able to fill the sales order. In addition to the liquidity issues, there is also a value issue. Because these products are not listed on a stock exchange, they may not be valued daily. In fact, many non-public REITs are only valued on an annual basis. So you could be looking at a statement of an asset that you cannot liquidate and may be significantly lower in value than what shows on the statement.

SPECULATIVE PRODUCTS

Some products, such as leveraged ETFs, are designed to over-emphasize a view, such as twice the performance (in either direction) of the stock market. The problem with some of these (check out the XIV ticker) is that they can perform so poorly if the bet goes wrong that they can collapse. Recently, XIV went down 85% in one day. It went down so fast that there were no buyers and trading was halted. If you owned it, that means you felt the full loss without the ability to sell.

OPTIONS

These can serve both as protection and speculation. During volatile stock markets, their price can swing dramatically and can trigger a buy or sell of the underlying stock. Depending on how they are being used, they can be very helpful or extremely costly in volatile markets. They also have an expiration date, meaning they are short-term in nature and both losses and gains are very susceptible to short-term volatility.

TAXES

If you have taxable investments (non-retirement accounts) you will most likely have some tax liability at the end of the year. Many tend to leave money that is owed for stock transactions fully invested until the last minute. The problem, again, is timing. There is a deadline for when you need to pay the IRS, and so if you leave the money invested until the last minute, you are very open to a market correction.

REFINANCING | BUYOUT | NEW MORTGAGE

For many divorces, there is a need to refinance a home, buy one person out, obtain a new mortgage for a new home, or do all three. Two elements are susceptible to volatile markets: interest rates and capital requirements. During the recent market moves, interest rates rose dramatically. If someone was looking to refinance or buy a new home, this could have impacted their ability to make the monthly payments they had originally budgeted. The more vulnerable element is capital requirements. To qualify for a loan, you often need to put money down as well as show other assets. If your investments are the source of this capital and the investments decline, you may no longer qualify for the house. If you are looking to buy someone out of the

house, it may require more money than the new value of your investments will allow.

> **Example:** A person has $300,000 in investments. They agree to buy their spouse out of the house for $200,000, leaving them with $100,000. If their investments decline by 20%, their new value is $240,000. This would only leave them $40,000 after the buyout. This may or may not affect the overall negotiations.

There are numerous other examples, such as Private Equity capital calls, Restricted Stock, and Stock Options that are tied to compensation, but the above are some of the more common scenarios.

STRATEGIES FOR A VOLATILE MARKET

So what should you do?

Build a cash reserve.
Look down the road (as best as you can) at your next 12 months of expenses. If possible, generate that amount in cash reserves. This will allow you greater control.

Don't be greedy!
Don't wait until the last minute to generate the cash for a transaction. If you know there will be a need to sell an investment, do it earlier rather than trying to "time the market." It is better to miss some gains then to not be able to make the transaction.

Identify potential problem investments.
Look for any investment that could be difficult to sell or that might delay your request to liquidate, and then talk to the provider to see what the terms are and to make a plan.

Close out any loans.
Every situation is different, but reducing or eliminating margin or any type of leverage will provide greater predictability. Leverage can enhance your returns on the way up, but wipe you out on the way down. A word of caution: before you sell any investments, look at the tax consequences. If you have significant gains in the account, a sale could also trigger a big tax bill.

Take control of your half.
If possible, split the investments early so you can make your own investment decisions. Even if it can't be moved into your name, you may be able to "clone" the account. This means making a second identical account. For example: One IRA with $500k becomes two IRAs (still in the same person's name) with $250k in each.

Factor in taxes.
Don't forget that when you sell an investment (as long as it's not in a retirement account), you will owe tax on the gains. Set that money aside in cash at the time of the sale instead of leaving that money invested.

Take stock "in-kind" instead of selling.
If your investments are down, you don't necessarily have to sell them. Most types of accounts allow you to transfer the shares instead of selling them and then transferring the money.

Everyone's situation is different. The key is getting educated. A good financial analyst will help clients learn about what they have and come up with a plan for a volatile market.

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Geoff is a CDFA® and CFP® with Harbor Investment Advisory servicing the Baltimore and DC market. He specializes in helping clients organize themselves and bring clarity to their financial situation in the beginning of the divorce process. He also assists clients as they transition to life after divorce by providing financial coaching, planning and asset management. Geoff is active in the collaborative community as well as working on mediated and litigated cases.

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