Concentrated Stock Positions

Strategies to help preserve and diversify

There are a number of advanced solutions that can be used to help reduce an investor's exposure to a concentrated position, each with its own benefits that may suit a particular situation or set of goals.

In today's world, pursuing your life's goals is being challenged in new ways. Which makes now the perfect time to review your goals in terms of "Advice. Beyond investing." Because when we collaborate on what matters most to you, we can create a plan tailored for you.

* Investing involves risks, including the potential of losing money or the decline in value of the investment. Performance is not guaranteed.

Key takeaways

- Investors should understand the risks of holding concentrated stock positions and the benefits of diversifying such positions
- Certain strategies can help investors preserve or diversify out of a concentrated position—depending on their goals, investors can implement a strategy to allow for continued participation in the growth potential of a stock or to simultaneously support their charitable goals
- Investors should consult with their tax advisors about the most tax-efficient way to diversify

Introduction

High net worth investors may hold large, concentrated stock positions. While the risks of holding a large portion of personal wealth in a single position are reasonably apparent, it is often challenging to determine the best way to mitigate these risks, often due to potential tax consequences or psychological affinity for the stock. This article outlines some of the strategies used to help preserve or diversify a concentrated equity position. It provides an overview of sophisticated and complex strategies, which must be evaluated based on the investor's individual needs in consultation with financial, legal, tax and other advisors.

In some cases the diversified portfolio may outperform the concentrated equity position.

Four potential strategies are outlined below:

- **Equity collar**—may be appropriate for investors who wish to protect the value of a concentrated equity position against downside risk, yet continue to participate in some of the potential stock price appreciation and dividend income (if any)
- **Prepaid Variable Forward (PVF)**—may be used by investors who wish to achieve the economics of an equity collar and also generate immediate cash proceeds (for investment spending or other liquidity needs)
- **Charitable Remainder Trusts (CRTs)**—enables investors to transfer highly appreciated assets to an irrevocable trust in exchange for a cash flow stream without generating an immediate capital gains tax or net investment income surtax on the entire embedded gain
- **Exchange fund**—a solution for achieving broad equity market diversification of a concentrated equity position, along with potential tax deferrals

Capital gains tax

One straightforward way to help mitigate the risk of a concentrated equity position is simply to sell the stock and reinvest the proceeds in a diversified portfolio. However, an investor must certainly consider the opportunity cost of selling that position, which is the after-tax hypothetical return differential between the concentrated position and a diversified portfolio. In some cases the diversified portfolio may outperform the concentrated equity position. To determine if such an action is prudent, an investor must consider that a stock sale may be subject to taxes and that the returns of a diversified portfolio should compensate for those taxes paid.

The maximum long-term capital gains tax rate is currently 20% and there is also a 3.8% surtax on net investment income that investors must consider. (Any applicable state taxes also add to the tax burden.) The combined maximum federal rate of 23.8% can be viewed as the hurdle or "make back" requirement of the reinvested net sale proceeds. Compounding the problem, cost basis in concentrated equity positions tends to be low (because such positions are often the result of options grants, stock buyouts, IPOs or accumulated over a long period of time). However, even in a high-tax environment, the advantages of a diversified portfolio may still be preferable to a concentrated position, which leaves an investor vulnerable to the rise and fall of a single company's fortunes.

Sometimes reducing exposure or completely divesting a concentrated position is not as simple as selling the stock. Accordingly, there are a number of advanced solutions that can be used to help reduce an investor's exposure to a concentrated position, each with its own benefits that may suit a particular situation or set of goals.

Equity collar

What is it?

Investors who wish to preserve the value of a concentrated equity position (i.e., hedge that position) and continue to participate in some of the potential stock price appreciation and dividend income (if any) may want to consider an equity collar. An equity collar helps protect a portfolio containing a concentrated equity position by limiting the portfolio's exposure to large moves in the stock price of the concentrated position (up and down).

An equity collar is made up of a purchased put option and a sold call option, with the same maturity date. The purchased put option allows an investor to sell the stock at maturity for a preset price ("Floor Price" or "Exercise Price") if the stock price ends below that level, or to receive the net cash value instead (receive Floor Price less stock price). The downside protection has an upfront cost, so typically the investor sells a call option to mitigate the cost. The sold call option generates upfront cash for the investor because the investor is giving up the appreciation in the stock price above a preset price ("Cap Price"). The investor is agreeing either to sell the stock at maturity at the Cap Price if the stock price ends above that level, or to pay the net cash value instead (pay Cap Price less stock price). The Floor-Cap combination essentially "collars" the future value of the stock. When the cost of the purchased put option is fully funded by the proceeds of the sold call option, the transaction is referred to as a "cashless collar."

An exchange-listed equity collar is established using exchange-listed put and call options that are physically settled only (must deliver shares at maturity) and "American style" only (which means the call option may be exercised during its life, requiring the investor to sell the shares before expiration).

An over-the-counter equity collar is established with an investment bank as the counterparty to the put and call options, with customizable size, strike prices, maturity date(s), etc. The options are either physically settled or cash settled (and the choice is made at maturity) and either "American style" or "European style"(the latter of which means the options cannot be exercised during their life).

During the life of both an exchange-listed and over-the-counter equity collar, the investor retains ownership, voting rights, and dividends on the underlying shares. If the investor needs liquidity during the life of an over-the-counter equity collar, it may be possible to borrow against the Floor Price. Be aware, equity collars do have tax consequences for dividends and at the maturity of the contract.[1]

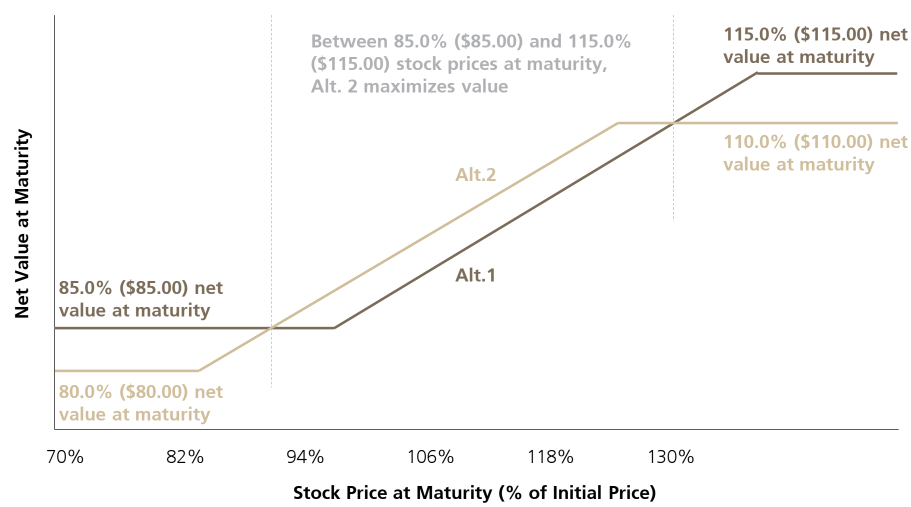
How does it work?
For example, an investor who owns stock with a market price of $100 per share seeks to limit his or her downside risk.

Alternative 1
The investor purchases a two-year put option with a strike price of $90 and simultaneously sells a two-year call option with a call strike of $120. The net upfront cost of the equity collar is $5.

The portfolio value at maturity (excluding any dividend income earned during the life) is as follows:
– If the stock rallies above the Cap Price (e.g., $130), the investor achieves a $20 payoff from the collar, for a total portfolio value of $120 per share ($115 net of upfront collar cost);
– If the stock falls below the Floor Price (e.g., $50), the investor receives a $40 payoff from the collar, for a total portfolio value of $90 per share ($85 net of upfront collar cost);
– If the stock ends between the Floor and Cap Prices (e.g., stays at $100), there is no payoff from the collar, and the investor maintains a total portfolio value of $100 per share ($95 net of upfront collar cost)

Alternative 2
For zero out-of-pocket cost upfront (“cashless collar“), the investor can lower the Floor Price to $80 and the Cap Price to $110.

The portfolio value at maturity (excluding any dividend income earned during the life) is as follows:
– If the stock rallies above the Cap Price (e.g., $130), the investor achieves a $10 payoff from the collar, for a total portfolio value of $110 per share;
– If the stock falls below the Floor Price (e.g., $50), the investor receives a $30 payoff from the collar, for a total portfolio value of $80 per share;
– If the stock ends between the Floor and Cap Prices (e.g., stays at $100), there is no payoff from the collar, and the investor maintains a total portfolio value of $100 per share



What are the settlement alternatives?
For an exchange-listed equity collar, the options are physically settled at maturity. If the stock price at maturity is either below the Floor Price or above the Cap Price, the investor delivers 100% of the shares and receives the Floor Price per share in cash (if the stock price is below) or receives the Cap Price per share in cash (if the stock price is above).

For an over-the-counter equity collar, the options are either physically or cash settled, at the investor's discretion. If cash settlement is chosen, the investor either receives cash if the stock price ends below the Floor Price (equal to the excess of the Floor Price over the stock price) or pays cash if the stock ends above the Cap Price (equal to the excess of the stock price over the Cap Price), and retains the underlying shares.

Prepaid Variable Forward (PVF)

What is it?
A prepaid variable forward is a commonly used hedging strategy because it combines the benefits of an over-the-counter equity collar with immediate cash proceeds, which can be used for investment or diversification purposes. The proceeds generated upfront can be used for any purpose, and the return on the invested proceeds can help offset the cost of the equity collar (if any) or increase the yield on the stock.

To execute a PVF, the investor executes an over-the-counter equity collar with an investment bank, choosing the maturity date, Floor Price, and Cap Price. The investor receives cash immediately equal to the Floor Price per share, less the financing cost, less the cost of the equity collar (if any). The investor continues to hold the underlying stock during its life, retaining voting rights and the dividends.

At maturity, the investor must settle the underlying equity collar as well as repay the proceeds received upfront (which equals the Floor Price per share). As with an over-the-counter equity collar, the investor has the option of physically settling (delivering shares) or cash settling the transaction. To finance a cash settlement, the investor may wish to enter a new PVF, using the proceeds from the new transaction to finance the amount owed for the maturing PVF. (Note: it is possible that sufficient proceeds are not generated from a new PVF to finance cash settlement of the maturing PVF in full)

How does it work?
For example, an investor who owns stock with a market price of $100 per share seeks to limit downside risk and generate upfront proceeds.

Alternative 1
The investor purchases a two-year put option with a strike price of $90 and simultaneously sells a two-year call option with a call strike of $120. The net upfront cost of the equity collar is $5 and the financing cost is $1. The investor receives net upfront proceeds of $84 per share, equal to the $90 Floor Price, less the $1 financing cost, and less the $5 equity collar cost.

The payoff at maturity (excluding any dividend income and any investment return earned on the upfront proceeds during the life) is:
– If the stock rallies above the Cap Price (e.g., $130), the investor achieves capped value of $120 per share, repays $90 upfront proceeds amount, and thus

receives additional cash of $30 per share at maturity (the investor achieves total portfolio value, net of collar and financing costs, of $114 per share);

- If the stock falls below the Floor Price (e.g., $50), the investor achieves floor value of $90 per share, repays $90 upfront proceeds amount, and thus receives no additional cash at maturity (the investor achieves total portfolio value, net of collar and financing costs, of $84 per share);
- If the stock ends between the Floor and Cap Prices (e.g., stays at $100), the investor maintains a value of $100 per share, repays $90 upfront proceeds amount, and thus receives additional cash of $10 per share at maturity (the investor achieves total portfolio value, net of collar and financing costs, of $94 per share).

Alternative 2

For a cashless collar alternative, the investor can lower the Floor Price to $80 and the Cap Price to $110. The investor receives net upfront proceeds of $79 per share, equal to the $80 Floor Price, less the $1 financing cost.

The payoff at maturity (excluding any dividend income and any investment return earned on the upfront proceeds during the life) is as follows:

- If the stock rallies above the Cap Price (e.g., $130), the investor achieves a capped value of $110 per share, repays the $80 upfront proceeds amount, and thus receives additional cash of $30 per share (the investor achieves total portfolio value, net of financing cost, of $109 per share);
- If the stock falls below the Floor Price (e.g., $50), the investor achieves floor value of $80 per share, repays the $80 upfront proceeds amount, and thus receives no additional cash at maturity (the investor achieves total portfolio value, net of financing cost, of $79 per share);
- If the stock ends between the Floor and Cap Prices (e.g., stays at $100), the investor maintains value of $100 per share, repays the $80 upfront proceeds amount, and thus receives additional cash of $20 per share at maturity (the investor achieves total portfolio value, net of financing cost, of $99 per share)

PVF Alternative 1: $90.00 – $120.00

		At maturity			
Stock price in 2 years	**Upfront net proceeds**	**Equity collar settlement**	**Proceeds repay**	**Stock value**	**Net portfolio value**
$70.00	$84.00	+$20.00	-$90.00	$70.00	$84.00
$80.00	$84.00	+$10.00	-$90.00	$80.00	$84.00
$90.00	$84.00	$0.00	-$90.00	$90.00	$84.00
$95.00	$84.00	$0.00	-$90.00	$95.00	$89.00
$100.00	$84.00	$0.00	-$90.00	$100.00	$94.00
$105.00	$84.00	$0.00	-$90.00	$105.00	$99.00
$110.00	$84.00	$0.00	-$90.00	$110.00	$104.00
$115.00	$84.00	$0.00	-$90.00	$115.00	$109.00
$120.00	$84.00	$0.00	-$90.00	$120.00	$114.00
$130.00	$84.00	-$10.00	-$90.00	$130.00	$114.00
$70.00	$79.00	+$10.00	-$80.00	$70.00	$79.00

PVF Alternative 2: $80.00 – $110.00

Stock price in 2 years	Upfront net proceeds	At maturity: Equity collar settlement	At maturity: Proceeds repay	At maturity: Stock value	Net portfolio value
$80.00	$79.00	$0.00	-$80.00	$80.00	$79.00
$90.00	$79.00	$0.00	-$80.00	$90.00	$89.00
$95.00	$79.00	$0.00	-$80.00	$95.00	$94.00
$100.00	$79.00	$0.00	-$80.00	$100.00	$99.00
$105.00	$79.00	$0.00	-$80.00	$105.00	$104.00
$110.00	$79.00	$0.00	-$80.00	$110.00	$109.00
$115.00	$79.00	-$5.00	-$80.00	$115.00	$109.00
$120.00	$79.00	-$10.00	-$80.00	$120.00	$109.00
$130.00	$79.00	-$20.00	-$80.00	$130.00	$109.00

What are the settlement alternatives?

The amount owed at maturity equals the proceeds repayment amount plus/minus the equity collar settlement amount. The amount is payable in shares or in cash.

If paid in shares, the investor delivers a decreasing number of shares the higher the stock price. For example, using PVF Alternative 1 above:

- If the stock ends below the Floor Price, 100% of the underlying shares are delivered (notice the stock value at maturity exactly equals the net amount owed at maturity);
- If the stock ends between the Floor and Cap, e.g., suppose it stays at $100: 90% of the underlying shares are delivered (= $90 net amount owed ÷ $100 stock value);
- If the stock ends above the Cap Price, e.g., suppose it ends at $130: 77% of the underlying shares (= $100 net amount owed ÷ $130 stock value).

Charitable Remainder Trusts (CRTs)

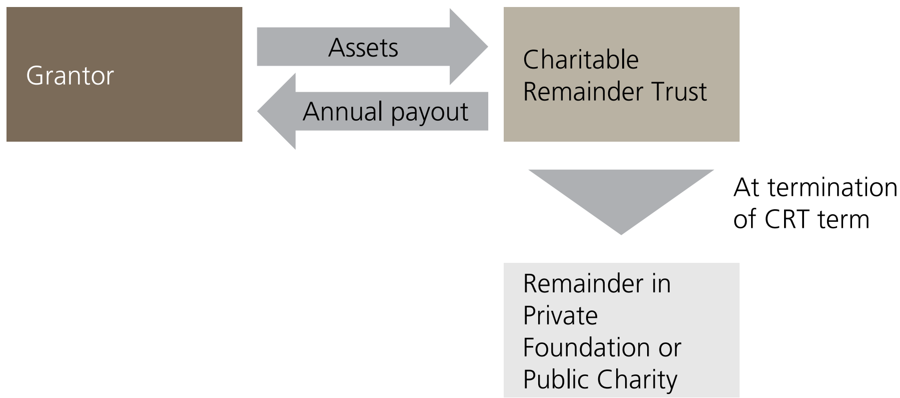
What is it?

A charitable remainder trust enables an investor to transfer highly appreciated assets to an irrevocable trust in exchange for a cash flow stream without generating an immediate capital gains tax or net investment income surtax on the entire embedded gain. The income stream can be in the form of a fixed dollar amount each year, or an annuity (Charitable Remainder Annuity Trust, or CRAT) or a percentage of the fair market value of the trust (Charitable Remainder Unitrust, or CRUT). The investor will also receive a charitable income tax deduction for part of the amount contributed to the trust. Upon death or at the end of the trust term, the remaining assets pass to one or more charities designated by the donor. The terms of the trust are determined upfront when the trust is established.

How does it work?

- The grantor transfers appreciated assets to a CRT
- The CRT distributes to the beneficiary the annuity amount or a percentage of the fair market value of the assets of the trust valued on the same day each year
- A CRT can have a term based upon a period of years (not to exceed 20 years), or on the lives of one or more persons

– At the conclusion of the term of the CRT, the remaining trust property is paid to one or more charitable organizations
– The present value of the remainder interest passing to charity from a CRT must equal at least 10% of the initial value of the assets contributed. This requirement effectively establishes a maximum annuity or unitrust payout from a CRT
– The payout amount cannot be less than 5% or more than 50% of the value of the trust
– CRTs are subject to certain private foundation rules, including rules prohibiting self-dealing and "taxable expenditure" provisions



While the CRT is tax exempt, the capital gain or any other taxable income generated inside the trust will be taxed to the individual as he or she receives annuity or unitrust payments from the trust, depending on what type of other income is earned by the trust. The tax nature of the distribution is based on a four-tier tax structure. This tiered structure will tax the distribution first as ordinary income to the extent ordinary income was generated within the trust. Then capital gains, tax-exempt income and finally a return of principal (tax-free). "Net investment income" for purposes of the 3.8% surtax thereon may be treated in one of two ways: (1) as part of the separate subclasses under each income category (ordinary income, short term capital gain and so on); (2) as being distributed out until exhausted (which requires an irrevocable election). Records must be kept to track all income generated over the life of the CRT.

CRT benefits and considerations
Potential benefits
– Tax-efficient diversification
– Charitable income tax deduction
– Generate annual cash flow
– Fulfill charitable intent
– May reduce size of the taxable estate—removes assets and the future appreciation of those assets from the estate
– Enhanced appreciation of assets due to CRT's tax-exempt status
– Mitigate tax liability in a high-income year, e.g., due to:
  – Liquidity event such as the sale of a business
  – Exercise of compensatory options
– May be combined with other investment vehicles to enhance their value, e.g.,:
  – A wealth replacement strategy using life insurance that provides for beneficiaries while minimizing estate taxes

Considerations

- Two types of CRTs:
  - Charitable Remainder Annuity Trust (CRAT)
  - Charitable Remainder Unitrust (CRUT)
- Income considerations:
  - Individuals seeking a steady income stream may prefer the reliability of a CRAT
  - Investors who favor the prospect of appreciating cash flows may prefer a CRUT
- Inflation considerations:
  - A CRUT provides an income distribution based on a fixed percentage of the fair market value of the trust assets. If trust assets appreciate in a rising market, the increased payment may act as a hedge against inflation. Conversely, if trust assets fall, the payment may decrease.
- Additional contributions: Further contributions may be made to a CRUT; however, they may not be made to a CRAT. Therefore, investors anticipating ongoing contributions may prefer the use of a CRUT over a CRAT.
- Beneficiary distributions may be taxable—although the sale of assets within the trust avoids capital gains and net investment income taxes in the year of sale, the distribution paid out to the beneficiary each year is taxable based on a four-tier system of taxation:
  - First: ordinary income (interest, followed by qualified dividends)
  - Second: capital gains (short-term, followed by long-term)
  - Third: tax-exempt income
  - Fourth: return of principal

  Also, "net investment income" for purposes of the 3.8% surtax thereon is carried out within these distributions until it is exhausted.
- Generally not appropriate for transfers or holdings of:
  - S corporation stock
  - Closely held stock
  - Partnership interests
  - Real estate encumbered by debt
  - Stock purchased on margin
  - Any other debt-financed property
- At the time the CRT is established, the donor must identify in the trust agreement one or more charitable beneficiaries. Determining charitable beneficiaries for a point in time that is many years in the future can be difficult. To alleviate this pressure, the donor may retain the right to change the charitable beneficiaries or choose to name a donor advised fund as a remainder beneficiary of the CRT.

Exchange fund

What is it?

A potential solution for achieving the diversification of a concentrated equity position, while deferring taxation, is exchanging shares of selected stocks for shares in a professionally managed, diversified portfolio called an exchange fund.

How does it work?

The investor contributes shares of selected stocks to the fund and after several years (seven years), the investor would be able to withdraw his or her interest in the form of a diversified basket of securities comprised of shares contributed by other investors in the fund. As long as the fund holds 20% of its assets in non-public securities, such as real estate partnerships, there are no capital gains taxes or net investment income surtaxes owed by the investor when shares are contributed or distributed.

Redemptions requested prior to seven years are met by distributing securities contributed by the redeeming shareholder. Exchange fund managers do not accept all securities. Stocks that are chosen must meet fund requirements such as market capitalization and trading volume. In effect, an exchange fund may be able to diversify away company risk, but an investor will still face market risk.

Benefits and considerations

Potential benefits

- Immediate diversification
- Tax deferral—cost basis of original equity contribution is retained. Capital gain or loss may be realized upon the eventual sale of securities distributed from the exchange fund
- Ongoing participation in the market based upon the underlying securities in the fund

Considerations

- Exchanging shares in one stock for those in a diversified fund may not protect an investor from a decline in the overall market
- The diversification of a concentrated equity position may lend higher or lower returns than the original stock contributed to the fund
- Exchange funds may offer only limited liquidity. Redemptions are often on a monthly or quarterly basis
- In order to receive shares in a diversified basket of securities, the required holding period must be met. Long-term investment objectives must be considered carefully
- Exchange funds generally have eligibility and minimum investment requirements
- The tax benefits associated with exchange funds are subject to tax law changes

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See important notes and disclosures on the next page.

[1] Please consult your tax advisor for information regarding option taxation. Options are risky and not suitable for all investors. Please ensure that you have read and understood the current options risk disclosure document before entering into any options transactions. The options risk disclosure document, also known as the Options Disclosure Document (ODD) "The Characteristics and Risks of Standardized Options," can be accessed at the following web address: *optionsclearing.com/about/publications/character-risks.jsp*.

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