Financial Planning

Concentrated Equity Positions:

Know Your Risk and Consider Your Options

We have all heard the adage of not having too many of your eggs in one basket. When it comes to investing, having a significant portion of your investment "eggs" concentrated in one position or industry increases the overall risk of your portfolio. While the impact of an individual stock decline in a diversified portfolio is cushioned because of the varied holdings, a stock decline in a concentrated position can have a much more significant negative impact to your net worth.

You may find yourself in this situation for a variety of reasons. Perhaps you inherited a significant equity position or you may have accumulated a large number of shares of your employer through stock compensation such as equity options or restricted stock grants. Sometimes business owners sell their business in exchange for stock in another company. No matter how you obtained the position, being aware of the additional risk that concentrated positions entail and knowing what alternatives you may have to address this risk is important.

While the most obvious solution to a concentrated position may be to sell it, there may be other solutions that better achieve your objectives. Are you focused purely on diversification? Do you want to increase the income on your portfolio? Is minimizing estate or income taxes a concern? Are you limited in what you can sell due to restrictions or other factors? Let's review some of the most common concentrated equity strategies and the objectives these strategies accomplish. Remember that the appropriateness of any strategy is dependent on your individual circumstances. Your financial advisor along with your tax and legal advisors can help determine which strategies are best suited for you.

How much is too much?
Generally, having more than 15% of your investable assets in one security or more than 20% in any one industry is considered concentrated

Gradually Sell and Reposition

One of the most common strategies is to simply sell the concentrated position over time.
By gradually selling the position, finding the best price by trying to time the market is less of a priority than minimizing taxes by selling over multiple calendar years, and reinvesting the proceeds over time. Some investors find it useful to have multiple price targets for their position– say one near-term and one longer-term. If the price exceeds the price target by a certain percentage, you may want to consider selling more. Other investors might set quantity goals and reduce their positions by a predetermined amount each quarter or each year. Similarly, you may want to consider a plan if the stock drops below a certain level. Price targets should be adjusted over time and should be reasonable given the current price and trading history of your stock position.

For tax efficiency, consider the following:

- Sell your long-term highest cost basis shares first. You can usually indicate this preference on your investment account so you don't have to request it for each transaction.
- If you have a capital loss carryover, remember you can use that carryover to offset gains when selling your concentrated position.
- If you own the concentrated position in different types of accounts, consider diversifying it within your tax-deferred accounts first. By selling inside an IRA or 401(k), you won't owe taxes on the sale. If that concentration is in employer securities inside your retirement plan, before you sell or roll over to an IRA, make sure you investigate the tax advantages for net unrealized appreciation (NUA) with your tax professional.
- If you are in the 15% or lower income tax bracket the capital gains rate is 0%. If you are in this situation, selling stock gradually would help you minimize or perhaps eliminate the capital gains tax. Remember that any capital gains will add to your income for the purposes of determining your income tax bracket for capital gain taxation purposes. Even if you are in the 15% income tax bracket before selling the stock, if you incur a large capital gain you will likely be subject to capital gains tax.
- Conversely, if you are in one of the higher income tax brackets, remember that for taxpayers in the highest tax bracket, 39.6%, the capital gains rate is 20% rather than 15% as it is for most taxpayers. Further, large capital gains will increase your net investment income which could subject you to the 3.8% Medicare tax (applicable when income exceeds $200,000 for single taxpayers, or $250,000 for married joint taxpayers) even if you weren't subject to it in prior years. Consequently, if you are in a high tax income tax bracket and are considering selling a large portion of stock, you may want to consult your tax advisor to address whether sales would increase your capital gains tax rate and subject you to additional taxes.
- If you want your family to inherit your assets rather than a charity, you may want to weigh the benefits of diversification with the step-up in cost basis your heirs would receive if you held the position at death and your beneficiaries then inherited it…

Net Unrealized Appreciation

If you hold employer stock in your retirement plan, one strategy to consider is called net unrealized appreciation or NUA. There is a special tax treatment that is available on shares of employer securities that are part of a lump sum distribution. Normally, a distribution would be subject to ordinary income tax, but for distributions of employer stock that are not rolled over to an IRA, ordinary income tax is due on only the cost basis of the stock. Any appreciation earned in the retirement plan would be taxed as long-term capital gains at the time the stock is sold. If sold a year or more after the distribution from the retirement plan, all appreciation, including that earned since the time the shares were distributed, receives long-term capital gain treatment. Factors such as the cost basis on the stock and how long you plan to hold the stock after distribution determine the appropriateness of this strategy. If you have employer stock in your retirement plan, ask your financial advisor for a Net Unrealized Appreciation Illustration to see how this strategy may work for you.

Covered Call Writing

Selling (or "writing") covered call options is one of the most basic option strategies. Some investors, even some who've never traded an exchange-listed option before, find that selling calls against their concentrated stock position may be a reasonable strategy to use as a part of their diversification plan. Selling a call generates cash for the stockholder in exchange for accepting the obligation to sell the stock at the call option's strike price. It can be thought of as a way to be paid cash today in exchange for targeting a future selling price.

While the strategy does create a benefit in that it reduces downside risk on the stock by the amount of cash received for selling the call, that amount is fairly small relative to the overall risk in the stock. The strategy's real benefit is that it enables stockholders to generate income while structuring a plan to exit some of their stock position. Typically, calls are written with a life of three to six months, though contracts that run up to two years are available on many actively traded stocks. Typically, calls are written with a strike price that is five to fifteen percent above the stock's current value, though a much wider range is available

Option strategies can provide a good solution for many objectives when working with concentrated positions

Collars

Listed options can also be used to create a more defensive hedge for some or all of a concentrated position. A "collar" combines the sale of a call option (a covered call write) with the purchase of a protective put option. Cash generated on the sale of the call is used to reduce or offset the cost of the put. These hedges can often be created with little or no money out-of-pocket.[1]

In the same way that the call sale creates an obligation that imposes a ceiling on the stock's upside, the put purchase, by giving the hedger the right to sell the stock at the put's strike price,

[1] A collar is a multi-leg option strategy. The transaction costs, including commissions, may be significant.

effectively creates a floor for the stock. A collar enables stockholders, for little or no out-of-pocket cost, to lock in a worst-case selling price for their stock in exchange for accepting a best-case ceiling value.

The good news is that the strategy establishes a minimum future value for the stock position, eliminating downside risk below the put strike price. While this strategy is often referred to as a "zero-cost collar," the real cost of using a collar is giving up the opportunity to participate in any appreciation beyond the call's strike price.[2]

Margin Loan

One holdover from the early days of concentrated positions is the practice of borrowing money, using the stock position as collateral, and investing the loan proceeds in a diversified basket of stocks. While this approach certainly can result in a more thoroughly diversified portfolio, it does not address the risk in the concentrated position. In fact, it amplifies the risk. A sudden and substantial decline in the value of the concentrated position could quickly eliminate much of the account equity and result in forced margin selling to cover the value of the loan.

Clearly, one big advantage of this approach is that the margin loan enables some diversification effect without having to recognize and pay tax on the gain in the stock. Just as clearly, the strategy is not very tempting unless something can be done to control the downside risk on the stock. Up until about 20 years ago, borrowers were able to hedge their stock exposure by selling "short-against-the-box." The short-against-the-box approach neutralizes the stock position to any market impact: No more upside; no more downside. In the late-1990s, changes in the IRS code eliminated the ability to maintain a short position for an uninterrupted and considerable time.

A few charitable strategies that work well with concentrated positions are direct gifts, charitable remainder trusts (CRT) and charitable gift funds such as pooled income funds and donor advised funds.

Charitable Strategies

Charitable strategies can accomplish a variety of objectives including diversification, benefiting a charity, providing income and estate tax benefits and possibly increasing your income stream. A few charitable strategies that work well with concentrated positions are: direct gifts, charitable remainder trusts (CRT), and charitable gift funds such as pooled income funds and donor advised funds. These types of strategies may be especially advantageous in a year where you have high income and would like a large tax deduction.

If you aren't doing so already, you may want to consider making your regular annual charitable gifts in appreciated stock rather than cash. When you donate an appreciated security that you have held for longer than one year, you can deduct the value of the security and you won't have to pay tax on the capital gain, decreasing the effective after-tax cost of the donation.

Should you desire to make a larger gift and wish to establish a longer-term program to benefit charities over multiple years, you may want to consider a

[2] Option trading and strategies are not suitable for all investors; they carry additional risk and may involve additional tax considerations. Additional information regarding the characteristics and risks of options may be obtained from your financial consultant, or by contacting The Options Clearing Corporation, One North Wacker Dr., Suite 500, Chicago, IL 60606 (1-800-678-4667)

private foundation or donor advised fund. These strategies allow you to create an enduring charitable giving program. Depending on the way it is structured, you may be able to receive a charitable deduction equal to 100% of the contribution.
If you wish to have a good amount of control and flexibility, you may prefer the private foundation. Conversely, if you want simplicity and ease in set-up, you may prefer the donor advised fund, which is typically structured by an investment company.

For those who desire an income stream as part of the strategy, charitable remainder trusts work well. A charitable remainder trust is an estate planning strategy generally used by someone looking to ultimately leave assets to charity while retaining an income stream from those assets for life or a certain number of years. The donor transfers the shares into the CRT. The donor receives an income stream during the life of the trust and at the end of the trust the assets pass to the designated charities. Because you're leaving assets to charity at the end of the trust, you can receive an immediate income tax deduction when you fund a CRT. Once the stock is moved into the CRT, it can be sold and diversified without any immediate capital gains tax to the donor. The donor would receive an income tax deduction equal to the amount of the actuarial calculation of the remainder passing to the charity. The asset that was donated is removed from the estate of the donor, so, upon death, no estate taxes will be owed on the assets held in the CRT. Sometimes, the donor uses some of the income from the CRT to purchase life insurance to replace the value of the assets for their family. Typically, the insurance is structured in a way so that it passes to the family income and estate tax free. A similar strategy to a CRT that is typically structured by an investment company is called a pooled income fund. As with the CRT, you can donate appreciated securities to the fund and you will receive an income stream as well as an income tax deduction. Pooled income funds can be easier to establish than a CRT so they may be preferred to CRTs when you desire to donate a smaller amount, alternatively pooled income funds may not allow for as much flexibility as CRTs. Also, payments from pooled income funds are considered ordinary income, while payments from a CRT could be taxed at capital gains rates or even tax-free depending on the assets donated to the trust and how the funds are subsequently invested in the trust. Ask your financial advisor about more details on any of these charitable giving strategies.

Combining Strategies

Objectives	Strategies
Diversify	• Gradually sell and reposition • Sell calls • Margin loan • Charitable strategies • Charitable gift funds • Custom collar with loan
Reduce Risk	• Collar • Gradually sell and reposition • Buy protective puts
Increase Income	• Charitable remainder trust • Pooled income fund • Sell calls • Gradually sell and reposition
Raise Cash	• Gradually sell and reposition • Sell calls • Margin loan • Custom collar with loan
Sell a Portion	• Gradually sell and reposition • Sell calls • Charitable remainder trust • Charitable gift funds
Maintain Control	• Gradually sell and reposition • Margin loan
Reduce Estate Taxes	• Charitable remainder trust • Private foundation • Gifting strategies • Charitable gift funds
Provide Inheritance for Heirs	• Direct gifting • Charitable remainder trust combined with an Irrevocable life insurance trust
Benefit a Charity	• Charitable remainder trust • Private foundation • Other gifting techniques

It may make sense to undertake more than one strategy in order to best accomplish multiple objectives. For instance, you may decide to sell your highest cost basis stock to diversify and minimize taxes while using your lowest cost basis stock for a charitable strategy. In some cases, it may also make sense to initiate these strategies over time such as selling some immediately and then undertaking a covered call write strategy that is used to target prices over the next year.

As discussed above, there are a number of strategies that can be helpful when dealing with a concentrated equity position. Deciding which strategies are most appropriate for you involves considering multiple factors such as the stock position, cost basis, in what type of accounts you hold the shares, any restrictions, time horizon, risk tolerance and objectives. Your financial advisor at Benjamin F. Edwards can offer a team of professionals at our headquarters who can assist with this analysis. While the information in this report covers some of the more common methods for dealing with a concentrated equity position, there may be other alternatives available as well. Therefore, it's important to work with your professional team, including your tax and legal professionals and your Benjamin F. Edwards & Co. financial advisor, to determine which alternative may be best for your particular situation. ■