



White Paper

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Managing Concentrated Positions in Your Portfolio

Concentrated positions bring the potential for increased volatility—massive windfalls or crushing losses. Here are some techniques for assessing and managing concentrated positions in your portfolio.

Our parents were always good at reminding us, “Don’t put all of your eggs in one basket.” However, many executives find themselves in this situation with a large concentration of their employer’s stock in their portfolio. They are faced with the possibility that this lack of diversification may result in tremendous disappointment if their “basket” of company stock fails to appreciate in value as they hoped, or, worse, if its price falls in the market and never recovers.

Concentrated positions can develop from a number of factors. Many companies have political positions on the amount of company stock each executive should own in order to meet shareholder expectations. In addition, high-level executives are often so focused on their work responsibilities that they don’t have adequate time to manage their portfolio and look for reasonable alternatives in order to meet their personal financial objectives. And, finally, some executives hold fast to an unbridled belief that their company’s stock will be the one that’s going to ring the bell for them and that to diversify would be unwise. This paper will outline some of the issues and opportunities of concentrated positions in portfolios, identify key concepts that may be helpful in assessing your current position, and offer suggestions for using them to chart your future.

Most people would agree that a diversified portfolio will have less volatility or fluctuation in value over a period of time than one that has one or two individual issues in it. For example, by diversifying over as few as 20 positions, one can reduce the volatility of the portfolio by over 50 percent. Of course very few of us are concerned about upside volatility, hence the belief that a concentrated position can be the way to greater financial success in a portfolio. But the opposite of upside volatility is downside volatility—the biggest incentive for a diversified portfolio. With diversification, a portfolio may go down when the market’s

going down, but it won’t dip as significantly as a concentrated position might have. Controlling volatility can be crucial to meeting financial goals. For example, a portfolio that has declined by 50 percent needs to appreciate by 100 percent to get back to even. Our firm can relay stories on hundreds, if not thousands, of companies where this has been a significant problem in the past. More recent examples include the stocks of Intel, Cisco Systems and other technology companies. During the Bear Market of 2000-2003, many executives that had concentrated positions in these companies also found the value of their stock falling dramatically. To add insult to injury, many also incurred significant tax liabilities to exercise these shares before the devastation began. Even today, many of them are below their basis, especially if they exercised options during the 1997-2000 timeframe. Clearly, protecting the value of options and stock in concentrated positions is likely to be a high priority for individuals in that situation.

There can be multiple objectives in mind as you manage a portfolio with concentrated positions. Among these would be to diversify further; another may be to merely hedge against price declines, but hold the stock; and another would be to provide cash for other needs that are more immediate in nature, such as college education funding and other needs that may be short on the time horizon.

There are four basic strategies to consider when dealing with these issues. It’s possible to have multiple permutations and adaptations of these strategies, but generally, they will fall within these four categories:

- Gradually reduced position over time;
- Derivatives;
- Exchange funds;
- Charitable techniques.

Gradually reduced position over time. Very few of us would have predicted a long-term capital gains rate in the 10-15 percent range five or six years ago. Nonetheless, here it is today. Clearly, the choice to diversify now has compelling advantages because we never know when the long-term capital gains rate may be increased to help balance the federal budget deficit. Developing a strategy of unwinding a position over a period of time can make some sense. One of the first things to do is establish price points where you feel the position is fairly priced and to execute orders at that time. One can use limit orders to execute sales so when you're busy dealing with your day-to-day duties, you won't have to watch the price so closely, diverting your attention from important obligations.

Another technique under this strategy would be to place the shares into a separately managed account and give directions to the manager to sell so many shares per month or per quarter, and to reinvest those dollars into a diversified portfolio. Of course the possibility exists that other parts of the portfolio may have some taxable losses from time to time and can even offset some of the long-term capital gains, however, a 15 percent long term capital gains rate is very desirable and should be considered extremely advantageous.

Derivatives. Derivatives got a bad name a few years ago, however they can be very useful tools in accomplishing your objectives.

The two techniques that are most often used in helping to hedge a concentrated position are equity collars and prepaid forwards. These transactions can be a way to convert the position to cash and open up capital in a diversified portfolio. In its most basic form, an equity collar is basically two options—a long put and a short call to provide a level of protection that the stock will not drop below a certain price, or ensure that you will be happily selling on the high side of the range. These are often called costless collars because the sale of the call can bring in enough to finance the put. However it is possible to structure a transaction where there's excess cash, because the short call

generates excess premium over and above the cost of the alternative. If you work directly with a financial institution, they can generate a proposal to help you understand how this might work specifically for you, and which dollar amounts may be appropriate. A zero cost collar does not generate cash other than the dividend paid on the stock. A number of financial institutions will loan funds using a collar's security as collateral to provide funds that can be used to create a diversified portfolio.

A prepaid variable forward provides some immediate liquidity. It's very similar to an equity collar. A prepaid variable forward allows the investor to protect the concentrated position while participating in future potential price appreciation. It also can provide some immediate cash for reinvestment in a diversified portfolio. In many cases, the stock is eventually sold to complete the forward transaction. A prepaid variable forward requires the delivery of a non-specified quantity of stock based on a formula established in the contract at a price specified within a certain range. Like the equity collar, a floor and a ceiling is set determining the price that we don't want the stock to fall below, and the high range at which we would be happy to sell.

There are issues with constructive sale and tax straddle rules which are beyond the scope of this paper, however equity collars and variable prepaid forwards are valuable techniques and tools to be examined when trying to maximize the value of a concentrated stock position.

Exchange Funds. An exchange fund can be an attractive way for an individual to dispose of a low basis stock and diversify their portfolio without incurring a tax liability.

Basically, exchange funds are private equity investments or partnerships formed by qualified investors to contribute their appreciated stock in return for shares of the fund. Other executives within companies contribute their stock much like you contribute yours. The tax rules require at least 20 percent of the portfolio exchange fund be invested in certain qualified assets such as real estate.

Once they are formed, the funds generally range like an index fund with no transactions. They provide the investors with diversification during a holding period, usually seven years, with the opportunity to receive the market value of the fund shares in the form of pro-rated portfolio securities that came from the portfolio. Some funds allow investors to redeem their shares prior to the seven years, subject to some fees and contractual limitations. When an investor redeems an interest in the fund, part of the securities received in distribution will incur tax liabilities unless they are identical to the shares contributed. The shares distributed in the early redemption are subject to the discretion of the portfolio manager.

Charitable Remainder Trust.

Charitable remainder trusts are a wonderful way to meet multiple objectives. A charitable trust can offer both short- and long-term benefits to those who use highly appreciated stock to make contributions. First, the contributor can claim an immediate income tax deduction for the amount equal to the present value of the remainder interest received by the charity. This deductible amount is determined by several factors including the market value of the contributed asset, the expected life of the trust, the amount to be distributed to the contributor or other beneficiary over the life of the trust, and a discount rate determined by the IRS. Once the stock has been contributed to the trust, the trust may dispose of the stock tax-free and invest the proceeds into a diversified portfolio, effectively providing the contributor with an income stream from a diversified investment.

As an added benefit, these assets are not in the contributor's estate for estate tax purposes. In addition to getting an income tax deduction, there is no recognition of the capital gain of the stock that's being contributed to the charitable remainder trust. The donor, or the one who contributes the stock, will receive income over the specified terms of the trust. This vehicle is most appropriate for individuals who already have a charitable intent. Tax and legal experts are needed in structuring the trust and identifying tax issues that will affect an individual.

Managing Concentrated Positions in Your Portfolio

	Provide Liquidity	Diversification	Hedge Downside Risk	Upside Potential	Position Exit Speed	Management of Tax Liability
Immediate Sale	Greater— Proceeds are available now.	Greater— Proceeds available for re-investment.	Greater— After sale portfolio no longer impacted.	Lesser— Position is exited immediately.	Greater— Position is exited immediately.	Lesser— Gains are immediately recognized.
Gradually Reduced Position Over Time	Moderate— Proceeds are available as plan allows.	Moderate— Proceeds from sales diversified.	Greater— Position may be hedged during workout period.	Greater— Price appreciation is available if unhedged.	Greater— Position is gradually exited.	Moderate— Exit strategy can be planned to moderate tax issues.
Equity Collar	Moderate— Client may borrow up to 50% of the position for re-investment.	Moderate— Loan proceeds may be re-invested.	Greater— Downside risk is limited to the put strike price for the duration of the contract.	Moderate— Price appreciation is limited to the call strike price during the duration of the contract.	Lesser— Portion may be disposed of when collar is unwound.	Moderate— Under straddle rules, gains from the put are realized and deductions may be limited.
Prepaid Variable Forward	Greater— Immediate payment of the floor amount.	Greater— Prepayment proceeds are available for investment.	Greater— Downside is limited to the floor amount.	Moderate— Price appreciation is limited to the ceiling.	Greater— Position is typically delivered at contract expiration.	Moderate— Gains are recognized upon distribution of the position at expiration.
Exchange Fund	Lesser— A seven-year commitment period is required.	Greater— Client receives share of diversified portfolio.	Moderate— Market exposure to a diversified portfolio.	Moderate— Market exposure to a diversified portfolio.	Greater— Client receives diversified portfolio at redemption.	Greater— The exchange of shares is tax-free.
Charitable Remainder Trusts	Moderate— Provides income stream based on the term of the trust.	Greater— Asset is sold and invested in diversified portfolio.	Moderate— Income stream is affected by the value of the diversified portfolio.	Moderate— Income stream is affected by the value of the diversified portfolio.	Greater— Immediate disposition of position.	Greater— Generates immediate tax deduction and the assets are excluded from donor's estate.

The table above will give you an idea of where these differing strategies and techniques can have the most value, however as with most tax and investment situations, please consult your advisors to see if these are appropriate for your situation.

If we can help you with a concentrated position or any other issues, we would be happy to do so, and would provide you with a specific analysis based on your individual circumstances and situations.

If you would like to learn more about the financial services provided by Robert J. Klosterman and White Oaks Wealth Advisors, Inc., call us at 800-596-3579, or visit www.whiteoakswealth.com.

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