Shifting Gears:

Ways to Handle Concentrated Stock Positions

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It's a scenario for many entrepreneurs and senior executives: You've spent your career helping to build a successful company and have reaped the professional and financial rewards. As you near retirement or a profitable exit from the business you love, you need to prepare for the next phase of life. You know that retaining a large position in a single entity may be too risky for your retirement years and the rational choice is to shift from building wealth to preserving it. The first step in this next phase is the uncomfortable process of divesting from your concentrated stock holdings.

There are many reasons why you should do this, which we will highlight in this piece, as well as many behavioral biases that prevent individuals from doing what is in their own best interest. We will explore both of those factors, as well as the number of innovative options available to help address concentrated stock risk. These solutions include selling programs, hedging strategies, charitable solutions, and risk sharing.

Why Some People Don't Want to Sell

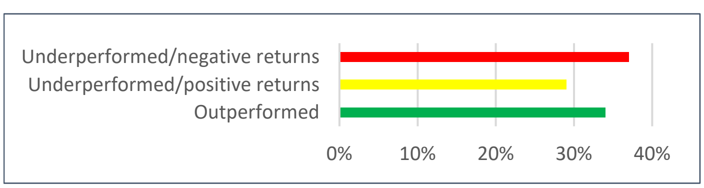
Maybe the stock reflected your life's work or reminds you of a loved one who bequeathed it to you. Maybe you have tremendous confidence in your successor and the ongoing growth potential for the firm. Emotional attachment is a powerful driver of human action (or inaction) when it comes to making financial decisions. There are also well-known behavioral biases that lead to irrational behavior:

- **Anchoring** is defined as the mental process of tethering your expectations to prior experiences. For stocks, this can take the form of price expectations. One might think "I'll sell once it's back to $100, since that's where I bought it" or "I'll sell once we get back to the prior high point, since I missed the last chance." There is obviously no guarantee that a certain price will be reached; anchoring can undermine financial discipline.

- Anchoring is tied to a similar behavioral issue, **loss avoidance** – an inherent unwillingness to concede defeat (you weren't wrong, you were just early!). So, you keep holding, waiting for the turnaround.

- Lastly, one behavior seen quite often is **overconfidence**. You were the CEO and/or the founder, and you know this company inside and out. You believe in the strategy and your successor. Rather than take prudent action to reduce your risk, you remain certain that the company will stay as strong as you left it. Only there are endless examples of companies not being as "foolproof" as founders once thought. For instance, between 1987 and 2021, two-thirds of the stocks in the Russell 3000 Index underperformed the benchmark, more than a third of which lost money. Let's also take a moment to recall those many large, blue-chip companies that have gone bankrupt over the years. It didn't matter whether their failure resulted from fraud, bad timing with regard to the economy, or technological obsolescence. In the end, their investors lost money. The company graveyard includes such failures as Washington Mutual, once the sixth largest bank in the U.S.; Enron, once valued at $70 billion; photography companies Polaroid and Eastman Kodak; and AIG Insurance, which was once ranked 10th among the Fortune 500.

Performance of Russell 3000 Stocks, 1987-2021



Source: BlackRock, Aperio. Russell 3000 index date range: 12/31/1986 – 13/31/2021.

Not all inaction is driven by irrational behavior. There are other circumstances in which one might continue to hold a concentrated position. For instance, sales of stock are often restricted for a period. Also, taxes loom large, especially if the stock appreciated dramatically during your tenure. You might seek to reduce taxes by holding the position until your death, when your heirs would receive a "step-up" in the cost basis (if the tax law at your time of death retained this feature). However, in most cases the latter would be a case of the "[tax] tail wagging the [estate planning] dog."

Fortunately, the solution set for the above issues is robust and includes selling programs, hedging strategies, charitable solutions, and risk-sharing options. We would first and foremost recommend that you consult with your investment advisor, estate lawyer, and tax attorney about your options, along with the plans you may wish to make. (Pathstone offers a unique matrix of services that can supplement many of these roles, except for legal advice.)

Strategies for Reducing Concentration Risk

Selling Programs

A **Conventional Sale Program** is a straightforward approach to reducing a concentrated equity position over time. Rather than utilizing derivatives, a conventional sale program can combine calendar-based and price-based triggers for reducing a set percentage exposure of a stock position. The price-based trigger can allow for upside when combined with a target price that increases over the years, The calendar-based trigger could then kick in if the price target had not been achieved by the end of the period. In addition, there could be a downside sell trigger, for example, if the stock declines by a material amount while at the same time underperforming the market by a material amount (such as 30%).

Another popular option is to **Sell Calls** against your stock at predefined levels spread out over time. You can sell at a level that gives you some upside exposure, while generating attractive income, and can use that income to help offset some of the tax cost burden as appreciated shares are called away. In the unfortunate circumstance where the shares decline in value rather than appreciate, your call income would help cushion some of your loss. By spreading this activity out over time, you reduce your timing risk and help to dollar-cost average your reduction over a market cycle.

Active Tax Loss Harvesting is a related strategy to offset the gains in your holdings. Fresh cash put into a volatile market can reliably track market returns while also producing losses that can be harvested to help offset gains.

Pathstone's P-Cubed platform facilitates active tax loss harvesting across individual positions and investment strategies. Contact your Pathstone advisor to learn more.

One of the newest opportunities engineered by Congress and enacted as part of the Tax Cuts and Jobs Act of 2017 are **Opportunity Zones** (OZs)**,** which spawned Qualified Opportunity Funds (QOFs). These first came into existence in 2018, so use them with caution as the track record on these products is short. These funds allow you to defer eligible gains much further into the future. If you hold your fund for at least 10 years you may be able to permanently exclude the gain resulting from the qualifying investment when it is sold or exchanged (the gain on your new investments within the OZ fund, not your original deferred gain). Please note that you must be timely on investing in a QOF after realizing a gain, so proper advanced planning is a must. Please consult with your investment advisor regarding timelines and deadlines pertaining to tax deferral.

There are also some clever contracts that can be used. **Variable Prepaid Forwards** allow you to sell a large portion of a position to raise cash today, with the transaction completed at a later date (typically 1 to 3 years). As the name implies, you are prepaid for agreeing to sell your shares at a time in the future, with the final settlement varying according to the terms of the contract. On the agreed-upon date, you provide shares or cash within a price range established in advance, which limits potential losses. This setup is technically a collar strategy (combining the purchase of a put on the stock with a sale of a call) paired with a loan against the underlying holding. Some added benefits of this strategy are that you continue to receive dividends and maintain your voting rights, and you also reduce the number of shares delivered relative to the current stock price, should the stock appreciate.

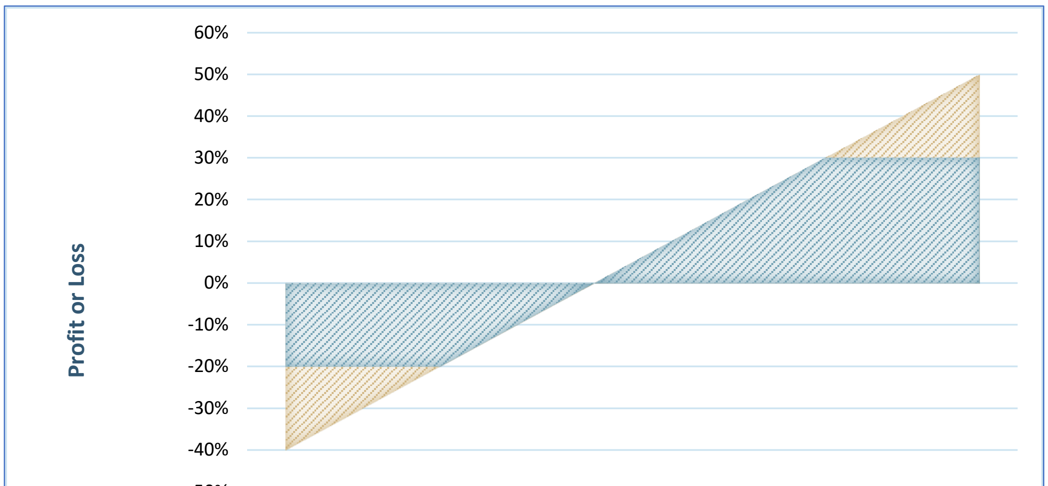
Hedging Strategies

For some, outright sale may not be the best path. Maybe you want to retain control of your shares, but you don't want to endure so much economic risk to do so. In such a case, we can look at various hedging strategies.

Collars

Collars can be very useful as a means of reducing the risk from a single concentrated holding. Collars need to be implemented in coordination with your investment team and tax counsel to help avoid violating any **constructive sale** rules. (The IRS regards the hedging of a position so much that it is essentially riskless as a sale; to avoid this distinction, one needs to make sure enough 'risk' is left in the position.) If you sell out of the money calls and use the proceeds to buy out of the money puts, you can effectively 'collar' your upside and downside exposure with little to no cost (a "Zero Cost Collar"). Also note that if the stock appreciates above the strike, it limits your upside potential and would trigger capital gains as the stock is called away.

Collar Profile



	60	70	80	90	100	110	120	130	140	150
Stock Return	-40%	-30%	-20%	-10%	0%	10%	20%	30%	40%	50%
Stock Return w Collar	-20%	-20%	-20%	-10%	0%	10%	20%	30%	30%	30%

Source: Pathstone.

One popular method is to construct a **collar with a loan** against the position. This strategy isolates your risk (and return) sufficiently to avoid the constructive sale rules, and cash from the loan can be used to purchase different assets that will help diversify your portfolio. This is similar in concept to the variable prepaid forward mentioned above, but rather than entering into a contracted sale as a means of receiving the funds, the hedged position serves as collateral for the loan, which is invested elsewhere. (Please note, the use of margin comes at a cost, just as any loan does.)

Additional Hedging Options

Constructive sale rules were motivated by savvy investors seeking ways to reduce risk while minimizing taxes. **Short Sale Against the Box** was one such scheme. While it sounds like an NFL play option, this was a frequently used tax avoidance scheme that ended with the Taxpayer Relief Act of 1997 (TRA). It involved short-selling shares of a stock you already own to avoid the capital gain that you would have incurred if you had sold your underlying shares. The TRA added a rule that such an action would result in a constructive sale of your underlying shares. There is one exception: If the investor closes out their short within the first 30 days of a tax year, and then leaves the long position at risk for 60 days before closing long, the constructive sale rules will not apply because there was economic risk to the investor during those 60 days.

Lastly, one very simple and effective risk management tool is a **protective put strategy**, which uses options to guard the portfolio against a loss in a stock. It entails buying 'put' options, which give you the right but not the obligation to sell your stock at a given strike price before a maturity date. This approach could also trigger a constructive sale if purchased in the money and should be used only after consultation with your advisor. Protective puts are also one of the more costly options, as you need to continuously roll your hedge forward if you plan on maintaining the hedged position.

Charitable Solutions

Sometimes the best option is to use concentrated assets to fulfill other lifetime goals. If you endeavor to be active with philanthropy as part of your broader wealth and estate planning strategy, then your highly appreciated shares can become a very valuable resource. (For further detail, please see Pathstone's report An Introductory Guide to Charitable Gifting to Sustain Your Legacy.)

Most 501(c)(3) public charities are set up to accept public stock as a **charitable donation** (some will take privately held C Corp stock and unencumbered real estate as well as other complex assets). As a donor you receive a tax write-off on the fair market value of the gift while also removing the highly appreciated securities from your taxable estate. Public charities can be either nonprofit organizations with a specific mission or local community foundations that have broad goals to improve the quality of life in given area.

Other approaches include establishing a **Donor Advised Fund (DAF)** or a **private family foundation.** Both structures enable donors to pre-fund charitable giving that they would like to do in future years. The donors receive a charitable tax deduction in the year that they fund the vehicle, which then holds and invests the funds in a tax-advantaged account structure until the donor (or the donor's family) is ready to make the distributions out of the vehicle for the benefit of the ultimate beneficiaries. Such vehicles frequently outlive their benefactors, allowing the donor's family to continue their philanthropic legacy over their own lifetimes and strengthening family relationships through shared values that focus on causes that family members choose to support.

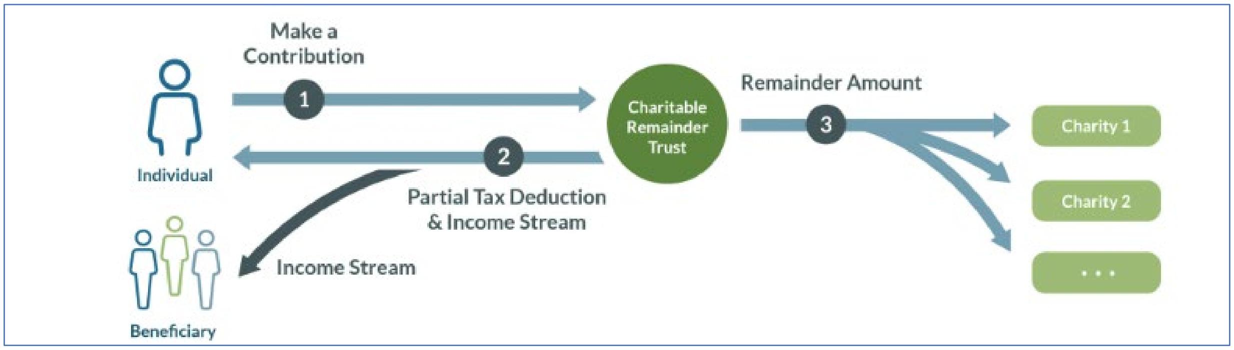
- A DAF is a charitable account that is created and maintained by a public charity, which is called the sponsoring organization. Donors benefit by being able to give on their own timeline with a lower administrative burden than a private foundation, although there are more limitations on how DAF funds may be invested.

- A private foundation is a 501(c)(3) organization set up solely for charitable purposes. Private foundations allow for more control than DAFs. That said, they come with added complexity and administrative expense as well as mandated gifting and disclosure requirements.

Under current tax law, upfront charitable income tax deductions are limited to 30% of adjusted gross income (AGI) for long-term capital gain property to a public charity, and 20% of AGI long-term capital gain property to a private foundation, with a five-year carry-forward for any excess not deductible in the year of contribution.

Split-interest **Charitable Remainder Trusts (CRTs)** also present an interesting diversification opportunity. A CRT is an irrevocable trust that upon contribution effectively splits the ownership of the underlying assets into two pieces: a current interest that is retained by the donor (or conveyed to a non-charitable beneficiary) and the remainder interest which is conveyed to one or more charities. What makes this attractive from a monetization/diversification perspective is that the CRT does not pay any taxes on the sale of the appreciated securities, thus allowing you to monetize immediately. Future trust distributions will carry out both pre-contribution capital gain and any other trust taxable income to the beneficiaries as they are received. Accordingly, this tax regime provides tax-deferral and potential income smoothing which helps minimize the beneficiary's effective capital gains tax rate.

Charitable Remainder Trusts



Source: Fidelity Charitable (https://www.fidelitycharitable.org/guidance/philanthropy/charitable-remainder-trusts.html)

The trust can be for a term of up to 20 years or for life of the recipient, and the actuarial value of the charity's interest at inception must be at least 10% of the value transferred to the trust based on interest rates in effect at the time that the trust is established. After that trust term ends, the remainder of the assets pass to a named charity (or multiple charities).

At a high level, there are two different types of CRTs:

- **CRAT:** annuity trust that pays a fixed amount each year.
- **CRUT:** unitrust, which pays a fixed percentage of the fair market value of the trust assets.

A CRT is thus a good vehicle for tax-sensitive donors with highly appreciated assets who have charitable intent but also want to retain an income interest either for themselves or their chosen beneficiaries. The following assets should NOT be used to fund a CRT: Assets you are obligated to sell, tax-exempt securities, S Corp stock, partnership interests (including publicly traded partnerships), personal residence (self-dealing), encumbered real estate, stock options, and tangible personal property. [1] If you have held your stock for less than one year, you can still donate it, but it usually won't make sense to do so since your deduction would be limited to the lesser of your cost basis or fair market value.

Risk Sharing & Diversification

Exchange funds are private placement funds (typically LPs or LLCs) only open to accredited investors. The concept is straightforward: You apply to be admitted; if accepted, you contribute your shares to the investment pool for a set percentage ownership of the fund. This enables you to diversify your holdings without triggering immediate capital gains taxes. The fund itself consists of a basket of contributed shares, but also must hold at least 20% of its assets in illiquid investments; funds normally buy operating units in specialized real estate partnerships to help them qualify. Once a fund is full, the fund administrator closes it to new contributions. At the end of the investment period (typically seven years), investors receive a basket of stocks at their new cost basis.

Exchange funds do present some challenges:

- It can be hard to find one when you want one, and there is no guarantee that the fund will accept your stock or take all your position. This can affect not only small cap stocks, but even large well-known stocks if another investor has already contributed shares and they don't need more of that same stock).
- Investors must hold the fund for seven years or face heavy fees; also, if you liquidate early, you receive your original shares back rather than the diversified basket – and at their original cost basis.

Investing in private placements requires thoughtful due diligence and evaluation of the risks relative to the benefits of diversification.

[1] https://www.journalofaccountancy.com/issues/2010/jul/20102678.html

A **Completion Portfolio** offers a different take on actively managing the position. A completion portfolio entails constructing a portfolio around your position and then preparing a staged diversification program that uses losses from tax loss harvesting to offset taxes on the sale of the concentrated holding. These programs can be customized and tailored to the client's needs, risk tolerance, and level of tax aversion. Pathstone has experience in executing completion portfolios for our clients.

The Path Forward

Whether selling, hedging, or diversifying, the matrix of options available to diversify a concentrated position may seem overwhelming. It's best to consult with your trusted team of professionals, who deal with these situations (and your unique circumstances) on a consistent basis. John Templeton once said: "Diversification is a safety factor that is essential because we should be humble enough to admit we can be wrong." With this in mind, we invite you to contact your Pathstone advisor to discuss the various options that may work best for you in achieving your financial goals.

Disclosure